Kirkpatrick & Lockhart LLP

Payne Shoemaker Building
240 North Third Street
Harrisburg, PA 17101-1507
717.231.4500
www.kl.com

September 13, 2004

ORIGINAL

James P. Melia
717.231.5842
Fax 717.231.4501
jmelia@kl.com

VIA HAND DELIVERY

James J. McNulty, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building, 2nd Floor
400 North Street
Harrisburg, PA 17120

DOCUMENT FOLDER

Re: Pennsylvania Public Utility Commission v. PPL Electric Utilities Corp.
Docket No. R-00049255

Dear Secretary McNulty:

Enclosed for filing please find an original and nine copies of the Reply Brief of the Commercial Customer Consortium.

Copies of this document are being served on all parties of record.

Very truly yours,

James P. Melia

JPM/cem
Enclosures

cc: Service List (w/Enclosures)

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HA-149416 v1 0606455-0801

BEFORE THE PENNSYLVANIA PUBLIC UTILITY COMMISSION
ADMINISTRATIVE LAW JUDGE ALLISON K. TURNER PRESIDING

Pennsylvania Public Utility Commission	:	
	:	
v.	:	Docket No. R-00049255
	:	
PPL Electric Utilities Corporation	:	

REPLY BRIEF OF COMMERCIAL CUSTOMER CONSORTIUM

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James P. Melia

Kirkpatrick & Lockhart LLP
240 North Third Street
Harrisburg, PA 17101-1507
(717) 231-4500
(717) 231-4501 (Fax)
jmelia@kl.com

Counsel for Commercial Customer Consortium

Dated: September 13, 2004

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SUMMARY OF ARGUMENT

The Commercial Customer Consortium ("CCC") recommends that the ALJ and Commission adopt PPL Electric's ("PPL's") distribution cost of service study in this proceeding. This recommendation is supported by the OSBA and PPLICA in its Main Brief.

CCC also recommends rejection of the Distribution System Investment Charge ("DSIC") for the reason that: (i) there is no statutory authority supporting its implementation; (ii) the proposal constitutes single-issue ratemaking; (iii) the administrative process for establishing and administering the DSIC is difficult; and (iv) the proposal eliminates essential aspects of Commission review of PPL rates. CCC's recommendation in this regard is supported by OTS, OCA, OSBA and PPLICA.

CCC recommends rejection of the Transmission System Charge ("TSC") for many of the same reasons as it recommends rejection of the DSIC. In this regard, CCC's position is supported by OTS. In the event that the TSC is approved, CCC recommends implementation of the TSC consistent with sound ratemaking principles. Rates should be designed that reflect cost causation and costs should be recovered in a manner that is consistent with how costs are incurred.

ARGUMENT

I. COST OF SERVICE AND RATE DESIGN.

A. CCC's Recommendation that PPL Electric's Cost of Service Presentation Should Be Adopted Is Supported by Other Parties.

In its Main Brief, CCC recommends that the ALJ and Commission should adopt PPL Electric's ("PPL's") distribution cost of service presentation as being more appropriate than the "average and excess" demand allocation method required by the Commission's filing requirements. Mr. Selecky's review of PPL Electric's cost of service study determined that the methodology employed by PPL was indeed appropriate for use in this proceeding. (CCC Main Brief, pp. 7-8; CCC St. No. 1, pp. 6-7). Examination of PPL's distribution cost of service study demonstrates that commercial and industrial rate classes are paying rates in excess of the cost to serve them. (CCC St. No. 1, p. 7; CCC Exhibit No. 1 (JTS-1)). CCC Exhibit No. 1 (JTS-1) is included as an Appendix to this Reply Brief. CCC Exhibit No. 1 (JTS-1) reflects Mr. Selecky's analysis of PPL's cost of service study of both current and proposed rates including rate of return and index of return. This exhibit illustrates the rate increase each class would have to receive in order to bring its rates to cost of service. The exhibit includes transmission, distribution, energy and capacity as well as competitive and intangible transition charge revenues while PPL's revenue requirement only shows the distribution portion of revenue requirements. (CCC St. No. 1, pp. 7-8).

A number of parties have also recommended utilization of PPL's distribution cost of service study. PPLICA does not object to PPL's filed cost of service study and believes it is reasonable to use to allocate any Commission authorized increase in PPL's distribution revenue requirement. (PPLICA Main Brief, p.88). The OSBA, through

its witnesses Knecht and Ewen, applied PPL's cost of service study but identified certain programming errors. PPL has indicated it will correct these program errors in the compliance stage of the proceeding. (OSBA Main Brief, pp. 5-6). OSBA concludes that, with the correction of these programming errors, PPL's cost of service study reaches the identical result as OSBA's cost of service study. Both cost of service studies show significant subsidies being provided by the commercial GS-1 and GS-3 classes to other rate classes. Fundamentally, OSBA's testimony and position in its Main Brief agree with PPL's distribution cost of service study and CCC's recommendation that PPL's cost of service study be adopted in this proceeding. Furthermore, CCC recommends that the maximum increase to any customer class be capped at 10% of present rates. To the extent that a revenue increase less than PPL's proposed request is granted, CCC recommends that any reduction to the revenue requirement be allocated to those classes whose rates are above cost of service or who have a rate of return in excess of the overall rate of return that PPL is proposing while simultaneously maintaining a rate increase cap of 10% to any rate class that is receiving a subsidy in order to gradually eliminate the level of cross-subsidies across different customer classes. (CCC Main Brief, p. 9; CCC St. No. 1, p. 9). Finally, CCC recommends that the illustrative example provided by Mr. Selecky at CCC Exhibit No. 2 (JTS-2) be utilized for purposes of allocating any reduction from the total recommended revenue request of PPL. CCC Exhibit No. 2 (JTS-2) is attached as an Appendix to this Reply Brief.

The Commission should reject OCA's proposed cost of service study. OCA's "peak and average" method is inconsistent with proper cost allocation procedures. As

indicated in PPL's Main Brief and Mr. Selecky's testimony, distribution facilities do not vary on the amount of energy consumed by customers, but are sized to meet peak demands of customers. The National Association of Regulatory and Utility Commissioner's Utility Cost Allocation Manual, the industry standard, indicates that there is no energy component of distribution-related facilities – only demand and customer components. (PPL Main Brief, p. 163).

II. DISTRIBUTION AND TRANSMISSION SURCHARGE

A. Virtually All Parties Oppose Implementation of the DSIC.

CCC witness Selecky recommends rejection of the DSIC for various reasons stated at CCC's Main Brief, p. 11. (CCC St. No. 1, p. 11). Virtually all other parties oppose implementation of the DSIC for basically the same reasons advocated by Mr. Selecky.

Many parties oppose implementation of the DSIC because it is not authorized by the Public Utility Code, 66 Pa. C.S. § 101, et seq. OTS argues that there is no statutory provision under Section 1307 of the Public Utility Code that authorizes implementation of a charge for collection of electric distribution-related costs. 66 Pa. C.S. § 1307. Section 1307(g) of the Code provides for recovery of costs related to distribution systems designed to enhance water quality not electric distribution service. The legislative intent behind this section is supported by testimony offered by a number of legislative representatives in this proceeding. (OTS Main Brief, pp. 62-64). OTS also rejects the DSIC concept as single-issue ratemaking.

The OCA also advocates rejection of the DSIC on a number of bases:

- The DSIC constitutes improper single-issue ratemaking and provides a means of guaranteed rate increases to recognize certain cost increases without recognizing offsetting cost savings.
- Verification of eligibility for inclusion in DSIC would be difficult.
- The administrative process for establishing the amount of the DSIC surcharge is unrealistic.
- DSIC eliminates essential aspects of Commission review of PPL's rates.

(OCA Main Brief, p. 188).

Of all these reasons, the most important basis for rejecting PPL's proposal is that the DSIC provides an automatic pass-through of costs for every single item of electric distribution expense while failing to take into account countervailing expense reductions and increased sales. (CCC Main Brief, p. 11). Further, single-issue ratemaking has been rejected by Pennsylvania appellate courts. National Fuel Gas Distribution Corporation v. Pa. PUC, 76 Pa. Commonwealth Ct. 102 (1983).

OCA recognizes that the DSIC proposal, if implemented, could guarantee a recovery of return and depreciation on capital improvements and could generate a return that is potentially higher than would be justified if all components of revenue requirement were considered for the surcharge. The DSIC would permit PPL to single out isolated elements of the ratemaking process while ignoring other elements of rates that may be considered to be offsetting such as lower interest rates, increased sales and customer growth. (OCA Main Brief, p. 193).

Both OCA and OSBA reject implementation of the DSIC on the basis that the existing precedent for DSIC for water utilities and the CSIC for wastewater utilities are inapplicable to electric distribution utilities. Furthermore, the Commission's grant of a

CSIC for certain wastewater utilities is currently on appeal to the Pennsylvania Commonwealth Court and was only implemented by the Commission due to certain exigent circumstances facing a number of wastewater systems in need of additional funding for upgrade purposes. (OSBA Main Brief, pp. 22-26; OCA Main Brief, pp. 198-201).

Finally, it should be noted that PPLICA advocates rejection of the DSIC for many of the same reasons advanced by the other parties discussed above: (i) the DSIC constitutes single-issue ratemaking; (ii) the DSIC eliminates regulatory review; (iii) the DSIC creates the potential for over-earnings on rate of return; (iv) the DSIC contravenes statutory authority; and (v) DSIC collection on an energy-only basis fails to account for cost causation issues. (PPLICA Main Brief, pp. 48-61). PPLICA also recognizes that the DSIC, as originally proposed by PPL, recovers a larger percentage of DSIC costs from large customers. (PPLICA Main Brief, p. 58; CCC Main Brief, p. 13). CCC argues for rejection of the DSIC as its primary recommendation but, as Mr. Selecky notes, if the DSIC should be implemented, its implementation should be based on an allocation using the appropriate demand allocators as demonstrated in CCC Exhibit No. 3 (JTS-3).

To conclude, CCC echoes the recommendations of virtually all other parties in this proceeding recommending rejection of PPL's proposal to implement a DSIC mechanism.

B. Rejection of the TSC in Its Current Form Is Appropriate.

CCC witness Selecky recommends rejection of the TSC for the same reasons as he advocates rejection of the DSIC. (CCC Main Brief, p. 11; CCC St. No. 1, p. 11). OTS likewise rejects PPL's proposal for implementation of a TSC. OTS's basis for

rejection is predicated on the clear lack of statutory authority under the Public Utility Code for implementation of an automatic transmission or distribution surcharge. OTS contends that recovery of transmission-related costs are an integral cost of doing business in the electric industry and should not be "carved out" for recovery through a separate mechanism. Further, PPL's proposal does not permit any annual prudency review examining the expenditure of transmission-related costs. (OTS Main Brief, pp. 65-66). CCC reiterates its opposition to imposition of a TSC based on the reasons it has presented coupled with the legal arguments presented by OTS.

A number of parties, however, do support recovery of transmission-related costs through the TSC. OCA supports PPL's uniform transmission rate concept as a means of keeping all rate schedule revenue increases under 10% thereby eliminating rate shock and recognizing the transitional period in which PPL continues to operate. If the Commission is inclined to approve the TSC, it should implement it recognizing cost causation principles and not expediencies which increase cross-subsidies across customer classes. (OCA Main Brief, pp. 142-143). PPLICA witness Baron proposes that the TSC be set to reflect the way PPL is billed for transmission service by PJM, e.g. roughly 70% of transmission charges are billed on a demand basis, while roughly 30% are billed on a kWh or energy basis. (PPLICA Main Brief, p. 68; PPL St. No. 4-R, pp. 29-30). PPLICA's witness Baron also criticizes PPL's TSC proposal for the following reasons:

- PPL's proposal violates cost-causation principles and is unduly discriminatory against large high-load factor customers.

- PPL's TSC proposal results in large commercial and industrial customers bearing a disproportionate amount of the overall transmission increase.

(PPLICA Main Brief, pp. 62-63, 68-74).

PPLICA witness Baron instead proposes a modified TSC that reflects cost causation. PPLICA alleges that its TSC proposal is allocated to and recovered from customers consistent with the cost basis associated with each of the transmission-related charges PPL incurs pursuant to the PJM operating agreement. (PPLICA Main Brief, pp. 75-80).

In response, CCC witness Selecky criticized PPL's TSC transmission cost recovery proposal as being inappropriate because it collects costs from all customers using a uniform kWh energy surcharge. Mr. Selecky instead recommended utilization of demand allocators to assign transmission cost responsibility on a demand basis and an energy basis as appropriate. CCC Exhibit No. 3 (JTS-3) shows the transmission level demands and the unannualized energy sales allocators contained in the jurisdictional cost of service study presented in PPL Electric's Exhibit JMK-2 for all rate classes except street lighting. Mr. Selecky concluded that his primary recommendation is that the TSC be rejected in its entirety. If, however, a TSC is approved by the Commission, transmission costs should be allocated to reflect cost causation. Transmission cost recovery should reflect cost causation and reflect the fact that these costs are generally demand-related as opposed to energy-related. It would be more appropriate to utilize a transmission level demand allocator to assign these costs to the appropriate rate classes. As indicated in PPLICA's brief, 73% of these costs are demand-related and 27% are energy-related. (PPLICA Main Brief, p. 67).

Rates should reflect cost-causation. As previously noted, since most costs are incurred because of demand, a demand allocator is more appropriate. Cost recovery should mirror the way in which costs are incurred.

OCA criticizes CCC's proposal at its Main Brief, p. 146 footnote 44. OCA contends that the CCC proposal does not capture costs that PPL incurs to serve retail customers. OCA contends that CCC's proposal (and for that matter the proposal of DOD witness Kincel) fails to recognize how PPL is billed by PJM.

CCC contends that the proposed allocation advocated by Mr. Selecky is the more appropriate allocation methodology for recovery of transmission related costs. What OCA fails to recognize is that after transmission related costs are assigned on a demand basis, kW or kWh charges for each class can be developed from the billing determinants. (CCC St. No. 1, p. 13).

On the contrary, the OCA's proposal, which basically supports PPL's proposal for the TSC, unfairly passes through transmission charges that PPL must pay PJM to all PPL's *retail customers on a uniform energy basis. As was demonstrated by CCC* witness Selecky, PPLICA witness Baron and DOD witness Kincel, recovery of transmission-related costs on a purely energy only basis perpetuates the cross-subsidization problems inherent in PPL's rate structures.

Finally, OSBA proposes yet another alternative recommendation for design of the TSC. OSBA's solution is to employ the underlying PJM transmission rate design but use a rolling five-year average on the peak demand component to smooth out volatility. OSBA also criticizes CCC witness Selecky's proposal to allocate transmission costs

through use of demand allocators as "too vague to compare to the proposals of other parties." (OSBA St. No. 3, p. 6; OSBA Main Brief, pp. 16-21).

CCC's proposed methodology is anything but vague. As demonstrated by CCC Exhibit No. 3 (JTS-3), CCC's proposal with regard to the TSC, if it is adopted, provides an understandable road map for the allocation of transmission-related costs in a manner that is consistent with cost causation principles. OSBA's proposal, on the other hand, prefers to ignore specific demand-related costs by utilizing a five-year rolling average peak demand component to "smooth out volatility." (OSBA St. No. 3, pp. 8-9). In conclusion, CCC recommends rejection of the TSC as a cost recovery mechanism. If, however, a TSC is deemed to be appropriate by the ALJ and/or Commission, CCC recommends adoption of a TSC mechanism consistent with the proposal of its witness Mr. Selecky.

CONCLUSION

WHEREFORE, for all the foregoing reasons, the Commercial Customer Consortium respectfully requests that its proposals be adopted as put forward in its Main Brief and as contained herein.

Respectfully submitted,

James P. Melia

Kirkpatrick & Lockhart LLP
240 North Third Street
Harrisburg, PA 17101-1507
(717) 231-4500
(717) 231-4501 (Fax)
jmelia@kl.com

Counsel for Commercial Customer Consortium

Dated: September 13, 2004

APPENDIX

PPL ELECTRIC UTILITIES CORPORATION

Cost of Service Components
Twelve Months Ended December 31, 2004
(Dollars in Thousands)

Line	Description	PA Jurisdition (1)	RS (2)	GS-1 (3)	GS-3 (4)	LP-4 (5)	LP-5 (6)	IST (7)	SL/AL (8)
1	Rate Base	$ 1,842,749	$ 1,216,771	$ 179,297	$ 250,040	$ 61,618	$ 2,036	$ 716	$ 66,001
	Present Rates								
	Operating Income:								
2	Operating Revenues	523,208	310,247	65,134	89,770	22,690	1,667	1,709	18,110
3	*Operating Expenses*	451,206	290,819	48,488	63,523	16,136	1,187	1,085	17,433
4	Operating Income	72,002	19,428	16,646	26,247	6,554	480	624	677
5	Rate of Return	3.91%	1.60%	9.28%	10.50%	10.64%	23.58%	87.15%	1.03%
6	Index of Return	100	41	238	269	272	603	2,230	26
7	Subsidy	$ -	$ (48,054)	$ 16,477	$ 28,163	$ 7,087	$ 684	$ 1,019	$ (3,251)
8	Present Rate Revenue	$ 2,534,772	$ 1,083,956	$ 202,631	$ 634,892	$ 336,079	$ 176,727	$ 76,489	$ 23,997
9	Subsidy		$ 48,054	$ (16,477)	$ (28,163)	$ (7,087)	$ (684)	$ (1,019)	$ 3,251
10	Percent Change		4.43%	-8.13%	-4.44%	-2.11%	-0.39%	-1.33%	13.55%
	Proposed Rates								
	Operating Income:								
11	Operating Revenues	687,664	392,357	87,612	133,391	33,316	1,693	1,148	20,201
12	Operating Expenses	525,490	327,935	58,626	83,205	20,931	1,198	834	18,381
13	Operating Income	162,174	64,422	28,986	50,186	12,385	495	314	1,820
14	Rate of Return	8.80%	5.29%	16.17%	20.07%	20.10%	24.31%	43.85%	2.76%
15	Index of Return	100	60	184	228	228	276	498	31
16	Subsidy	$ -	$ (72,918)	$ 22,573	$ 48,167	$ 11,900	$ 540	$ 429	$ (6,817)
17	Proposed Rate Revenue	$ 2,742,007	$ 1,188,699	$ 222,531	$ 683,072	$ 356,150	$ 185,378	$ 79,794	$ 26,382
18	Subsidy		$ 72,918	$ (22,573)	$ (48,167)	$ (11,900)	$ (540)	$ (429)	$ 6,817
19	Percent Change		6.13%	-10.14%	-7.05%	-3.34%	-0.29%	-0.54%	25.84%
20	Percent Rate Change	8.18%	9.66%	9.82%	7.59%	5.97%	4.90%	4.32%	9.94%

PPL ELECTRIC UTILITIES CORPORATION

Allocation of Decrease from PPL's Proposed Amount Twelve Months Ended December 31, 2004 (Dollars in Thousands)

Line	Rate Classes	Subsidies for Classes with Rates of Return Higher than System Average at Proposed Rates Amount (1)	Percent (2)	Allocate $50 Million Decrease (3)
1	RS		0.00%	$ -
2	GS-1	22,573	27.00%	(13,499)
3	GS-3	48,167	57.61%	(28,805)
4	LP-4	11,900	14.23%	(7,116)
5	LP-5	540	0.65%	(323)
6	IST	429	0.51%	(257)
7	SL/AL		0.00%	-
8	Other		0.00%	-
9	Total	$ 83,608	100.00%	$ (50,000)

PPL ELECTRIC UTILITIES CORPORATION

Rate Base and MWh
Twelve Months Ended December 31, 2004
(Dollars in Thousands)

Line	Rate Classes	Transmission Level Demands kW (1)	Transmission Level Demands Percent (2)	Primary Level Demands kW (3)	Primary Level Demands Percent (4)	MWh Amount (5)	MWh Percent (6)
1	RS	2,320,941	38.49%	2,819,810	43.37%	12,899,883	35.16%
2	GS-1	377,743	6.26%	566,500	8.71%	2,034,025	5.54%
3	GS-3	1,465,094	24.30%	1,760,092	27.07%	8,732,335	23.80%
4	LP-4	829,643	13.76%	939,736	14.45%	5,567,372	15.17%
5	LP-5	491,779	8.16%	-	0.00%	3,348,588	9.13%
6	IST	219,103	3.63%	-	0.00%	1,944,598	5.30%
7	Other	325,310	5.40%	415,036	6.38%	2,162,328	5.89%
8	Total	6,029,613	100.00%	6,501,174	100.00%	36,689,129	100.00%

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission

v.

PPL Electric Utilities, Inc.

Docket No. R-00049255

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CERTIFICATE OF SERVICE

I hereby certify that I have this day served true and correct copies of the foregoing document upon the individuals listed, in accordance with the requirements of Section 1.54 (relating to service by a participant).

Via First Class Mail

Tanya McCloskey, Esquire
James A. Mullins, Esquire
Office of Consumer Advocate
Forum Place, 5th Floor
555 Walnut Street
Harrisburg, PA 17101-1923

Johnnie E. Simms, Esquire
Richard A. Kanaskie, Esquire
Office of Trial Staff
Pennsylvania Public Utility Commission
P.O. Box 3265
Harrisburg, PA 17105-3265

Steven C. Gray, Esquire
Office of Small Business Advocate
Commerce Building, Suite 1102
300 North Second Street
Harrisburg, PA 17101

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

Michael W. Gang, Esquire
John H. Isom, Esquire
Morgan Lewis & Bockius LLP
One Commerce Square
417 Walnut Street
Harrisburg, PA 17101-1904

Kent D. Murphy, Esquire
Exelon Business Services Company
2301 Market Street, S23-1
P.O. Box 8699
Philadelphia, PA 19101-8699

Paul E. Russell, Esquire
PPL Electric Utilities Corporation
Two North Ninth Street
Allentown, PA 18101-1179

Joseph L. Vullo, Esquire
1460 Wyoming Avenue
Forty Fort, PA 18704-4237

David A. McCormick, Esquire
U.S. Army Legal Services Agency
901 North Stuart Street, Room 713
Arlington, VA 22203-1837

Pamela C. Polacek, Esquire
David M. Kleppinger, Esquire
McNees Wallace & Nurick LLC
100 Pine Street
P.O. Box 1166
Harrisburg, PA 17108-1166

Louise A. Knight, Esquire
Saul Ewing LLP
2 North Second Street, 7th Floor
Harrisburg, PA 17101-1604

Roger E. Clark, Esquire
Sustainable Development Fund
718 Arch Street, Suite 300 North
Philadelphia, PA 19105-1591

Richard S. Herskovitz, Esquire
Duquesne Light Company
411 Seventh Avenue, 8th Floor
Pittsburgh, PA 15219

Hon. Phyllis Mundy, Chair
Northeast Delegation
House Box 202020
Harrisburg, PA 17120-2020

John L. Munsch, Esquire
Allegheny Energy
800 Cabin Hill Drive
Greensburg, PA 15601-1689

Michael Fiorentino, Esquire
Clean Air Council
135 S. 19th Street, Suite 300
Philadelphia, PA 19103

David MacGregor, Esquire
Morgan Lewis & Bockius LLP
1701 Market Street
Philadelphia, PA 19103-2921

Peter Adels, General Counsel
Citizens for Pennsylvania's Future
117 S. 17th Street, Suite 1801
Philadelphia, PA 19103

Eric Joseph Epstein
4100 Hillsdale Road
Harrisburg, PA 17112

Daniel Clearfield, Esquire
Kevin J. Moody, Esquire
Wolf Block Schorr & Solis-Cohen
212 Locust Street, Suite 300
Harrisburg, PA 17101

Patricia Armstrong, Esquire
Thomas T. Niesen, Esquire
Thomas Thomas Armstrong & Niesen
212 Locust Street, Suite 500
P.O. Box 9500
Harrisburg, PA 17108-9500

Mark C. Morrow, Esquire
460 North Gulph Road
King of Prussia, PA 19406

Kirkpatrick & Lockhart LLP
240 North Third Street
Harrisburg, PA 17101-1507
(717) 231-4500
(717) 231-4501 (Fax)
jmelia@kl.com

James P. Melia

Counsel for the Commercial Customer Consortium

Dated: September 13, 2004

SAUL EWING LLP
ATTORNEYS AT LAW

ORIGINAL

LOUISE A. KNIGHT
Phone: (717) 238-7655
Fax: (717) 257-7580
lknight@saul.com
www.saul.com

September 13, 2004

VIA HAND DELIVERY

DOCUMENT FOLDER

James J. McNulty, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street
Harrisburg, PA 17120

Re: Pennsylvania Public Utility Commission v. PPL Electric Utilities Corporation; Docket No. R-00049255; **PPL PUBLIC LIGHTING USER GROUP'S REPLY BRIEF**

Dear Mr. McNulty:

Enclosed for filing please find an original and nine (9) copies of PPL Public Lighting User Group's Reply Brief in the above-referenced matter.

Please date-stamp the extra copy and return with our messenger service. Please feel free to call the undersigned with any questions regarding this filing. Thank you in advance for your cooperation.

Sincerely,

Louise A. Knight

Louise A. Knight

LAZ:clj
Enclosure

c: Per Certificate of Service

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

ADMINISTRATIVE LAW JUDGES
ALLISON K. TURNER
SUSAN D. COLWELL
EMBER JANDEBEUR

ORIGINAL

Pennsylvania Public Utility Commission *et al.*, **Complainants** v. **PPL Electric Utilities Corporation, Respondent**	**Docket No. R-00049255 *et al.***

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REPLY BRIEF OF PPL PUBLIC LIGHTING USERS GROUP

DOCUMENT FOLDER

Louise A. Knight, Esquire
Joseph J. Malatesta, Jr., Esquire
David P. Zambito, Esquire
Attorney Nos. 26167, 20404, 80017
Saul Ewing LLP
2 North Second Street, 7th Floor
Harrisburg, PA 17101
Tel: (717) 238-7655
Fax: (717) 257-7580

Dated: September 13, 2004

Counsel for PPL Public Lighting Users Group

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STATUTES & REGULATIONS

The PPL Public Lighting Users Group ("PPL PLUG") hereby replies to the Initial or Main Briefs filed by PPL Electric Utilities Corporation ("PPL"), the Office of Trial Staff ("OTS"), the Office of Consumer Advocate ("OCA"), the Office of Small Business Advocate ("OSBA"), PP&L Industrial Customer Alliance ("PPLICA"), and the U.S. Department of Defense ("DOD").

I. PPL'S POSITION ON STREET LIGHTING SERVICE SHOULD BE REJECTED

PPL argues with respect to street lighting service ("SL/AL")[1] that its SL/AL service is satisfactory and that the issues and concerns raised by PPL PLUG's witnesses are exaggerated, misplaced, or simply irrelevant. To summarize, PPL, in its Initial Brief (pp. 172-176), argues as follows:

1. that the rate increase will not be burdensome to municipalities;
2. that its street light maintenance programs are effective;
3. that SL/AL should not be considered a public good; and
4. that SL/AL service is not interruptible service.

PPL is wrong on all counts.

First, PPL PLUG submits that the rate increase will be burdensome. Mr. Link, Mr. Bradley, and Mr. Musser all testified about the burden a rate increase imposes. In all cases, the fact is, as Mr. Link concisely stated: "[T]o the extent that PPL's rates increase, we have less resources for other needed services and programs. Operating a city is a constant exercise in determining priorities because there is always a greater need for public services than we can

[1] Street lighting is referred to as SL/AL in PPL's supporting documents and that abbreviation is used in this Reply Brief.

afford." (PPL PLUG St. No. 2, pp. 2-3). Mr. Musser concurred, observing that "on a municipal level, there are always more needs than money" and that the burden of the rate increase likely will be manifested in increased taxes or decreased services. (PPL St. No. 3, p. 2). In either case, the burden is definable and significant for these customers. While not one single customer class looks forward to increased electric rates, none testified as persuasively as to the effect of the rate increase on it. Other public needs will be foregone because municipalities street lighting is not an optional public service that can be reduced or eliminated. The rate increase directly affects their ability to meet other public needs.

Second, PPL's SL/AL service is qualitatively different from service it renders to other classes of customers and it is not adequate. Mr. Bradley described the SL/AL service PPL provides. PPL relies exclusively on SL/AL customers to identify outages on PPL's own facilities[2] at substantial cost and/or inconvenience to those customers and it refuses to give its customers feedback on the status of repairs. (PPL PLUG St. No. 1, pp. 3-4). After it does receive reports of outages, PPL has an aspirational goal of repairing 90% of nonfunctioning lights within three (3) working days. (PPL St. No. 6-R, p. 14). Finally, PPL contends that the "vast majority of other customers inform PPL electric of service issues"[3] and, so, apparently PPL believes that SL/AL customers are not unduly inconvenienced by the continuous, unrelenting need to patrol for non-functioning lights. PPL's argument is (1) based on facts not in evidence (there was no testimony given with respect to how PPL identifies outages experienced by non-SL/AL customers, and therefore, this statement should be stricken); (2) fails to recognize that the facilities in question are PPL's, not the customers and, therefore, are PPL's

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2 PPL owns and maintains approximately 150,000 public lights. (N.T. 1000).

3 PPL Initial Brief, p. 175.

responsibility; and (3) apparently equates the difference between having to patrol PPL's facilities 365 days a year to a customer's arriving home on a rare occasion, and not having electricity. PPL PLUG submits that no other customer group is expected by PPL, as a condition of service, to continuously identify and report outages on PPL's own facilities. Further, PPL's reporting system is frustrating and inefficient for SL/AL customers and, finally, even after customer dispatches all the identification and reporting duties PPL unilaterally imposes on them, PPL has refused to give any feedback. (PPL PLUG St. No. 1, p. 4). This testimony was unrefuted. To equate the burden on SL/AL customers to other customer groups trivializes the efforts SL/AL customers must exert to receive the service for which they pay.

PPL relies on its repair policy and goals to demonstrate that its SL/AL service is satisfactory. That policy establishes a goal of repairing 90% of reported burnt-out lamps within three (3) business days. PPL PLUG submits that reliance on that goal is unwarranted for several reasons. First, it is a "goal." PPL produced no testimony suggesting that the goal is satisfactory to customers; indeed, it was developed without customer input (N.T. 1002-03). Second, because it relies on reports from customers who, as Mr. Bradley stated, have to rely on police resources who have many other important duties, the goal gives no reasonable assurance how long a nonfunctioning lamp goes unrepaired. (N.T. 1002). Third, PPL gave no testimony as to whether the goal is met. Mr. Kasper acknowledged that PPL conducted no audit to verify whether it was meeting its goals. (N.T. 1003). And fourth, it allows 10% of reported outages to go on for an indeterminate period of time.

PPL PLUG need not rely exclusively on its own testimony to demonstrate how ineffective PPL's goal has been. It is corroborated by PPL"s own testimony. Mr. Kasper testified that PPL reinstated group relamping owing to the number of customer complaints.

(N.T. 1000, 1005). He said that "the number of spot outages was increasing dramatically" after PPL decided to repair lights on an as-needed basis, as did customer complaints. (N.T. 1000, 1005).

But group relamping as implemented by PPL will create its own problems. According to PPL, group relamping envisions changing all lights on a six-year cycle. (N.T. 1000). Mr. Kasper testified that PPL only reinstated group relamping about two years ago. (N.T. 999, 1005). Therefore, at this time, more than two thirds of SL/AL customers are still experiencing spot replacements. Further, according to Mr. Kasper, the lights PPL uses have an average life of 24,000 hours. (N.T. 1013-1014). PPL's SL/AL service is predicated on 4,300 hours of on-time annually. (N.T. 1014). Therefore, it is predictable that at the end of each relamping cycle, many lights will be out because the lights have a useful life of 5 1/2 years. (N.T. 1014).[4] No other customer group is served with PPL equipment which manifests a distinct and definitive likelihood of not working.

In conclusion, PPL PLUG contends that the quality of service SL/AL customers receive is qualitatively different from the service received by other PPL customers. Conceding that PPL will not patrol for outages, will not institute a system for giving customer feedback and will not give credits for outages, PPL PLUG submits that the qualitative differences in SL/AL service support, in conjunction with other factors, the SL/AL classification not receiving a rate increase.

Next, PPL PLUG submits that PPL presents no colorable argument that SL/AL is not a public benefit. PPL apparently contends that, because street lighting's usage characteristics differ from those of public fire protection, it does not qualify as a public benefit. PPL is wrong. Street lighting is a public benefit because it matches precisely the definition supplied by Mr.

[4] 24,000 hours / 4,300 hours/year = 5.58 years.

Baron, which specifies that service that constitutes a public benefit is not contingent on amount of use, as PPL argues in its comparison to public fire protection service.[5] Rather a public benefit is one that, the consumption of which by one person, does not reduce the consumption by the other. (PPLICA St. No. 1-R, p. 6). Or as Mr. Bradley testified, "street lighting customers are buying electric to be used as a public good. Public lighting has a value to society as a whole. Street lights provide safety and security for our roads, and neighborhoods. And never has security been more important than it is today." (PPL PLUG St. No. 2-R, p. 3).

Furthermore, PPL misconstrues PPL PLUG's public benefit argument insofar as it relates to Section 1328 of the Public Utility Code, 66 Pa. C.S. § 1328. PPL PLUG's argument is similar to the argument made by PPL with respect to its request for a DSIC: that the Commission already has general authority to establish just and reasonable rates and simply because Section 1328 refers only to public fire protection does not restrict the Commission from applying the "public benefit" concept to other service that is a public benefit by nature.[6] The Commission has ample discretion to recognize public benefit in setting rates and Section 1328 is but one example of a public benefit that is mandated to be reflected in rates.

Finally, PPL is disingenuous when it argues that its SL/AL service is not inherently interruptible. Simply stated, SL/AL service is interrupted whenever one of PPL's lamps burn out, which can be at any time. The lamp will not function again until someone other than PPL reports it. When reported, there is no assurance when that light will be back in service. These outages are not associated with acts of God, but with PPL's capability to provide the service.

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5 Furthermore, the fact that hydrants are used sporadically does not mean they do not impose constant capacity demands on a utility system; the service must be available all day, every day.

6 In PPL's argument regarding the DSIC, the equivalent sections of the Code are 1307(a) (in lieu of § 1301) and 1307(g) (in lieu of § 1328).

Group relamping will not change this basic characteristic of SL/AL service, since PPL's lamps do not have anticipated lives that are synchronized with the replacement schedule and since, regardless of design parameters, lights can fail at any time. The characteristics of interruptible service is not that service will be interrupted, but that it may be – it allows for the possibility and the customer assumes the risk. Furthermore, at this time, PPL does not even give credits for non-functioning lights. The fact is that SL/AL service can be interrupted at any time but there is no rate recognition of this fact.

In conclusion, PPL tries, but does not, rebut the facts and positions established by PPL PLUG. SL/AL service is a public benefit which the Commission may and should recognize in rates. SL/AL service is not the same quality service received by other PPL customers; this fact may and should be recognized in rates. SL/AL is not firm but interruptible; this fact may and should be recognized in rates. For these reasons, PPL PLUG submits that its rates should be frozen and that PPL should be directed to account for these differences in service in assigning costs and allocating rates in its next rate case.

II. THE RATE ALLOCATIONS ADVOCATED BY THE OTS, OCA, DOD, AND PPLICA ARE FLAWED IN THAT THEY HAVE TAKEN INTO ACCOUNT NEITHER THE PUBLIC BENEFIT PROVIDED BY STREET LIGHTING NOR THE QUALITY OR INTERRUPTIBLE NATURE OF THE SL/AL SERVICE

For all the reasons set forth in Section I, above, PPL PLUG submits that SL/AL customers should not be accorded the increases in rates advocated by OTS, OCA, OSBA, DOD, and PPLICA.

All, in one way or another, are driven by the cost of service study and do not recognize the peculiar characteristics of SL/AL service. However, if Your Honor disagrees that SL/AL should be allocated no rate increase, the PPL PLUG asserts that, at most, its distribution rates

should be allocated as proposed by PPL. Further, PPL PLUG submits that any decrease in PPL's revenues request should be applied to all rate classes equally on a percentage basis.

III. PPL SHOULD BE DIRECTED TO ESTABLISH AN UNMETERED TRAFFIC SIGNAL SYSTEM RATE AND A DEMAND SIDE MANAGEMENT PROGRAM FOR LED LIGHT PURCHASES

PPL opposes PPL PLUG's advocacy of an unmetered traffic signal system tariff/ rate for two reasons: (1) PPL contends that the electricity used in traffic signals is too variable, and (2) the changeover to an unmetered system would be administratively complex when taking into account the need to identify and categorize equipment and while removing PPL's meter boxes. (PPL Initial Brief, pp. 171-72). PPL PLUG contends that PPL is exaggerating the difficulty of such a changeover while minimizing the benefits.

PPL PLUG witness Link, City Engineer for the City of Harrisburg, testified that traffic signal systems fit the same criteria as street lights with respect to monitoring a separate rate schedule. They represent a large amount of assignable end-use equipment wherein the usage also is consistent and ascertainable. In his view, the metering function is unnecessary at intersections and imposes costs which are avoidable. Mr. Link is a professional engineer and testified that intersection usage can be determined accurately. (PPL PLUG St. No. 2, pp. 3, 5). He noted that the electric utilities that serve the largest cities in Pennsylvania do not have metered traffic signal system usage. These utilities include PECO, Duquesne, and Metropolitan Edison Company. (PPL PLUG St. No. 2, p. 5; PPL PLUG St. No. 2-S, pp. 1-2; PPL PLUG Exh. No. 3). These tariffs provide effective means of quantifying usage at intersections.

Mr. Link's testimony is premised to some extent on his advocacy of LED lights and municipalities' trying to realize maximum benefits by converting to LED lights. Mr. Link

testified that Harrisburg is in the process of converting from incandescent traffic lights to LED lights because LED lights are much more reliable, do not burn out as quickly (lasting more than 5 years), and saves energy (using less than 15% of the electricity consumed by an incandescent bulb). (PPL PLUG St. No. 2, p. 3). They greatly reduce whatever variability exists in electric consumption by traffic signal systems.

PPL PLUG submits that it has demonstrated that compelling reasons to support its view that a non-metered traffic signal system rate schedule is feasible and beneficial. However, should the Your Honor and the Commission believe that, on balance, the concept is meritorious, but premature, then PPL PLUG requests that the Commission direct PPL to immediately implement a pilot project to determine the feasibility, costs, and benefits of an unmetered rate.

PPL PLUG submits that this pilot study should go forward in conjunction with a demand side management program focused on establishing LED light rebates. Section 1505(b) of the Public Utility Code, 66 Pa. C.S. § 1505(b), contemplates such construction or demand side management programs, so long as they are "reasonable" and "prudent." The testimony in this record demonstrates that dramatic cost and energy savings would accrue if governmental entities with traffic signal systems would convert on large scale to LED lights. Mr. Link's testimony regarding cost savings was supported by the testimony of Dr. Thomas J. Tuffey, Executive Director of the Sustainable Energy Fund. Dr. Tuffey noted that LED technology had been only slowly adopted in Central Pennsylvania despite the fact that the technology would reduce usage by 85% or more. (SEF St. No. 1, p. 25). The factor impeding deployment of LED lights on a large scale is, according to Mr. Link, because many communities cannot budget the upfront costs. (PPL PLUG St. No. 2, p. 4). PPL PLUG's position is that deployment could be significantly expedited through the coordinated assistance of the Sustainable Energy Fund,

coupled with a demand side management rebate program implemented by PPL, as described more fully in PPL PLUG's Main Brief. (PPL PLUG Main Brief, pp. 16-18).

In conclusion, PPL PLUG submits that PPL's position on traffic signal systems should become proactive rather than reactive. If a non-metered traffic signal system tariff is premature at this point, then PPL PLUG advocates a working group and pilot project for the establishment of a non-metered LED traffic signal system tariff program as well as to develop a rebate program. This approach is prudent, cost-effective, and compelling, and supported by Section 1505(b) of the Code.

Respectfully submitted,

Louise A. Knight, Esquire
Joseph J. Malatesta, Jr., Esquire
David P. Zambito, Esquire
Attorney Nos. 26167, 20404, 80017
Saul Ewing LLP
2 North Second Street, 7th Floor
Harrisburg, PA 17101
Tel: (717) 238-7655
Fax: (717) 257-7580

Dated: September 13, 2004

Counsel for PPL PLUG

CERTIFICATE OF SERVICE

I hereby certify that I am this day serving a copy of PPL PLUG REPLY BRIEF upon the participants listed below in accordance with the requirements of 52 Pa. Code § 1.54 (relating to service by a participant).

VIA E-MAIL and FIRST CLASS MAIL

Honorable Allison K. Turner
Administrative Law Judge
Pennsylvania Public Utility Commission
Philadelphia State Office Building
1400 West Spring Garden St., Rm. 1302
Philadelphia, PA 19130

Honorable Ember Jandebeur
Administrative Law Judge
Pa. Public Utility Commission
PO Box 3265
Harrisburg, PA 17105-3265

Honorable Susan D. Colwell
Administrative Law Judge
Pennsylvania Public Utility Comission
Commonwealth Keystone Building
2nd Floor, L-M West, 400 North Street
Harrisburg, PA 17120

Scott J. Rubin, Esquire
3 Lost Creek Drive
Selingsgrove, PA 17870-9357

Michael W. Gang, Esquire
John H. Isom, Esquire
Morgan Lewis & Bockius LLP
One Commerce Square
417 Walnut Street, 4th Flr.
Harrisburg, PA 17101-1904

David MacGregor, Esquire
Morgan, Lewis & Bockius LLP
1701 Market Street
Philadelphia, PA 19103-2921

Richard A. Kanaskie, Esquire
Pa. Public Utility Commission
Office of Trial Staff
Commonwealth Keystone Building
400 North Street, 2nd Floor West
PO Box 3265
Harrisburg, PA 17105-3265

Paul E. Russell, Esquire
PPL
2 North Ninth Street
Allentown, PA 18101-1179

David A. McCormick, Esquire
US Army Legal Services Agency
901 North Stuart Street, Room 713
Arlington, VA 22203-1837

William R. Lloyd, Jr., Esquire
Steven C. Gray, Esquire
Office of Small Business Advocate
Commerce Building, Suite 1102
300 North Second Street
Harrisburg, PA 17101

Tanya J. McCloskey, Esquire
James A. Mullins, Esquire
Lori A. Herman, Esquire
Aron J. Beatty, Esquire
Office of Consumer Advocate
555 Walnut Street
Forum Place, 5th Floor
Harrisburg, PA 17101-1923

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

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SECRETARY'S BUREAU

Mark C. Morrow, Esquire
UGI Utilities, Inc.
460 North Gulph Road
King of Prussia, PA 19406

Patricia Armstrong, Esquire
Thomas Niesen, Esquire
Thomas, Thomas, Armstrong & Niesen
212 Locust Street, Suite 500
P.O. Box 9500
Harrisburg, PA 17108-9500

Kent D. Murphy, Esquire
Legal Department
Exelon Business Services Co.
2301 Market Street S23-1
PO Box 8699
Philadelphia, PA 19101-8699

David M. Kleppinger, Esquire
Pamela C. Polacek, Esquire
Karen S. Miller, Esquire
McNees Wallace & Nurick
100 Pine Street, PO Box 1166
Harrisburg, PA 71108

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

Honorable Phyllis Mundy, Chair
Northeast Delegation
House Box 202020
Harrisburg, PA 17120-2020

Richard S. Herskovitz
Duquesne Light
411 Seventh Avenue, 8th Floor
Pittsburgh, PA 15219

Eric Joseph Epstein
4100 Hillsdale Road
Harrisburg, PA 17112

Joseph L. Vullo, Esquire
Attorney at Law
1460 Wyoming Avenue
Forty Fort, PA 18704-4237

Thomas Catlin
Exeter Associates, Inc
5565 Sterrett Place, Suite 310
Columbia, MD 21044

Michael Fiorentino, Esquire
Joseph Otis Minott, Esquire
Clean Air Council
135 S. 19th Street, Suite 300
Philadelphia, PA 19103

Kevin J. Moody
Wolf, Block, Schorr and Solis-Cohen LLP
212 Locust Street, Suite 300
Harrisburg, PA 17101

Stephen J. Baron, President
J. Kennedy & Associates Inc.
570 Colonial Park Drive, Suite 305
Roswell, GA 30075-3770

Eugene M. Brady
Commission on Economic Opportunity
165 Amber Lane
P.O. Box 1127
Wilkes-Barre, PA 18703

Roger E. Clark
Sustainable Development Fund
718 Arch Street, Suite 300 North
Philadelphia, PA 19106-1591

Peter Adels, General Counsel
Charley McPhedran, Sr. Attorney
Penn Future
117 S. 17th Street, Suite 1801
Philadelphia, PA 19103

Mr. John Hanger
Penn Future
610 North Third Street
Harrisburg, PA 17101

Roger D. Colton
Fisher, Sheehan and Colton
34 Warwick Road, Suite 310
Belmont, Ma 02478

Michael G. Wolfe, Esquire
FirstEnergy Corp.
2800 Pottsville Pike
PO Box 16001
Reading, PA 19612-6001

Daniel Clearfield
Wolf, Block, Schorr and Solis-Cohen LLP
212 Locust Street, Suite 300
Harrisburg, PA 17101

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

Dated: September 13, 2004

Louise A. Knight, Esquire

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

IN REPLY PLEASE
REFER TO OUR FILE

September 13, 2004

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

ORIGINAL

Re: Pennsylvania Public Utility Commission v.
PPL Electric Utilities Corporation
Docket No. R-00049255

DOCUMENT

Dear Secretary McNulty:

Enclosed please find for filing an original and nine copies of the Reply Brief of the Office of Trial Staff in the above-captioned proceeding. Copies have been served according to the certificate of service.

Respectfully submitted,

Richard A. Kanaskie
Prosecutor

Enclosure
cc: Parties of Record

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ORIGINAL

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

DOCKETED
SEP 14 2004

Pennsylvania Public Utility Commission	:	
	:	
v.	:	Docket No. R-00049255
	:	
PPL Electric Utilities Corporation	:	

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Johnnie E. Simms
Chief Prosecutor

Richard A. Kanaskie
Prosecutor

Office of Trial Staff
Pennsylvania Public
Utility Commission

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

Dated: September 13, 2004

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I. INTRODUCTION

A. Status of the Proceeding

The procedural history of the proceeding is detailed in the Office of Trial Staff's ("OTS") Main Brief filed on September 3, 2003. In its Main Brief, OTS presented the evidence and law in support of its recommendation that PPL Electric Utilities, Inc. ("PPL" or "Company") be permitted the opportunity to recover no more than $101,464,000 in additional annual revenue.

Timely Main Briefs in this proceeding were also filed by the Company, the Office of Consumer Advocate ("OCA"), the Office of Small Business Advocate ("OSBA"), the Department of Defense and Federal Executive Agencies ("DOD"), PPL Industrial Customer Alliance ("PPLICA"), Eric Joseph Epstein ("Mr. Epstein"), PPL Public Lighting Users Group ("PLUG"), the Commission on Economic Opportunity ("CEO"), Citizens for Pennsylvania's Future, Char Magaro and Edward M. McGovern ("Penn Future Parties"), Mid-Atlantic Power Supply Association ("MAPSA"), the Clean Air Council ("CAC"), Wal-Mart Stores East, LP ("Wal-Mart"), the Pennsylvania Energy Consortium ("PEC"), the Pennsylvania Retailers Association ("PRA") and the Sustainable Energy Fund of Central Eastern Pennsylvania ("SEF").

This Reply Brief is supplemental to the Main Brief of OTS and is limited to those matters raised by the Company and the other parties in their Main Briefs. In addition, this Reply Brief will discuss matters previously addressed by OTS that

require additional discussion or comments as a result of statements offered by the other parties in their Main Briefs.

B. Burden of Proof and Evidentiary Standard

The Company retains the burden of proving the reasonableness of each and every element of its claim throughout the entire proceeding. This standard has been examined in detail and is well established and recognized by the courts. OTS Main Brief, pp. 5-8.

In the proceeding before us, it is the obligation of the Company to affirmatively prove the reasonableness of each and every element of its claim with substantial evidence. A review of the evidence demonstrates that PPL has failed to accomplish this. In a number of instances identified herein the Company has offered unsupported statements as proof of its claim. As such, these claims should be rejected based primarily upon the Company's failure to sustain its burden of proof.

II. SUMMARY OF ARGUMENT

The Company has failed to adequately support its requested level of increased annual revenues in this proceeding. The credible evidence in the record clearly demonstrates that PPL's request must be denied and its increase in distribution revenue must be limited to no more than $101,464,000. This recommendation is based on the adjustments offered by OTS and detailed in the body of its Main Brief. A brief summary of the remaining contested issues follows.

The Company's rate base must be reduced by $613,000 to reflect the capitalized portion of its inappropriate pension expense claim. Revenues also need to be adjusted to correct the Company's understatement. An additional $4,305,000 is needed to address PPL's improper calculation of its late payment fees and its weather normalized load for residential heating customers.

After acknowledging the Company's corrections and updates, its revised base rate revenue increase requested in this proceeding is still overstated by $57,979,000 and must be adjusted.

PPL's pension expense claim must be denied, its Hurricane Isabel claim must be adjusted, the Automated Meter Reading ("AMR") Displacement Costs must be eliminated, the Community Betterment Initiative claim is improper, the Service Corporation Charges are overstated, the On-Track and WRAP claims must be adjusted and mandatory funding for SEF is improper. These O&M expenses

serve to inflate the Company's requested revenue requirement and must be rejected or adjusted as necessary.

The Company has presented a flawed claim for Capital Stock Tax that must be rejected. There are several errors in PPL's calculation that must be corrected. Furthermore, the Company's claimed overall rate of return includes an inflated cost of common equity claim that must be amended as it provides an overly generous benefit to shareholders at the expense of ratepayers.

PPL's proposed Distribution System Improvement Charge ("DSIC") is illegal and constitutes single issue ratemaking and, therefore, must be denied. In addition, the Company's requested Transmission Surcharge is inappropriate and must be rejected.

III. RATE BASE

The Company erred in its Main Brief by stating that there were only two remaining issues concerning rate base. PPL Main Brief, p. 17. PPL fails to address the necessary adjustment associated with pension expenses.

A. Pension Costs

The Company's Rate Base must be adjusted due to the improper inclusion of the capitalized portion of its Pension Expense claim. The adjustment related to SFAS 87 is detailed in the OTS Main Brief in Section V (Expenses), subsection B (Pension Expense), pp. 22-24. The appropriate ratemaking treatment of this adjustment requires that the Company's Rate Base be reduced by $613,000. Details of the analysis of this claim are also contained in OTS Statement No. 2, pp. 7-14. To correct the overstatement of Rate Base due to the inclusion of the capitalized portion of its Pension Expense claim, the Company's Rate Base claim should be reduced by $613,000.

IV. REVENUES

A. Weather Normalization

The Company's calculation of the weather normalized load for residential heating customers is flawed and results in an understatement of its annual revenue at present rates. There are errors associated with at least two data inputs used by PPL's in the calculation of weather normalized sales. The errors include its determination of "normal" weather and its forecasted average use per residential heating customer. There may be more errors, but, without a working copy of the model employed by the Company, it is virtually impossible to make further determinations. The Company used its own internal data and created forecasts and conclusions that cannot be examined in depth because of the inability to analyze the relationship of the data contained in its model. The Company criticizes OTS' use of widely accepted and available data while admitting that its data is essentially unattainable as the model used by the Company requires access to its network in order to operate. PPL Main Brief, p. 22, footnote 3. PPL Electric Statement No. 3-R, pp. 5-6. Furthermore, the Company attempts to cloud the issue by erroneously stating that OTS' principle objection is that the Company did not comply with a data request to supply a working copy of the model. PPL Main Brief, p. 22. Although true in that the Company did not supply a working copy of its model, the issue is that PPL has not supported its claim with substantial evidence, therefore it must be denied. All the rhetoric surrounding supplying a working copy of the model must be addressed within the standards of a rate case

proceeding. The Company maintains the burden of proof as to all elements of its claim. As is undisputed, the evidence needed to support a claim must be substantial. OTS' principle objection is that the Company has not met this standard. The Company has presented evidence based on a model that can only be utilized internally and presents the results as though they are to be accepted as fact. Notwithstanding the fact that the entire model cannot be reviewed, OTS has identified two flawed inputs. Correction of these flawed inputs is the basis of the OTS recommendation. Using official NOAA data and a thirty year "normal", OTS, through its own analysis, determined that an adjustment of an addition of $3,065,000 to the Company's claimed revenue is necessary.

OTS recommends that the Company's use of data supplied by a private entity is flawed and must be rejected. Furthermore, the data used by the Company represents only a twenty year period, not the commonly used, and widely accepted, thirty year period.

The Company readily admits that the data it ultimately receives from its private entity has been reviewed and adjusted. This entity "excludes erroneous observations and includes estimates for any missing values." PPL Main Brief, p. 23. Apparently the private entity alone determines what observations are erroneous and calculates its own estimates for missing values. Support for this premise of use of massaged data from a private entity is lacking in the record and must be denied. The appropriate data to be used must come directly from its source and not be subject to some unsubstantiated and unknown review by a

private entity. OTS recommends data supplied and published by the National Oceanic and Atmospheric Administration ("NOAA"). This source is widely accessible and its reports are unadjusted. Any realistic evaluation of weather normalization must begin with widely accepted, unadjusted data. OTS will not dispute, at this time, the Company's claim that its data is *indirectly* provided by NOAA. The impropriety of the Company's methodology lies in the fact that it requires this data to be reviewed and adjusted by a third party before using it in its model. The record indicates that there are differences in the data supplied by NOAA and the data supplied by the Company's private entity and used by the Company in its calculations. OTS Statement No. 3, p. 8, OTS Exhibit No. 3, Sched. 1, p. 2. The data used by OTS has not been massaged and has been utilized exactly as published by NOAA.

As correctly stated in OTS Witness Kubas' testimony, the core data needed to calculate weather normalized sales includes the number of customers by month for each month of the test year, the actual sales for these customers, the base load of these customers, the actual monthly heating degree days for this time period and the normal heating degree days. OTS Main Brief, pp. 17-18, OTS Statement No. 3, page 5. The Company is attempting to inject more into a weather normalization calculation than there actually is. PPL attempts to identify mitigating factors such as summer load and daylight hours that were not included as part of the OTS analysis while failing to support these same factors in its own claim. There is no evidence in the record indicating how the Company accounted for summer load.

Similarly, the Company fails to support its allegation that lighting affects the calculation. Every attempt to discredit the analysis of other parties magnifies in own failures in supporting its claim. Admittedly, there may be shortcomings in the OTS recommendation based on the limited data OTS was able to obtain from the Company. However, the OTS analysis and principles used are open and available to everyone for review. The Company would like you to believe that its model is so superior to any widely accepted principles that it should be used and accepted without question. In other words, PPL, in essence, states that the Commission should abandon its longstanding, traditional evaluation of weather normalization using widely accepted data and rely solely on the offerings presented by the utilities in these matters. And the Company would like the Commission to accept this premise by not requiring the utility to meet its burden of proof anymore.

The entire analysis provided by the Company is nothing more than an attempt to deflect inquiry away from its own unsupported claim. The Company uses as support of its own premise the statement that OTS made a substantial error in developing its forecast. PPL Main Brief, p. 24. OTS admitted to, and corrected, an error in its original calculation on August 5, 2004 and notified the Company through submission of its Surrebuttal testimony[1]. At the same time, an appropriate adjustment was made to the revenue requirement. This was a mathematical error that is no longer the subject of any controversy, yet the

[1] OTS Statement No. 3-SR, P. 2 (Surrebuttal Testimony of Joseph Kubas)

Company attempts to paint it as a flaw in the development of the OTS normalized sales figure.

It is a bold assertion to proclaim that your own private model that utilizes your own inputs, is superior, and then offer as proof only a six month snapshot of year to date performance. Further obfuscating the point is the fact the comparison the Company is attempting to make on pages 25 and 26 of its Main Brief are wrong based on two fundamental errors. First of all, what the Company characterizes as a growth rate, is not a growth rate at all. It is simply the ratio of the weather normalization that the Company shows to the kWh sales presented by OTS. The resulting calculation offered by the Company is meaningless. It is noteworthy that not only does it serve no purpose in this proceeding, the calculation is wrong. The Company neglected to use updated information in its self-serving calculations resulting in further distortions to its support for its premise. A review of the record will indicate that the Company did not use the updated normalized sales presented by OTS in its calculation. A simple update to reflect record evidence would have resulted in a calculation of less than one half of what the Company offers in its exhibit and Brief. Not only is the premise incorrect, the Company made a substantial error in its calculation.[1] Furthermore, the Company's schedule is based on twenty year non-NOAA data which, as

[1] The Company used normalized sales of 7,132,413. This number was revised by OTS to 6,713,314. The Company based its calculation on the unrevised number. A proper computation would have yielded 6%. However, this discussion is moot in that it does not represent a growth rate as the Company alleges and serves no probative value in this proceeding.

described earlier, is improper. As it is based on faulty inputs, reliance on PPL Exhibit DRW-2 is misguided.

The Company has not satisfied its burden of proof with substantial evidence to merit consideration of its proposed methodology and, as a result, its recommendation must be rejected. The OTS recommendation offered in its supporting evidence and presented in its Main Brief is appropriate as it is consistent with accepted practices. Weather normalization calculations are not used to predict the weather. They are not forecasts as the Company has attempted to characterize it. The goal is to establish a normal level of degree days as a basis for any adjustment.

The additional usage of 47 kWh per Residential Heating customer as derived by using the properly calculated inputs increases the Company's claimed present rate revenue by $3,065,000.

B. Late Payment Fees

The Company's methodology in calculating Late Payment Fees is flawed and unreliable, therefore, it must be rejected. The Company's assertion that a five year average will smooth out any anomalies must not be confused with the methodology presented by OTS. This is not an issue of five years versus three years. The issue is the propriety of utilizing a ratio to determine an appropriate level of late payment revenue as opposed to the Company's offering of an average calculated figure based on five years of late payment revenue with no relationship to overall revenue. OTS Witness Gruber appropriately recommends using an

historical average of the percentage of overall revenue represented by late payment revenue and applying it to the revenue figure allowed by the Commission at the conclusion of this proceeding. OTS Main Brief, p. 20, OTS Statement No. 5, pp. 18-19. This is similar to the methodology the Company describes on page 28 of its Main Brief in its discussion of uncollectible accounts expense. Inexplicably, PPL uses this premise to support its claim that its late payment fees should be accepted as they are. There is no relationship between an uncollectible accounts expense claim and a late payment revenue claim. As clearly seen, one deals with expenses, the other with revenue. Furthermore, the Company's own uncollectible accounts expense filing already accounts for the effect of a rate increase. Its very formula applies the "historical relationship of uncollectible accounts...to its *proposed increase in rates.*" (emphasis added), PPL Main Brief, p. 28. Notwithstanding this fact, the Company now offers that this adjustment will offset any adjustment proposed by another party. PPL has clearly accounted for this claim and is now attempting to have it considered again. If this is not the case, surely the Company is not suggesting a correction or change to its methodology in its Main Brief where it is not subject to analysis by the parties. The Company again attempts to satisfy its burden of proof through an unsupported analysis of another party's position, going as far to suggest that this adjustment is offset by another adjustment that the *Commission* should make.

The Company has the burden of proving why its methodology should be used. The Company has as much as admitted that its methodology is flawed but

the results net out when the Commission makes another adjustment for them. OTS offers that this rationalization by no means satisfies the burden of proof as established by case law.

By establishing a ratio based on the last three years data, OTS Witness Gruber's methodology more accurately presents the Company's anticipated late payment revenue. PPL's methodology should be rejected as it understates its present rate revenue by under-calculating late payment revenue. OTS offers its methodology that applies a ratio of 0.2818% to the revenue granted in this proceeding as an appropriate means of calculating late payment revenue. The OTS recommendation is based on its proposed total revenue allowance but acknowledges that this recommendation may change pending final Commission action. Based on the recommended revenue allowance established by OTS, this adjustment requires $1,240,000 be added to the Company's revenue calculation presented in its filing.

Based on the OTS recommended adjustments to the Company's revenue calculations is it necessary to add at least $4,305,000[2] to the Company's claimed revenue.

[2] $3,065,000 to adjust for weather normalization and $1,240,000 for late payment fees.

V. EXPENSES

A. Pension Expense

The Company's *accounting* treatment of an expense must not be confused with the proper *regulatory* treatment of its pension expense claim. The Statement of Financial Accounting Standards ("SFAS") No. 87 does not address the proper ratemaking treatment of a claimed pension expense. The Company readily admits that it has received over ten million dollars a year from ratepayers since its last base rate case but has contributed absolutely nothing to its pension fund during that time. These ratepayer contributions did not reduce the Company's current liability in any manner. Instead, the funds that were received, but not contributed, had a net positive effect on the Company's financial status to the direct and sole benefit of shareholders. In other words, ratepayers contributed $10,000,000 a year to the Company's bottom line for the benefit of shareholders. The Company incorrectly would like you to believe that its proclaimed 75 million dollar liability will be due, in cash, in the future. The reality is that his proclaimed liability will remain on PPL's balance sheets until it is forced to make an actual contribution to its pension fund that exceeds the SFAS No. 87 calculated expense. It must be noted that PPL has not done this in the last 15 years and has presented no evidence that it will make any contributions in the foreseeable future.

A recent Commission Decision has approved an actual cash contribution to a pension fund by agreeing with the premise that the determination of the actual funding amount be done by "establishing the mid-point between the ERISA

minimum and the IRS maximum." Pa. P.U.C. v. Aqua Pennsylvania, Inc. Docket No. R-00038805 (Order entered August 5, 2004) ("Aqua Pa."). The Company in that proceeding made an actual contribution to its pension fund as determined by the above referenced methodology. In the present proceeding, no cash contribution has been made and if the reasoning of the Commission's recent decision is used, no contribution will be made as the mid-point of the ERISA minimums and the IRS maximums is still zero

Two separate adjustments are necessary to cure the Company's misplaced reliance on accounting standards in the ratemaking process. The Company's expense claim of $1,396,976 should be denied and the corresponding capitalized portion of the expense of $613,062 must be removed from rate base. The Company has not demonstrated, by substantial evidence, that this expense is warranted and does not violate sound ratemaking principles. Failing in this burden, the expense claim must be rejected.

B. Hurricane Isabel

There are two components of the Company's claim for recovery of expenses associated with Hurricane Isabel that must be addressed. First, the total claim is overstated and must be reduced. Second, the recovery period must appropriately balance the interests of ratepayers and the Company.

PPL's claim for recovery of an expense classified as wages and benefits – regular time is inappropriate and must be removed. The Company filed for this recovery in its initial filing and then identified it as a proxy for contractor

expenses. The Company's regulatory asset already includes a claim for contractor expenses (outside crews). Furthermore, a normal level of contractor expenses is included in the Company's filing in this proceeding. Notably, this claim has not been challenged by any party. Now, the Company wants the Commission to allow recovery of an expense based on the Company's portrayal of a normal and routine expense associated with doing business as a proxy for another expense. In what can best be described as a post hoc rationalization, the Company wants to classify a normal operating expense as a proxy for an incremental expense it claimed it incurred because of the storm. OTS contends that the Company's filing for wages and benefits – regular time in its regulatory asset is unreasonable and must be denied. The Company did not demonstrate that it would not have incurred this normal operating expense absent the storm. The expense was claimed in a regulatory asset associated with the storm, not as a proxy for anything else. For this expense to be considered recoverable in rates the Company must demonstrate that this expense would not have occurred absent the storm. The Company has clearly failed to do this. Instead they offer it as a proxy and contend it should be recoverable on this basis. OTS does not contest the balance of the regulatory asset (absent the claim for wages and benefits – regular time) as it accurately reflects costs associated with the storm. OTS does contend that the Company has not met its burden of proof in support of a regular time claim in its storm related regulatory asset.

Recognizing that recovery of this claim should be permitted, OTS recommends that recovery be extended to ten years to strike an appropriate balance between ratepayers and the Company. PPL's request to amortize this expense over five years is too short and unduly burdens ratepayers.

The Company's analysis regarding the present value basis of its proposed recovery is of no consequence in the ratemaking allowance of a claim. Recognizing the fact that every amortization of an expense can be calculated to yield a present value, the Company, interestingly, has proposed this concept with only this recovery claim. In essence, the issue in this proceeding is a matter of degree. Both the Company's proposal and OTS' proposal will provide the Company with dollar for dollar recovery of the appropriate expense level. The difference is that the Company's proposal puts an additional unnecessary burden on ratepayers. The Commission has adopted recovery periods of ten years for storms of this magnitude in the past and should adopt the same recovery period in this proceeding. The Company's offered support of the PG & W case in its Main Brief is distinguishable just on the sheer magnitude of the claim. A five year recovery in that case did not present an excessive burden to ratepayers so as to be allowed by the Commission. This proceeding presents a different scenario. Even adjusting the dollars in the Company's referenced case to today's dollars, the magnitude of the claim does not approach PPL's claim in this case.

A proper balance of the interests of ratepayers and the Company is to allow recovery of the adjusted level of the regulatory asset over ten years. As detailed in

the OTS Main Brief as well as in its testimony and exhibits, the Company's claim in this proceeding must be reduced by $1,864,000.

C. Automated Meter Reading Displacement Costs

The Company's expense claim of $8,818,000 amortized over five years for automated meter reading displacement costs must be denied.

The determination of these costs based on an accounting standard is inconsequential. OTS does not contest the amount that this initiative may cost, the issue is the impropriety of recovering this expense from ratepayers. It has not been disputed that the PPL Retirement Plan Pension Trust and PPL Electric Utilities, Inc. are two distinct entities. The Company has also not produced any evidence to indicate that this expense will not be paid by the pension fund. The Company's own evidence indicates that these costs will be paid by the PPL Retirement Plan pension trust. OTS Main Brief, p. 26. PPL Statement No. 2-R, p. 5. Simply put, this expense will be paid by the pension trust, not PPL.

OTS recommends that $1,764,000 be removed from the Company's distribution operating expenses claim.

D. Community Betterment Initiative

OTS continues its objection to the Company's proposed Community Betterment Initiative costs to be recovered from ratepayers. Similar social programs have been presented in the past and the findings have been consistent. The Company has failed to demonstrate that its initiative will provide a direct benefit to ratepayers. Lacking such evidence, this claim must be rejected.

Furthermore, the Office of Consumer Advocates offer of a self serving study done in Colorado by its witness does nothing to establish the necessary benefit to ratepayers that is required to permit consideration of the recovery of the costs of this initiative. The Company's expense claim of $1,000,000 must be removed as being unsupported.

E. Service Corporation Charges

The Company's claim for Rate Case Communication contained in its External Affairs Services claim must be rejected. According to the Company's testimony, the claim is in both External Affairs and Rate Case Expense. This results in a double count. Therefore, the Company's claim of $130,000 must be removed.

F. On-Track and WRAP Programs

The Company's claim for recovery of the expenses associated with these programs is overstated and must be adjusted. The Company proposes to collect more than it plans to expend on these programs in the next two years. This time period is significant as it represents the anticipated time before the Company's next rate case based on its rate case expense claim for amortization over two years. There is no need to advance funds before they are needed. The OTS adjustment still allows the Company to recover the funds it expends in support of these programs. Traditional ratemaking allows companies to file for an increase in rates when operating expenses have eroded its ability to earn a fair rate of return on its investment. That is the appropriate approach to take with respect to these

programs. The Commission should allow recovery of only the funds that the Company has demonstrated it will expend in the next two years. Subsequent rate cases can deal with future funding. The Company's proposal requires over-funding the program and then dealing with the consequence in future rate cases. This is an improper methodology that must be rejected.

The appropriate adjustment to the Company's claim reduces its operating and maintenance expense claim by $1,950,000.[3]

G. Sustainable Energy Fund

The paramount issue associated with ratepayer funding of the Sustainable Energy Fund ("SEF") is whether SEF provides a direct benefit to ratepayers. As noble as the cause may be, it fails to establish, with substantial evidence, that it will provide a benefit to the distribution system ratepayers to merit their forced contribution to the fund. The meager evidence offered in support of a distribution system benefit, if accepted, only demonstrates that ratepayers are being asked to contribute $3,689,000 annually for a fund that will assist them to such a negligible degree that it cannot be quantified. Vague assertions that the reduction of customer load delaying the need to upgrade the distribution system and defer future rate increases are not the basis upon which a determination of ratepayer benefit can be based. As such, the expense claim associated with this fund must be denied. The Company's assertion that there is nothing "hidden" about SEF misses the point of OTS' objection to ratepayer funding entirely. If ratepayers are

[3] $1,500,000 for On-Track and $450,000 for WRAP.

forced to fund a social program through an unidentified addition to their kWh charge, it is akin to a tax. The fact that it is not clearly identified on ratepayers bills and most are probably not even aware of its existence, one must conclude that it is hidden. OTS would agree that SEF is not hidden. The Company's attempt to characterize the OTS position in this manner is wrong. The mandatory funding is what OTS characterizes as "hidden" as it is for a program that lacks discernable benefits to distribution system ratepayers.

As PPL has not satisfied the burden of proof in proposing that this distribution expense claim be continued and funded solely by ratepayers it must be rejected. This adjustment reduces the Company's operating and maintenance expense claim in this proceeding by $3,689,000. However, as discussed in the OTS Main Brief,[4] OTS would support a voluntary contribution from ratepayers or continued Company funding of this program.

[4] See OTS Main Brief, pp. 33-37.

VI. TAXES

The Company's inclusion of the year 2000 income in its Capital Stock Tax calculation is inappropriate and must be rejected. It is undisputed that 2000 total reported by the Company includes a sizeable amount of generation related income. Use of this calculation distorts the funds needed by the Company and requires ratepayers to contribute more than is necessary. The recommendation of OTS utilizes a consecutive five year average in its calculation as required by the Department of Revenue. The Company, on the other hand, excludes 2004 income and uses 2005 projections.[5] This method enables them to retain the inflated income figure from 2000. Obviously, this results in a higher expense claim.

PPL's 2004 Capital Stock Tax liability is not the focus of the establishment of rates to go into effect in January of 2005. Funds for the 2004 liability have been included in rates that are currently in effect. This filing is to establish for the collection of funds for the 2005 period, which is when these rates will go into effect. The Company's criticism of OTS using 2005 income in its calculation is disingenuous as they have included the impact of 2005 in its calculation.

The Company's proposal to retain its effective rate for Capital Stock Tax as 6.99 mills as opposed to the published rate of 5.99 mills must be rejected for obvious reasons. 5.99 mills is the posted effective rate scheduled to become effective on January 1, 2005. The Company's support is that this *may* be rescinded. The evidence present in the record dictates that the effective rate be set

[5] See PPL Exhibit JMK5. See also, OTS Exhibit No. 2, Sched. 3.

at the appropriate level. This level is 5.99 mills. Speculation as to what may or may not happen is not the basis for establishing an inappropriate rate.

The Company claim for Capital Stock Tax is seriously flawed and must be rejected. The Company's errors include calculating its liability at the wrong rate, including the effects of generation income in calculating its liability and finally, its iteration of Capital Stock Tax under proposed rates.

VII. RATE OF RETURN

A. Introduction

The Company's interpretation of the importance of this proceeding is certainly poignant. This is the first electric distribution company filing in the Commonwealth. The determinations in this distribution proceeding will be used as the basis in future distribution proceedings. Arguably the capital markets are interested. Certainly the ratepayers are interested. All of this rhetoric relates to the role of the Commission in establishing rates that balance the interests of the Company and its ratepayers. The proceeding is governed by the statutory requirement that rates be "just and reasonable." Shareholders have options, ratepayers do not. A benefit to one entity invokes a detriment to the other. Lehman Brothers has already indicated that Pennsylvania regulation favors investors over ratepayers. PPL Main Brief, p. 60, footnote 10.

B. Return on Common Equity

The standards relating to rate of return have been well established over the years with various court cases defining the particular aspects of the issue. A review of the Company's Main Brief underscores the fundamental flaw in its return on equity analysis and its subsequent rationale for an inflated equity request. The Company states that "the Commission should provide PPL Electric with an opportunity to create a credit profile that will produce an *upgrade* to an A bond rating." (emphasis added), PPL Main Brief, p. 61. The Company's entire evidentiary presentation is based on the premise that the Commission should

award it a return that will enable it to improve it's A- bond rating. In order for this approach to be plausible, the standards presented in the landmark Supreme Court cases of Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia, 262 U.S. 679 (1923) and Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1944) must be abandoned in favor of the Company's new proposed standard. The court in Bluefield stated:

> ..."[t]he return should be reasonably sufficient to ensure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.

Bluefield at 692-3. Similarly, the court in Hope remarked "[t]hat return, however, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." Hope Natural Gas Co. at 603.

It is the position of OTS that these cases establish the standards by which the Company's request must be examined. There are several factors affecting the Company's bond rating, not just the excessive equity return that the Company is requesting in this proceeding. First it is important to examine the Company's established capital structure. A better balance of its debt/equity ratio would serve to strengthen its credit position. The Company does not need Commission intervention to do this. The Company's current capital structure is in accord with

the structures found in comparable companies with an A- rating. See PPL Rebuttal Exhibit PRM-4.xls.[6]

Also, the Company's bond ratings are affected by its relationship to a non-regulated entity. Standard and Poors ("S&P") commented on this relationship in its April 29, 2003 summary when it stated "structural elements of the ring-fencing are not strong enough to completely isolate PPLEU from PPL's credit quality."[7] PPL Exhibit Regs. §53.53, Part III, Rate of Return, Attachment III-F-4c, p. 1. Further explanation is contained in the following:

> PPLEU has been insulated (ring-fenced) from the rest of PPL through legal and structural enhancements that transformed PPLEU into a single-purpose entity bankruptcy remote from PPL. The ring-fencing results in a rating that is not equal with PPL and that is based on PPLEU's stand-alone creditworthiness. However, the ring-fencing is not strong enough to support more than a two notch differential between PPLEU and PPL. PPLEU is now rated two notches above PPL. If PPL is downgraded, PPLEU's ratings would be lowered as well.

Id. A simple review of the Company's exhibit establishes that the financial risk of PPL is much higher than that of PPLEU. Id at Attachment III-E-2, p. 1 of 1. A basic understanding of finance yields the conclusion that, if not for the two notch tether established by S&P, the Company's bond rating would be even higher. The financial reporting institution has established that it will connect the two entities for rating purposes until the distribution Company (the subject of this proceeding)

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[6] This exhibit is attached to the Rebuttal testimony of PPL witness Paul Moul. The Company's claimed debt of 51.3% is closest to the 52% required in this exhibit for an A- rating.

[7] It must be noted that the commentary by S&P refers to PPL Corporate as PPL and the electric distribution company (the subject of this proceeding) as PPLEU.

can be viewed solely as a stand alone entity. This relationship obviously has a negative effect on the Company's rating. No action by the Commission is going to remedy this situation. Any failings or misgivings by PPL Corporation are going to be reflected in the ratings assigned to PPL as well.

A 9.00% return on common equity serves to best balance the interests of ratepayers and investors. The 11.50% return recommended by the company's witness is clearly excessive and unsupported by the facts. An excessive return on common equity would result in rates that are neither just nor reasonable and should, therefore, be rejected.

As presented in its testimony and its Main Brief, OTS recommends employment of the Discounted Cash Flow method ("DCF") to arrive at an appropriate recommended return on common equity. This method has been traditionally endorsed by the Commission and remains the foundation upon which return on equity recommendations are made. To compute the components of the DCF method, OTS Witness Deardorff utilized current, historical and forecasted market data for a barometer group of six electric companies, the nine company electric barometer group used by the Company as well as PPL Corporation. Mr. Deardorff's barometer group includes all the companies in PPL's barometer group with the exception of those that did not offer two sources of analysts' forecasts of earnings growth. OTS St. No. 1, p.10. OTS, as is its customary practice, updated its recommendations as new, more current data became available. The Company

openly admits that it relies on stale data and offered no updates to its testimony despite ample opportunity to do so. Transcript p. 565.

The barometer group identified by Mr. Deardorff in OTS Exhibit No. 1 represents similar risk enterprises that are necessary to establish a benchmark for comparison when establishing a return on common equity. Reliance on the gas industry is misguided and serves only as an attempt to justify an excessive equity return request. The barometer groups used by OTS present sufficient data and clearly must be used as a similar risk enterprise in accordance with the standards involved in establishing an appropriate equity return. The Company's analysis errs in its belief that just about any regulated industry satisfies the criteria necessary for use in a barometer group.

The evidence in the record supports the conclusion that electric distribution companies are low risk and comparison to the natural gas industry is inappropriate. S&P has commented on the low risk nature of PPL when it summarized the characterizations reflected in its rating. S&P states that its rating reflects the "low risk transmission and distribution ("T&D") electric operations" of PPL. PPL Exhibit Regs. §53.53, Part III, Rate of Return, Attachment III-F-4c, p. 1. The Company's industry is clearly low risk and, as has been demonstrated, its financial risk is subject to many influences, some of which are under the Company's control.

The data for the barometer groups utilized by the OTS Witness Deardorff is market based. Subsequently, the results have implicitly accounted for all

aggregate risks that financial markets take into account when assessing investments. These risks are reflected in the price per share of the issued stock. OTS St. No. 1, p. 11. As such, no gratuitous adjustments to the data are necessary in making calculations within established formulas. As the Company has stated "investors determine risk." PPL Main Brief, p. 90. The DCF, being market based, has obviously accounted for all these factors rendering any adjustments unnecessary.

The Company's growth rates used in its analysis are unsupported and overstated. By overstating its growth rates, the Company's calculations will overstate its equity recommendation.

To arrive at a representative dividend growth rate in its DCF analysis, OTS surveyed several series of projected growth rates published by established forecasting entities. The Company, after proclaiming that the OTS projections (based on forecaster's) were biased, concluded that its own witness' projections were superior to anything that Value Line, Thomson's, S&P or Smart Money could project. These Company witness projections, coincidentally, are significantly higher than the nationally published forecasters. As a result, its equity determination is significantly higher as well.

Based upon his analysis of the revised growth rates forecasted by the above referenced entities, OTS Witness Deardorff has concluded that investors could reasonably expect to achieve a growth rate of 4.10% for the six company barometer group. This recommendation is supported by the evidence introduced

into the record as OTS Exhibit No. 1-SR, Schedule. 2, page 4 of 4. This data presented in this exhibit indicates an average expected growth rate for the barometer group of 4.10%. This is in stark contrast to the Company's unsupported forecast of 5.50%.

The Company further complicated its DCF analysis by including an unwarranted ex-dividend adjustment in its calculation. This issue has been addressed in OTS' Main Brief and need not be repeated here other than to reaffirm the impropriety of any adjustments to the DCF analysis. Finally, the Company distorted its DCF findings by including a market to book adjustment to a market based analysis.

OTS Witness Deardorff properly calculated the DCF return for the six company barometer group, the nine company barometer group and PPL Corporation with the resulting calculations supporting an equity recommendation of 9.00%.[8] OTS' recommendation accounts for the difference in perceived financial risk between the barometer group's actual common debt ratios and PPL's prospective capital structure as detailed in its testimony as well as the Main Brief on pages 53 and 54.

The company's cost of equity study should be dismissed as it mistakenly utilizes the RP, CAPM and CEM methods in determining its equity request. The Company did not, as Aqua Pa. suggests, use these methods to check the

[8] The DCF results for the nine company barometer group suggests that the range could be as low as 8.75%. The DCF results for PPL Corp. indicate 9.00%.

reasonableness of its DCF calculation, it used it as leverage to request an inflated equity return in this proceeding. Furthermore, the Company's reliance on this Decision is misguided as the facts contained in that Order are clearly distinguishable from the present proceeding. The Company's reference that "the Commission has concluded that an unadjusted DCF analysis understates the cost of equity and, therefore, that other cost of equity models must be considered" is factually incorrect. PPL Main Brief, p. 75 (referencing Aqua Pa. Order at p. 63). The Order in that proceeding made no such proclamation and no reasonable interpretation can support the Company's statement. The Order merely states that the ALJ failed to consider these other models "as checks upon the reasonableness of the DCF results." Aqua Pa., p. 62. It does not require that their analysis be integrated into determining an appropriate equity return. If the Commission proclaimed that an unadjusted DCF requires reliance on the other models, then logic would dictate than an adjusted DCF would negate this need. However, this is not consistent with the Company's own statements as its adjusted DCF doesn't even support its recommended return on equity.

A careful review of the Decision that the Company uses as support for its claim reveals the following facts. The ALJ recommended a 10.00% cost of equity (relying, as the Commission stated, too heavily on the DCF methodology). The ALJ failed to consider the latest available data in considering that Company's financial risk. There was evidence concerning corporate bond yields increasing. The Commission, in this water proceeding, felt it necessary to include a financial

risk adjustment to the DCF calculation. The findings also concluded that the ALJ did not give sufficient weight to management performance in the areas of water quality, customer service, low-income customer assistance and regionalization efforts. The Order details the Company's acquisition of a troubled water company as proof. The total adjustment to the ALJ's findings was a total of 60 basis points resulting in a final equity allowance of 10.60%.

The Company has failed to present similar facts in support of its proposal. The Decision in Aqua Pa. is clearly distinguishable from this proceeding and, as such, offers no support for the Company's position. One could reasonably conclude that the acquisition of NUI influenced the Commission's decision to award a higher equity return. There has been no similar evidence presented in this proceeding to support the analogy the Company is attempting to make.

Mr. Deardorff's DCF analysis provides the most reliable information for determining a proper cost of common equity and should be the primary method utilized in this proceeding.

The appropriate weighted cost of capital in the case before us is 7.63%. This result is based on Mr. Deardorff's 9.00% cost rate of common equity.

VIII. MISCELLANEOUS ISSUES

A. Distribution System Improvement Charge

PPL's proposal to institute a surcharge to its base rates that provides for the collection of ratepayer funds outside the context of a rate case is illegal and must be rejected. The Company's proposal lacks statutory authority and also violates the accepted regulatory principle barring single-issue ratemaking.

The statute and the subsequent actions of the legislature clearly address the illegality of this proposal. The Honorable Phyllis Mundy has testified to the intent of the Legislators and House actions, on two separate occasions, clearly demonstrate the need for statutory authority in the implementation of this proposal. The full House of Representatives has twice voted against a proposal extending this type of provision to gas utilities. Under the company's premise, this would not have been necessary as 66 Pa. C.S.A. §1307(a) allows for the charge. Obviously, the legislature did not interpret the statute in the same manner as the Company or the matter would not have been brought to the floor – twice.

The statute is clear on its face and the legislative intent undoubtedly demonstrates that the distribution system improvement charge ("DSIC") proposed by the Company violates the statute and must be rejected.

Furthermore, the provision violates the regulatory prohibition against single issue ratemaking as presented in OTS testimony and Main Brief. As the Company's proposal lacks statutory authority and violates the regulatory principle prohibiting single-issue ratemaking, it is unlawful and, therefore, must be rejected.

B. Transmission Surcharge

OTS reiterates its prior position as set forth in its Main Brief opposing the Company's proposed reconcilable Transmission Service Charge ("TSC"). Transmission related costs are an integral part of the business of supplying electricity service to customers and, as such, they are no different, at least from a regulatory viewpoint, than distribution related costs or other operating expenses of the Company.

In attempting to differentiate transmission costs, PPL has characterized these costs as being unlike any other costs because they are substantial, they vary greatly and such variation is beyond its control. PPL Main Brief, p. 98. In and of themselves, these reasons do not sufficiently justify the imposition of a reconcilable automatic adjustment clause. While not arguing that transmission related costs represent approximately 29% of the Company's projected distribution revenue, the Company's characterization that the substantial variation of these costs being beyond its control is without merit. The Company attempts to portray itself as being subject to the whims of outside forces that are both uncontrollable and unpredictable. This portrayal is used as the main thrust for its justification of a reconcilable TSC. In essence, PPL would have the Commission believe that its transmission related costs are akin to commodity charges that can vary substantially from month to month, or even day to day, based on market projections and supply and demand.

To the contrary, the assessment of the Company's transmission costs by PJM are not subject to the fickleness of a commodity market. The assessment is based upon a FERC approved tariff that sets forth known and measurable charges for services. Based upon projections with an established margin of error, the Company can forecast its transmission expenses in the same manner that it forecasts its other operating expenses.

The Company's proposal should be rejected and it should continue to collect all transmission related charges through an unbundled, non-reconcilable transmission rate.[9] There is no justification for treating transmission costs any different than normal operating costs and, accordingly, they should only be reviewed and recovered in the context of the entire cost of doing business. The proposed transmission charge in this filing should be an unbundled rate based on the final transmission related costs and kWh sales figures determined at the conclusion of this proceeding.

[9] As a matter of clarification, OTS does oppose a reconcilable TSC. See PPL Main Brief, p. 95, footnote 29. The referenced testimony of Mr. Gruber indicates that he was not opposed to a transmission service charge *as long as it was not reconcilable.* Transcript, pp. 529-530 (emphasis added). As explained in the Main Brief, the statement of OTS Witness Gruber and its position with regard to the TSC represents a distinction without a difference because a non-reconcilable surcharge is the functional equivalent of requiring the Company to roll those costs into its base rates. See OTS Main Brief, p. 67, footnote 15.

IX. RATE STRUCTURE

OTS reaffirms its recommendation with respect to rate structure and rate design as presented in the testimony of Mr. Yarolin and as summarized in its Main Brief.

As a review of its position, OTS represents that a customer charge of $8.25 with no usage included and two usage blocks with rates as supported by the OTS errata sheet to Statement No. 4 are appropriate. Furthermore, rate schedules RS and RTS deserve close scrutiny as the average rate of return in these classes dictate the appropriate movement to the system average rate of return.

OTS recommends its proposal for rate schedule RS be adopted as it appropriately resolves some of the subsidy issues present in this class. OTS contends it is necessary to move this classification to the system average rate of return as an equitable balance of the interests of all ratepayers.

The OTS proposal moves schedule RTS to a zero rate of return. This is still way below the system average but gradualism is necessary to avoid rate shock. It must be understood that aggressive movement is necessary in this classification as they are substantially subsidized by other ratepayers.

As presented in prior documents, any increase in excess of the OTS recommendation of $101,464,000 should be applied across the board. This would present a maximum increase to rate schedule RS of $91,735,055. Under the same constraints, rate schedule RTS would be faced with a maximum increase of

$67,500,000.[10] This movement is appropriate as these classes have been consistently below the system average rate of return and should bear an equitable portion of any rate increase. The Company's self imposed limitation on increases to particular classes only serves to continue the inter class subsidies that already exist. As such, its proposal is inappropriate and must be denied.

[10] The calculations are based on the Company's original requested amount. The calculations presented in the Office of Consumers Advocate's Main Brief are incorrect as they are inconsistent with the testimony of the OTS witness. For example, the Company's original proposal allocated approximately 49% of the increase to rate schedule RS. Any amount *over* the $101,464,000 recommended by OTS would be distributed to RS in the same manner.

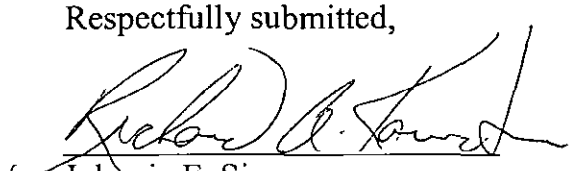
X. CONCLUSION

The PPL Electric Utilities has not borne its burden of proof with respect to each and every element of its proposal. Failing in this burden, the Company's request must be denied as it is not in the public interest.

OTS offers this Reply Brief as a supplement to the positions presented earlier in its Main Brief. The issues addressed in this Reply Brief were deemed to need additional clarification based on the presentations of other parties in their respective Briefs. Failure of OTS to address an issue in this Reply Brief is of no consequence as it was adequately explained in its Main Brief and did not require repeating. It does not signify withdrawal from an issue.

For the reasons stated herein as support for its position, the Office of Trial Staff respectfully requests that the Administrative Law Judge and the Commission adopt its recommendations in this proceeding and allow the Company to increase its rates by no more than $101,464,000.

Respectfully submitted,



Johnnie E. Simms
Chief Prosecutor

Richard A. Kanaskie
Prosecutor

Office of Trial Staff
Pennsylvania Public Utility Commission

Dated: September 13, 2004

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission	:	
	:	
v.	:	Docket No. R-00049255
	:	
PPL Electric Utilities Corporation	:	

CERTIFICATE OF SERVICE

I hereby certify that I am serving the foregoing **Reply Brief** of the Office of Trial Staff, dated September 13, 2004, either personally, by first class mail, electronic mail, express mail and/or by fax upon the persons listed below:

Paul E. Russell, Associate
General Counsel
PPL Electric Utilities Corporation
Two North Ninth Street
Allentown, PA 18101-1179

David B. MacGregor, Esquire
Morgan, Lewis & Bockius LLP
1701 Market Street
Philadelphia, PA 19103-2921

Michael W. Gang, Esquire
John H. Isom, Esquire
Morgan, Lewis & Bockius LLP
One Commerce Square
417 Walnut Street
Harrisburg, PA 17101-1904

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SECRETARY'S BUREAU

David A. McCormick, Esquire
Regulatory Law Office
U.S. Army Legal Services Agency
DAJA-RL 4120
901 N. Stuart Street, Room 713
Arlington, VA 22203-1837

David M. Kleppinger, Esquire
Pamela C. Polacek, Esquire
Karen S. Miller, Esquire
McNees Wallace & Nurick LLC
100 Pine Street
P.O. Box 1166
Harrisburg, PA 17108-1166

Steven C. Gray, Esquire
Office of Small Business Advocate
Commerce Building - Suite 1102
300 North 2nd Street
Harrisburg, PA 17101

Tanya McCloskey, Esquire
James A. Mullins, Esquire
Lori A. Herman, Esquire
Aron Beatty, Esquire
Office of Consumer Advocate
555 Walnut Street
Forum Place - 5th Floor
Harrisburg, PA 17101-1923

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

Mr. Eric Joseph Epstein
4100 Hillsdale Road
Harrisburg, PA 17112

Daniel Clearfield, Esquire
Kevin J. Moody, Esquire
Wolf, Block, Schorr and Solis-Cohen LLP
212 Locust Street
Suite 300
Harrisburg, PA 17101

Scott Rubin, Esquire
3 Lost Creek Drive
Selinsgrove, PA 17870-9357

Joseph L. Vullo, Esquire
1460 Wyoming Avenue
Forty Fort, PA 18704-4237

Roger E. Clark, Esquire
Sustainable Development Fund
718 Arch Street
Suite 300 North
Philadelphia, PA 19106-1591

Kent Murphy, Esquire
Legal Division
Exelon Business Services Company
2301 Market Street, S23-1
P.O. Box 8699
Philadelphia, PA 19101-8699

Patricia Armstrong, Esquire
Thomas T. Niesen, Esquire
Thomas, Thomas, Armstrong & Niesen
212 Locust Street, Suite 500
P.O. Box 9500
Harrisburg, PA 17108-9500

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

Mark C. Morrow, Esquire
UGI Utilities, Inc
460 North Gulph Road
King of Prussia, PA 19406

Richard S. Herskovitz, Esquire
Duquesne Light Company
411 Seventh Avenue, 8th Floor
Pittsburgh, PA 15219

Honorable Phyllis Mundy, Chair
Northeast Delegation
House Box 202020
Harrisburg, PA 17120-2020

Louise A. Knight, Esquire
Saul Ewing LLP
2 North Second Street, 7th Floor
Harrisburg, PA 17101-1604

Michael Fiorentino, Esquire
Clean Air Council
135 South 19th Street, Suite 300
Philadelphia, PA 19103

Peter Adels, General Counsel
Citizens for Pennsylvania's Future
117 South 17th Street, Suite 1801
Philadelphia, PA 19103

Michael G. Wolfe, Esquire
Metropolitan Edison Company,
Pennsylvania Power Company, &
Pennsylvania Electric Company
2800 Pottsville Pike
P.O. Box 16001
Reading, PA 19612-6001

Hon. Allison K. Turner
Administrative Law Judge
Pa. Public Utility Commission
1302 Philadelphia State Office Building
Broad and Spring Garden Streets
Philadelphia, PA 19130

Hon. Susan D. Colwell
Administrative Law Judge
Pa. Public Utility Commission
P.O. Box 3265
Harrisburg, PA 17105-3265

Hon. Ember Jandebeur
Administrative Law Judge
Pa. Public Utility Commission
Room 317, Scranton State Office Building
100 Lackawanna Avenue
Scranton, PA 18503

Johnnie E. Simms
Chief Prosecutor

Richard A. Kanaskie
Prosecutor

Office of Trial Staff
Pennsylvania Public Utility Commission

Dated: September 13, 2004
Docket No. R-00049255

COMMONWEALTH OF PENNSYLVANIA

OFFICE OF CONSUMER ADVOCATE
555 Walnut Street, 5th Floor, Forum Place
Harrisburg, Pennsylvania 17101-1923

IRWIN A. POPOWSKY
Consumer Advocate

(717) 783-5048
800-684-6560 (in PA only)

FAX (717) 783-7152
consumer@paoca.org

September 13, 2004

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FOLDER

James J. McNulty, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Bldg.
400 North Street
P.O. Box 3265
Harrisburg, PA 17120

Re: Pennsylvania Public Utility Commission
v.
PPL Electric Utilities Corporation
Docket No. R-00049255

Dear Secretary McNulty:

Enclosed for filing, please find an original and nine (9) copies of the Office of Consumer Advocate's Reply Brief, in the above-referenced case.

Copies have been served to the parties of record as indicated on the enclosed Certificate of Service.

Sincerely,

James A. Mullins
Assistant Consumer Advocate

Enclosures
cc: All Parties of Record
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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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v.	:	Docket No. R-00049255
PPL Electric Utilities Corporation	:	

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OFFICE OF CONSUMER ADVOCATE'S REPLY BRIEF

Tanya J. McCloskey
Senior Assistant Consumer Advocate

James A. Mullins
Lori A. Herman
Aron J. Beatty
Shaun A. Sparks
Assistant Consumer Advocates

Counsel for:
Irwin A. Popowsky
Consumer Advocate

Office of Consumer Advocate
555 Walnut Street, Forum Place, 5th Floor
Harrisburg, PA 17101-1923
(717) 783-5048

Dated: September 13, 2004

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I. INTRODUCTION

On September 2, 2004, Main Briefs were filed by PPL Electric Utilities Corporation ("PPL" or "the Company"); the Office of Consumer Advocate ("OCA"); the Office of Trial Staff ("OTS"), the Office of Small Business Advocate ("OSBA"); the PPL Industrial Customer Alliance ("PPLICA"); the United States Department of Defense and other affected Federal Executive Agencies ("DOD"); Eric Joseph Epstein, the Commission on Economic Opportunity ("CEO"); PPL Public Lighting Users Group ("PLUG"); Clean Air Council ("CAC"); Sustainable Energy Fund of Central Eastern Pennsylvania ("SEF"); Citizens for Pennsylvania's Future ("PennFuture"); and Pennsylvania Energy Consortium/Pennsylvania Retailers Association/Wal-Mart Stores East, L.P. ("PEC/Wal-Mart"). The OCA now files its Reply Brief in response to PPL and certain arguments raised by other parties. The OCA believes that its Main Brief ("M.B.") provides the Administrative Law Judge ("ALJ") and the Pennsylvania Public Utility Commission ("Commission" or "PUC") with a comprehensive discussion of the issues in this proceeding. The OCA's Main Brief fully addresses and responds to virtually all of the contentions made by the Company and the other parties in their Main Briefs.

It is not the purpose of this Reply Brief to respond to all of the arguments contained in these Main Briefs. The OCA will limit its Reply Brief to those issues requiring additional clarification. Thus, the failure of the OCA to address specific arguments contained in the Company's and the other parties' Main Briefs should not be considered as acquiescence to a specific argument or position. The OCA would note that based on a review of these Main Briefs, the OCA is not revising any of its adjustments or

positions. The OCA respectfully refers the ALJ, the Commission and other interested parties to its Main Brief for a full discussion of these issues.

As the OCA discussed in its Main Brief, this is the first distribution-only case for a major electric utility since restructuring and the first base rate case for PPL in nearly a decade. Although many traditional base rate issues have been presented in this case, many of these issues must be viewed in a new light given the restructuring of the electric industry since 1996. Of particular importance is the Company's claim for a return on equity of 11.5%, as well as the proposals of the parties on how to allocate the burden of this rate increase across the customer classes. The Company's claim for its return on equity significantly overstates its market-required cost of capital by any reasonable measure and fails to recognize the changes in both the markets over the past several years, and the Company's risk profile since restructuring. Indeed, the Company seeks the same level of return as it was awarded in 1994 despite the evidence of record that capital costs have declined since 1994 and PPL has evolved into a less risky, wires-only business.

Sensing that its return on equity claim may be overstated based on market data, the Company attempts to further boost its claim by asking that its management effectiveness be recognized in its return on equity award. PPL argues that the ultimate test for this bonus is the ability to provide reliable and efficient service at reasonable rates – a test PPL claims it has met. The OCA submits, however, that the test PPL sets forward is the statutory requirement for all public utilities. There is nothing extraordinary or exceptional about the utility doing its job and meeting its statutory requirements. Boosting PPL's return on equity award for "management efficiency" has no basis, and is

even more inappropriate while ratepayers continue to pay billions of dollars in stranded costs that resulted from PPL management's decisions.

The Company also tries to argue that this case will send a message to the investment community about the Commission's continued commitment to electric restructuring and its willingness to set rates that attract the necessary capital to provide reliable service. PPL cautions the Commission about sending the wrong message by not adopting PPL's position. The Commission, however, must not base its decisions on what message the decision sends to the investment community. The Commission must base its decisions on the constitutional and legal principles that guide all of its decisions when determining if rates are just and reasonable. As the OCA has shown, the OCA's recommended return on equity of 9.5% is a fair return on equity that, along with the OCA's other recommendations, results in just and reasonable rates. Despite PPL's concerns about sending the wrong message to the investment community, the OCA's recommended return and proposed rate increase have been shown, by PPL's own testimony, to meet the investor expectations that PPL is so concerned about. PPL's own witness presented the recent Morgan Stanley Report, which stated, "PA regulatory staff (adversarial unit) & major intervenor proposed rate increase more supportive than expected, implying incremental EPS of $0.43 - $0.53 – right around our estimate." There is every indication that the investment community will take away the right message from a Commission decision that properly reflects the cost of capital for PPL as recommended by the OCA.

Another significant issue in this proceeding is the sharing of the burden of this rate increase among the customer classes. The OCA and PPL are in agreement as to the allocation of the rate increase, and the principles that should guide the Commission's determination in this matter. Importantly, PPL and the OCA agree that the Commission must fully recognize the continuing transition to fully unbundled rates, and the fact that the unbundling process drove any cross-subsidies in the rates into individual rate components. These cross-subsidies, in many instances, worked in opposite directions. Here, however, the Commission is reviewing only one component – the distribution and transmission component – while generation remains under a rate cap. The OCA submits that allocating the rate increase in a manner that considers the overall rate impacts for the customer classes, while still making progress toward the system average rate of return for each class for distribution service, is the appropriate approach. The proposed allocation of PPL and the OCA achieves this goal. The allocations of the other parties, however, would seek to significantly burden the residential customer class with extremely high rate increases that ignore the time-honored principle of gradualism and produce substantial rate shock for residential customers. These parties would impose this burden on residential customers even though cross-subsidies in other rate elements that might inure to other classes' benefit cannot be addressed. The OCA does not disagree that the first step in moving residential rates closer to the system average return for distribution service should begin in this case, but the allocation proposed by the Company and the OCA achieves this first step while recognizing all of the important factors at issue here.

In its Main Brief, the Company also continues its claim for an unprecedented electric Distribution System Improvement Charge ("DSIC"). The Briefs of the OCA and every other consumer representative compellingly demonstrate that PPL's proposal is contrary to the Public Utility Code, Commonwealth Court precedent, and sound ratemaking principles. PPL's proposal is nothing more than an attrition adjustment that would guarantee it increased rates each year, whether an increase was needed or not. In fact, over the past several years, PPL's depreciation recovery of its existing plant has exceeded its reinvestment in its distribution system. There is no evidence of a significant change in this trend. PPL's proposal for a DSIC must be soundly rejected.

As set forth in the OCA's Main Brief and in the Main Briefs of several other parties, the Company has failed to justify several of its requests or establish that its proposed increase will produce rates that are just and reasonable. As set forth in detail in the OCA's Main Brief and below, it is the position of the OCA that PPL's rate increase should be denied and that the Commission should increase the Company's distribution revenues by no more than $115.2 million as proposed by the OCA. See OCA M.B., Appendix A, Table I.

II. SUMMARY OF REPLY ARGUMENT

As indicated in the OCA's Main Brief, the OCA submits that rather than allowing a distribution rate increase of $164.4 million as originally proposed by the Company, the Commission should allow a rate increase of no more than $115.2 million as proposed by the OCA. For the reasons discussed below, and in the OCA's Main Brief the OCA submits that the arguments presented in PPL's Main Brief are not supported by substantial evidence and otherwise fail to meet PPL's burden of proof and the requirements of the Pennsylvania Public Utility Code. The OCA urges the Commission to adopt the recommendations of the OCA.

III. RATE BASE

A. Introduction

In its Main Brief, the Company claims that its total Pennsylvania jurisdictional rate base as of December 31, 2004, the end of the future test year, is $1,837,003,000. PPL M.B. at 17. This amount reflects several rate base adjustments proposed by the OCA and accepted by the Company. Id. As explained in the OCA's Main Brief, the rate base adjustments agreed upon are plant held for future use and customer deposits. See OCA M.B. at 14. The rate base issues remaining and addressed in the OCA's and the Company's Main Briefs are cash working capital and prepaid postage. The OCA submits that for the reasons set forth in its Main Brief, and in this Reply Brief, the Company's claim for rate base of $1,837,003,000 should be adjusted to reflect the OCA's recommendations. The adjustments made to rate base by the OCA result in a recommended rate base of $1,829,071,000. Id. at 20, Appendix A, Table II.

B. Prepaid Postage

PPL's recommended rate base includes a claim for the net lag in recovery of operating expenses based upon a lead/lag study, which impacts cash working capital, and a separate claim for average prepayments. PPL M.B. at 18. As explained by the OCA in its Main Brief, PPL's claim for prepaid postage included in the average prepayment balances as well as the lead/lag study results in a double recovery. PPL disagrees that a double-count is occurring. Id. at 19.

According to PPL, PPL bases its prepaid postage adjustment on two components. PPL M.B. at 19. First, PPL explains that as it sends out bills, it draws down from the prepaid postage balance to a specified level. Id. When the Company reaches

this specified level, it makes a new prepayment for postage to replenish its postage meter. Id. These prepayments are recorded as an asset on the Company's balance sheet and included in the claimed average prepayment balance in rate base, but the Company also includes postage expense in its lead/lag study with lead days assigned. Although the Company argues that these two components are measuring different periods of time, this argument is incorrect. See OCA St. 1-S at 5.

As OCA witness Lafayette K. Morgan explained:

> When lead days are applied to an expense it measures prepayment of an expense, and it has the effect of increasing the allowance for cash working capital. The lead/lag study is based upon measuring time intervals and converting the effect of the interval into working capital requirements. That working capital amount is then added to rate base for the company to earn a return on it.
>
> In this instance the Company has calculated the lead days from the prepayment date to the date the postage was used. Consequently, the working capital for that period of time has been fully captured by the lead/lag study, and there is no need to add prepaid postage to rate base.

OCA St. 1-S at 5-6.

The Company has included the balance of prepaid postage in rate base to reflect the fact that it purchases postage in advance of using it to send bills. The OCA does not dispute that PPL has a prepaid postage balance. However, the manner in which PPL has measured the postage lead for its lead/lag study fully accounts for this prepayment. In its lead/lag study, PPL has measured the expense lead for postage expense based on the time from when it first purchases the postage (when it is prepaid) until when the postage is used to send bills (or other correspondence) to customers. Because the revenue lag is added to this postage expense lead in the lead/lag analysis, the

Company's cash working capital allowance accounts for the full time from when postage is first purchased until customers pay their bills. Accordingly, there is no need to separately include the balance of prepaid postage in rate base.

Based on the evidence submitted by the Company, the OCA submits that the Company's claim for prepaid postage expense of $361,000 should be removed from rate base.

C. Cash Working Capital

In its Main Brief, the Company takes issue with various expense adjustments resulting from the OCA adjustments relating to, *inter alia*, PPL's universal service programs. These issues are addressed in the Company's Main Brief relating to the individual expenses impacting the Company's cash working capital claim and will be addressed in the particular expense portions of the OCA's Reply Brief. The OCA submits that PPL's cash working capital claim should be $7,571,000 after the Pennsylvania jurisdictional allocation factor is applied. OCA M.B. at 17.

IV. REVENUES

A. Late Payment Revenues

In its Reply Brief, PPL disagrees with OTS's proposal to increase revenues for late payment fees. PPL M.B. at 27. PPL agreed with OTS's recommendation to include an additional $336,000 in revenues but did not accept OTS's adjustment based on the use a three-year instead of a five-year period. PPL St. No. 2-R at 16. At the surrebuttal stage of this proceeding, the OCA agreed with OTS's adjustment of $336,000 and the use of a three-year average ratio. OCA St. No. 1-S at 3-4; OCA M.B. at 21. As the OCA explained in its Main Brief, the Commission has found the three-year average to be reasonable for estimating uncollectibles and, therefore, a three-year average is appropriate for calculating late payment revenues. OCA M.B. at 21. The OCA recommends an adjustment of $330,000 after the Pennsylvania jurisdiction allocation factor is applied to the $336,000 adjustment to late payment revenues. The OCA also recommended that the late payment revenues reflect the rate increase. The OCA made an adjustment to increase late payment revenues by $1,080,000 to reflect this rate increase.

The Company expressed concern with the OCA's claim that the increase in late payment revenues resulting from the rate increase should be reflected. PPL M.B. at 28; See OCA St. No. 1-S at 3-4. PPL explained that it agrees with the logic of the OCA's adjustment in this regard but claims that the same logic applies to the Company's uncollectible expense, which would increase by $1,044,000 if the same numbers of customers fail to pay their bills. PPL M.B. at 28. This, the Company claims, should offset the OCA's adjustment of $1,080,000. Id.

The OCA submits, however, that the Company has incorrectly applied this logic to uncollectible accounts without addressing the fact that many aspects of the Company's uncollectible expense are within management's control and can be affected by Company policies and procedures. For example, PPL's credit and collection procedures impact the level of uncollectibles. The number of months that a customer is allowed to be behind before collection activity or termination activity is pursued will have an impact on uncollectible expenses. Late payment revenues, on the other hand, occur when customers pay their bills late, even though they may pay the bill in full. Therefore, the late payment revenues do not necessarily correlate to the Company's level of uncollectibles. The Commission should reject the Company's proposal to offset the OCA's late payment revenue adjustment with the Company's proposed uncollectibles expense adjustment.

V. EXPENSES

In its Main Brief, PPL states that it reduced its originally claimed annual operating and maintenance expenses by $11,679,000 and that these reductions will be flowed through to customers. PPL M.B. at 29. The reduction is a result of the Company's acceptance of many of the adjustments proposed by the OCA and other parties. The OCA expense issues remaining are the universal service program costs, which will be addressed in the universal services section of the OCA's Reply Brief; Hurricane Isabel costs; and AMR displacement costs. The OCA submits that for the reasons set forth in its Main and Reply Briefs, the Commission should adopt the OCA's remaining adjustments to the Company's proposals on these items.

A. PPL's Request for Recovery of Hurricane Isabel Expenses Should Be Rejected

PPL argues that it should be entitled to recover the costs associated with Hurricane Isabel that PPL incurred in 2003. PPL M.B. at 32-40. The Company argues that these storm damage expenses were extraordinary and recovery should be permitted under the exceptions to the bar against retroactive ratemaking. PPL also argues that recovery would not violate the rate caps since recovery would be through prospective rates, and it was rates, not costs, that were capped under the Act. As set forth below, and as set forth in the OCA's Main Brief, PPL's arguments do not justify recovery of this expense.

In its Main Brief, PPL first argues that the expenses associated with Hurricane Isabel were extraordinary and are, therefore, eligible for recovery under the exceptions to the bar against retroactive ratemaking. PPL M.B. at 32. PPL cites to numerous cases addressing the exceptions to retroactive ratemaking. PPL M.B. at 32-34. The OCA submits, however, that PPL's analysis of exceptions to the doctrine against

retroactive ratemaking is completely off the mark. The exceptions that control this case are the exceptions to the rate caps set forth in Section 2804(4)(iii), not the exceptions to the prohibition against retroactive ratemaking. 66 Pa.C.S. § 2804(4)(iii). In this first case for PPL following the rate cap period, it is the rate cap that controls a request for such recovery of past costs.

It is undisputed that the costs that PPL seeks to recover were incurred during 2003, prior to the expiration on December 31, 2004 of the transmission and distribution ("T&D") rate caps agreed to by PPL in the Company's Restructuring Settlement at Docket No. R-00973954. OCA St. 2 at 11. To allow recovery of these costs now would constitute a *de facto* rate cap exception in violation of the Electricity Generation Customer Choice and Competition Act (the "Act") and PPL Electric's Restructuring Settlement. See ARIPPA *et al.* v. Pennsylvania Public Utility Commission, 792 A.2d 636 (Pa. Commw. Ct. 2002)(ARIPPA). As the Commission and the Commonwealth Court made clear in the case involving the former GPU Energy Companies, deferral of costs during the rate cap period for recovery outside of the rate cap period is the same as an exception to the rate cap. Petition of Metropolitan Edison Company and Pennsylvania Electric Company For Interim Relief Pursuant To Section F.2 Of Their Approved Restructuring Plan, Docket Nos. P-00001860 and P-00001861, (Reconsideration Order of February 21, 2001), Id. at 663-666.[1]

[1] In discussing ARIPPA, PPL suggests that the Court's discussion was limited to addressing whether purchased power costs are stranded costs. PPL M.B. at 37. Such a suggestion is incorrect. As explained in the OCA's Main Brief, the Court was specifically analyzing whether the deferred recovery of purchased power costs would meet the requirements for a rate cap exception. OCA M.B. at 28. The Court also found that such costs did not qualify as stranded costs, barring another avenue of recovery that GPU had sought. ARIPPA, 792 A.2d at 666-668.

The statutory rate cap contains limited exceptions in Section 2804(4)(iii). A review of those exceptions reveals that there is no exception to the rate cap for storm damage. 66 Pa.C.S. § 2804(4)(iii). The storm damage costs that PPL has deferred and now seeks to recover in the instant proceeding are the types of costs encountered by an electric distribution company ("EDC") in operating and maintaining its distribution system over the course of many years. Therefore, these are the very types of costs that the EDC was at risk for under the statute and that PPL was at risk for under its Restructuring Settlement. The fact that the storm was significant or "extraordinary"—as PPL argues—does not change this fundamental point. Through the rate cap, operating risks, including risks of events like storms, were assumed by the Company, with only limited specified exceptions. PPL's claim does not meet any of the specified exceptions in either the Statute or the Restructuring Settlement.

PPL also asserts that it is not seeking a rate cap exception, since recovery of the costs will commence in *prospective rates*, after the rate cap period expires. PPL M.B. at 35-36. If an EDC were simply able to defer costs for subsequent recovery until after the agreed-upon rate cap expired, the rate caps would be meaningless. It was surely not the General Assembly's intent to allow the rate caps to be so easily circumvented.[2]

As set forth by OCA witness Catlin, allowing recovery of Hurricane Isabel costs beginning in 2005 is effectively the same as having allowed an exception to the rate cap to permit recovery in 2003 or 2004. OCA St. 2-S at 3. The PUC and the

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[2] PPL also argues that it was rates not costs that were capped under the Act. PPL M.B. at 12. PPL makes a distinction without a difference. The only way to recover increased costs from ratepayers is to raise rates. Indeed, the exceptions to the rate cap itemized in Section 2804(4)(iii) refer to specific items of cost such as taxes, nuclear decommissioning costs, distribution system upgrade costs, purchased power costs, fuel costs, non-utility generation costs. PPL's attempt to distinguish rates from costs under the rate cap provisions of the Act and the Restructuring Settlement simply fails.

Commonwealth Court have agreed. PPL's claim here does not meet any of the exceptions to the rate cap contained in the Act or PPL's Restructuring Settlement. PPL assumed the risk of operating costs, whether extraordinary or not, during the rate cap period and this risk cannot now be transferred to ratepayers.

For the reasons set forth above, and for the reasons set forth in the OCA's Main Brief at 23-30, the Company's claim for Hurricane Isabel costs must be denied. This adjustment reduces future test year expenses by $3,002,000 and increases net income after taxes by $1,756,000. OCA Schedule LKM-3S (Revised).

B. PPL Should Not Be Allowed To Recover The $8.8 Million Associated With Its AMR Displacement Costs

In its Main Brief, PPL argues that it should be allowed to recover $8.8 million related to employee displacement costs as a result of the Company's AMR implementation. PPL M.B. at 40-47. PPL argues that: 1) recovery of these costs (recorded as a charge to the Company's books in 2003) will not constitute a breach of PPL's rate caps, 2) non-economic benefits will be realized as a result of the AMR implementation, and 3) even though the $8.8 million represents an expense accrual, the Company should still be allowed recovery of this amount. As discussed in the OCA's Main Brief at 30-34, each of these reasons must fail.

First, as discussed with regard to the Company's claim for Hurricane Isabel costs, allowing PPL to now recover an expense accrual incurred during the rate cap period would constitute a *de facto* exception to the rate cap. See, ARIPPA *et al.* v. Pennsylvania Public Utility Commission, 792 A.2d 636 (Pa. Commw. Ct. 2002)(ARIPPA) and Petition of Metropolitan Edison Company and Pennsylvania Electric Company For Interim Relief Pursuant To Section F.2 Of Their Approved Restructuring

Plan, Docket Nos. P-00001860 and P-00001861, (Reconsideration Order of February 21, 2001), p. 4-5. PPL has not identified any applicable exception to the rate cap for this expense and there is none that is applicable. There is simply no basis for recovery of this cost from the rate cap period.

Second, the Company's argument that non-economic benefits should be recognized in determining whether the costs exceed the benefits of the AMR implementation is misplaced. The OCA has not challenged the Company's decision regarding AMR implementation, but rather has challenged one element of cost recovery associated with this program. The non-quantifiable benefits that the Company seeks to include are uncertain, unverifiable, and might not even materialize. Some of these purported benefits are generation-related, and could accrue to other entities. See PPL St. 4 at 16. Such uncertain and distant benefits do not support recovery of the AMR displacement costs, particularly when the Company may never have to make a cash contribution to fund this expense.

Finally, PPL argues that whether it makes a cash outlay or not, is irrelevant, analogizing this argument to the recovery of its pension expense. PPL M.B. at 45-46. PPL's analogy does not work in this instance. The termination charge at issue here is a one-time accrual under FAS 88, which did not require a cash outlay by the Company because the pension trust fund balance is over funded. OCA St. 2 at 12. As noted by Mr. Catlin, depending on the performance of the pension trust fund, PPL may never be required to make a cash contribution. OCA St. 2 at 14. The FAS 87 pension accrual is an annual accrual, not a one-time accrual, which is intended to account for the annual pension obligations incurred on behalf of PPL's entire workforce.

For the reasons set forth above, and in the OCA's Main Brief at 30-34, the OCA submits that the Company's claim for recovery of $8.8 million of AMR displacement costs should be rejected. Rejection of this claim will have no effect on PPL's displaced employees since the termination benefits have already been assured and will be paid from the pension trust fund. This adjustment reduces future test year expense by $1,764,000 and increases net income after income taxes by $1,032,000. OCA St. 2 at 14; OCA St. 1, Sch. LKM-8S.

C. Universal Service Programs

In its Main Brief, PPL takes issue with the OCA's adjustment to the Company's expense for OnTrack and WRAP funding. The OCA will address these issues in Section X of this Reply Brief. The OCA submits that the Commission should base PPL's universal service expense on PPL's proposed expenditures for 2005 and 2006. The OCA proposes a normalization of expense over those two years.

VI. TAXES

A. Capital Stock Tax

In its Reply Brief, PPL takes issue with two components of the OCA's adjustment to its capital stock tax claim: 1) the exclusion of net income data for the 2000 and 2001 tax years and the corresponding inclusion of 2005 data, and 2) the use of the 5.99 mill rate that is to be effective January 1, 2005. PPL M.B. at 56. The Company argues that the OCA's adjustments are incorrect.

With regard to the OCA's adjustment regarding exclusion of the 2000 and 2001 tax year information, PPL claims that elimination of the 2000 and 2001 tax year data is incorrect because the capital stock tax is based on an average of net income for the past five years and that is how it has calculated net income in previous rate proceedings. Id. at 57. As the OCA stated, however, the reason the 2000 and 2001 tax year data must be excluded is because PPL owned and operated generation assets that were included in the net income calculations for 2000 and 2001. As the Commission is aware, PPL's rate case is the first major distribution-only rate case before the Commission. There is no basis for reflecting the tax effect associated with previously owned generation assets in the distribution rates.

For this same reason, PPL's reliance on its procedures from its prior rate proceedings, which occurred when PPL was a fully integrated utility, must fail. Since restructuring, the cost of generation operations should no longer be included in the distribution rates. OCA M.B. at 42. The Company's claim for capital stock tax would include generation operations in distribution rates, and the Commission should, therefore, exclude 2000 and 2001 tax year data from PPL's claim.

PPL also objects to the use of 2005 projected net income, contending that use of information beyond the future test year is contrary to Commission regulation.[3] PPL M.B. at 57-58. The OCA submits that using the projected net income for 2005 allows more data to be included in the average calculation and considers that the Company's net income will increase as a result of a rate increase that is granted. OCA M.B. at 40. Taking this factor into account in this instance is necessary.

PPL further takes issue with the OCA's removal of the gross-up factor from the Company's capital stock tax claim. PPL M.B. at 58-59. PPL claims that removal of the gross-up factor is inconsistent with the way it calculates other taxes and with the way rates were set in all prior proceedings. Id. at 59. As explained by the OCA in its Main Brief, because the 2005 net income is included in the capital stock tax calculation, the effect of the rate increase is already reflected and, therefore, the revenue gross-up factor should not include a component for capital stock tax. OCA M.B. at 41. Because the OCA included the 2005 net income in its capital stock tax calculation, it removed the Company's gross-up factor of $471,000 from the revenue requirement. Id.

PPL's other disagreement is with the OCA's use of a 5.99 mill tax rate that is to become effective on January 1, 2005 the date new rates go into effect. PPL M.B. at 57-58. PPL proposes to set rates based on a tax rate of 6.99 mills, the 2004 capital stock tax rate. Id. Although the Company agrees that 5.99 mills is the rate to become effective on January 1, 2005, the Company proposes to use the state tax adjustment surcharge ("STAS") mechanism to adjust its tax rate when the 5.99 mill tax rate goes into effect on January 1, 2005. Id. at 58; PPL St. 5-R at 16-17. PPL argues that the 2004 rate should be

[3] PPL further explains that the Department of Revenue requires five-year average net income in calculating the tax amount and that 2000 through 2004 should be used. PPL M.B. at 57. As discussed above, PPL owned generation assets in 2000 and 2001.

used because some prior capital stock tax reductions did not go into effect as originally planned. PPL M.B. at 58.

The OCA submits that the Commission should not rely on the possibility of a change in a statute in setting rates in this proceeding. There is no evidence in this case that the capital stock tax rate for 2005 will be rescinded or changed. Although the General Assembly did slow down the phase-out of the capital stock tax in 2002 and 2003, during cross-examination, Company witness Kleha agreed that the reason the tax decrease was slowed in 2003 was to address a large deficit facing the Commonwealth. Tr. 425. No such change in the capital stock tax rate was enacted by the General Assembly in the 2004 budget process.[4]

Moreover, the Company's reliance on the STAS mechanism is contrary to the Commission's regulations. The Commission's regulations relating to payment of state taxes provides that the state tax adjustment surcharge must be zeroed and rolled into base rates in a company's base rate filing. See 52 Pa. Code § 69.55. The capital stock tax rate for 2005 is 5.99 mills as set by legislation. This will be the tax rate on January 1, 2005, the day PPL's new rates will go into effect. PPL should zero out its STAS as required by the regulations.

[4] PPL opines that if the General Assembly changed or rescinded the tax rate retroactive to January 1, 2005, it would have to make a large adjustment. PPL M.B. at 58. The Company would have to do this under its proposed approach anyway since the STAS has to reflect the lower rate to customers on January 1, 2005. Tr. 427.

VII. COST OF CAPITAL

A. Introduction

In support of its rate of return request, at page 60 of its Main Brief, PPL argues that the Commission should look beyond the facts of this case to set PPL's prospective rates. A substantial portion of PPL's argument is devoted to the idea that the Commission should set its rates not to balance ratepayer and shareholder interests, but instead to please the investment community, and to avoid any perception of a "change" in the "quality" of Pennsylvania's utility regulation. PPL M.B. at 60. These are not the standards used to set utility rates in Pennsylvania, and they reach to factors and considerations well beyond the record in this proceeding. Here, the Commission is considering rates for PPL; it would be entirely inappropriate to set PPL's rates based on such considerations. PPL M.B. at 60.

PPL also argues that it would be a "dangerous path" for the Commission to adopt the level of rate increase proposed by the OCA. PPL believes this would be contrary to investor expectations. PPL M.B. at 63. This is entirely incorrect. PPL ignores the fact that PPL provided evidence here to show that Goldman Sachs wrote that PPL's stock was "still attractive at current levels" in January of 2004, a full year before the OCA's $115.2 million increase would be added to PPL's base rates. PPL M.B. at 90. The Company engages in hyperbole; the real danger here is that PPL's ratepayers will be subject to excessive rates if PPL is awarded a return on equity above 9.50%.

In fact, PPL presented recent evidence showing that the OCA's recommendation *exceeds* the published expectations of the investment community. PPL St. No. 10-R at 2-3. Directly addressing the OCA's recommendation, Morgan Stanley

wrote that it was "more supportive than expected," and that it produced earnings "right around our estimate." Id. Those earnings also agree with the published expectations of all the other institutional investors cited by PPL. PPL M.B. at 90-91. It would thus appear that OCA witness Kahal's recommendation is right on target. As the OCA will discuss below, PPL's myriad upward adjustments to its DCF model and its CAPM model, its arbitrary exclusion of data from its proxy group calculations, and its overstated growth rate are all symptomatic of PPL's excessive request. PPL's recommendation would clearly produce a return far in excess of a fair rate of return.

PPL also overstates its case when it continues to suggest that it has a significant business risk. PPL fails to acknowledge that its risk is now lower than it was when it operated as a fully integrated utility. In past filings with this Commission, the Company has recognized that as a wires-only company, it has lower business risk. OCA Cross Exam. Exh. No. 1 at 3. It has also written that its agreement for generation supply lowers its risk even further. Id. at 5. Here, though, the company overstates its risk in an attempt to increase its return on equity award.

The Company also seeks to increase it return on equity award by arguing that it should receive a management efficiency award. PPL M.B. at 4, 68. PPL seeks an additional award though it is only doing what it is legally obligated to do in the first place – provide safe and adequate service at just and reasonable rates. 66 Pa.C.S. § 1501. The Commission should not provide the utility with management bonuses for simply doing its job.

Before discussing the Company's arguments in more detail, the OCA would note that throughout its Brief, the Company misconstrues the Commission's

reasoning in the recent Pa. P.U.C. v. Aqua Pennsylvania, Inc., Docket No. R-00038805, Opinion and Order (August 5, 2004)(Aqua PA)(relevant excerpt in OCA Main Brief in Appendix C). The Company argues that this case stands for the proposition that its proposed multi-model averaging technique is now accepted practice to determine cost of equity. The Company is wrong. This case simply states that other models may be used as a *check* on the DCF model. Aqua PA at 61-62. This is exactly how Mr. Kahal used his CAPM model here, and his result is thus in accord with Commission precedent. OCA St. No. 3 at 32. Mr. Moul's methods, on the other hand, are contrary to the Commission's direction in Aqua PA, and in addition, his averaging method was not adopted by the Commission in that case. For the reasons set forth in the OCA's Main Brief and below, the OCA submits that it is appropriate for the Commission to award PPL no more than a 9.50% return on equity.

In addition, the Company attempts to portray the OCA's recommended 9.50% return on equity as being out of step with 2003 state commission decisions from across the United States. PPL M.B. at 62. The OCA points out that PPL's arguments only show that some decisions are above and others are below.[5] Also, these rates reflect all utilities – integrated, non-integrated, utilities with non-regulated assets, electric, sewer, water, gas, telephone. This comparison is inappropriate and not in accord with

[5] A decision to adopt the 9.50% cost of equity recommended by the OCA is not out of step with other regulatory determinations as PPL alleges. PPL M. B. at 62. The data that PPL provides there only shows that Pennsylvania awards rates lower than those provided by some state commissions and higher than others. There are, however, a large number of cases where regulatory determinations have awarded a cost of equity in the range proposed by the OCA. For example, just such a result has occurred in these cases: Re Chazy & Westport Telephone Corp., Case 02-C-1294, N.Y. PUC LEXIS 475 (2003) (ROE – 8.01%); Re Crown Point Telephone Corp., Case 02-C-1293, N.Y. PUC LEXIS 474 (2003), (ROE – 8.93%); Re Fishers Island Electric Corp., Case 03-E-0513, 02-E-0993, N.Y. PUC LEXIS (2003)(ROE – 9.0%); Re Lower Valley Energy, Inc., Docket No. 30018-GR-02-15, Wyo. PUC LEXIS 128 (2003)(ROE – 9.21%); Re St. Lawrence Gas Co., Case 02-G-1275, 02-G-1011, N.Y. PUC LEXIS 427 (2003)(ROE – 9.5%); Re Jersey Central Power & Light Co., Docket No. ER02080506, N.J. PUC LEXIS 248 (2003)(ROE – 9.5%).

Pennsylvania law. PPL's arguments and evidence do not support its case, particularly for a distribution only electric case.

B. PPL's Own Evidence Proves That The OCA's 9.50% Cost Of Equity Recommendation Meets Investor Expectations

In its Main Brief, the Company argues that the OCA's recommended 9.50% cost of common equity does not meet investor expectations. PPL M.B. at 63, 64, 88-92. While PPL has provided testimony that it seeks an 11.50% cost of equity, it also states that investors expect a cost of common equity in the range of 10 to 12%. PPL M.B. at 63, 71. To support its position, PPL provides a January 28, 2004 quote from a Goldman Sachs report. PPL M.B. at 90. There, Goldman Sachs provided that "earnings upside from the rate review could be substantial, with approval of even a low 10.5% ROE potentially adding $.045 to earnings." PPL M.B. at 90. PPL also quotes a January 29, 2004 Merrill Lynch report providing much the same information. PPL M.B. at 90.

PPL fails to recognize, however, that its witness, Ms. Cannell, provided a more recent June 30, 2004 Morgan Stanley. There, Morgan Stanley provided an analysis that expressly addressed the OTS and OCA recommendations. In its report Morgan Stanley provided:

> PA regulatory staff (adversarial unit) & major intervenor proposed rate increase **more supportive than expected**, implying incremental EPS of $0.43 - $0.53– **right around *our estimate***. *We see this as a worse case scenario, and we think PPL could ultimately receive a better deal in Dec. final decision or through settlement.*

PPL St.No. 10-R at 2-3 (emphasis added). If these quotes are to be taken for investor sentiment as PPL contends, it is clear that this quote shows that the OCA's recommendation is entirely consistent with investor estimates. Indeed, the earnings per

share estimate of this report shows that Mr. Kahal's 9.5% recommendation will produce exactly what all PPL's quoted sources expect -- earnings in the range of $0.43 to $0.53 per share. PPL's evidence on this point conclusively proves that Mr. Kahal's recommendation is right on target.

In addition, the OCA points out that the January 2004 Goldman Sachs report discussed above is titled "PPL (OP/N): Stock Still attractive at current levels." Mr. Kahal's recommendation will provide PPL with a substantial earnings increase in addition to the Company's January 2004 performance. Clearly, this will make PPL's stock even more attractive to investors than it was in January of 2004. PPL's own evidence shows that its arguments to the contrary are without merit.

C. The Company's Risk Exposure As A Wires-Only Distribution Company Is Lower Than When It Was A Fully Integrated Utility

At page 61 of Main Brief, PPL argues that the parties have misstated PPL's current level of risk as a distribution company. PPL M.B. at 61. PPL then proceeds to compare its risk levels not with the former integrated utility of which it was a part or to the proxy groups at issue in this proceeding, but instead to American Water Capital Corporation, a non-utility financing vehicle used by Pennsylvania American Water Company ("PAWC") and to Aqua Pennsylvania ("Aqua PA"), a regulated water utility. PPL M.B. at 62. The Company makes this comparison in an attempt to show that it has more risk than either of these entities, and should therefore receive a cost of equity award larger than 10.60%, the amount recently awarded to the regulated PAWC and Aqua PA. PPL M.B. at 62. The OCA points out that while the Commission did award a 10.60% cost of equity to PAWC, it did not award a cost of equity to American Water Capital Corporation; PPL's implication on this point is misleading. PPL's attempt to

compare itself with a water utility and an unregulated financing company is wholly without merit. In any event, the appropriate comparison in this regard is between PPL and the companies in the Commission's adopted proxy group with recognition of PPL as a wires-only company. Clearly, Aqua PA and this financing corporation have nothing to do with any proxy group put forward by any witness in this proceeding.

The evidence in this case shows that PPL has a reduced risk as a distribution company that must be recognized in this proceeding. Mr. Kahal explained PPL has been transformed from an integrated utility with a high degree of generation asset concentration to a low risk delivery service company. OCA St. No. 3 at 6. This change in business profile alone warrants a reduction in the authorized return. Id.

Indeed, in OCA Cross Examination Exhibit No. 1, which is a PPL application to the Commission for approval for PPL to issue additional debt, the Company provides the following:

> the current capital structure of PPL Electric Utilities continues to reflect its prior role as the owner of generating assets. In order to more accurately reflect the lower business risk of a wires company, and to reduce its overall cost of capital, PPL Electric Utilities has decided to increase the amount of debt in its capital structure.
>
> ***
>
> [t]o further reduce its operating risk and to establish an arms length separation from its affiliates, PPL Electric Utilities will solicit bids to contract with energy suppliers for a generation supply agreement...

OCA Cross Exam. Exh. No. 1 at 3, 5. This clearly states, in the Company's own words, that it is not as risky as the previously integrated PPL.

PPL also asserts that its bond ratings reveal its level of risk, and because its risk level is greater than that of American Water Capital Corporation (which PPL refers to as PAWC in its Brief) and Aqua PA, it should therefore receive a higher cost of equity award than 10.60%. PPL M.B. at 62. The OCA points out that this contradicts Mr. Moul's testimony that changes in the Company's bond ratings "really don't reveal any significant change in the Company's risk since the last case." Tr. at 563. If changes in the Company's bond ratings do not reveal changes in its level of risk, then it would be incorrect to conclude that the Company's risk levels are revealed through its bond ratings. The Company's Brief is therefore out of step with its own testimony.

All this shows that the Company has not made a showing that its risk level is any different from that of the proxy group companies representing electric utilities such as PPL. The OCA submits that PPL's comparison with an unregulated entity and to a water company to suggest that it has a higher risk profile is unpersuasive and should be disregarded. If anything, PPL has a lower risk profile than in its last base rate case, which must be recognized in this case.

D. Mr. Kahal's Recommended 9.50% Cost Of Common Equity Will Provide The Company With Sufficient Interest Coverage

The Company argues that its credit ratings will suffer if the Commission were to provide it with the OCA's 9.50% cost of equity. Mr. Kahal addressed this concern. He testified: "[m]y rate of return recommendation incorporates a 51.6% debt ratio (below the 53 to 55 percent cited by Ms. Cannell) and would provide a pro forma pre-tax interest coverage ratio of 3.3x." OCA St. No. 3 at 20. Related to the issue of interest coverage is that of cash flow. Mr. Kahal's 9.5% recommendation also provides adequate cash flow for PPL. He testified:

I agree that the ability to fund construction is important, and the Company's cash flow appears adequate in that regard. The construction estimates cited by Mr. Moul appear to be a slight reduction from PPLEU's actual construction outlays in 2002 and 2003.

Although it is difficult to forecast cash flow, the following table shows what PPLEU's cash flow would have been in 2001 through 2003 had the Company actually earned the 9.5 percent on equity that I recommend in this case (i.e., $117 million based on $1.23 billion of common equity.)

PPL Electric Utilities Corporation
Pro Forma Cash Flow Analysis
(Million $)

	2003	2002	2001
Cash Flow from Operations	$528	$274	$392
Adjustment to Earnings at 9.5% ROE	+92	+ 78	(02)
Pro Forma Cash Flow from Operations	$620	$352	$390
Construction	(235)	(224)	(138)
Net Cash Flow	$385	$128	$252

Source: SEC Form 10K for 2003

Cash flow from operations, adjusted for earnings of $117 million (i.e., 9.5 percent ROE) clearly are strong and can finance construction. Moreover, cash flow coverage appears to be more than sufficient to meet the 3.0 x to 3.1 x standard cited by Ms. Cannell. For example, the pro forma 2003 results, at a 9.5 percent ROE, would provide a cash flow coverage ratio of nearly 4.0x.

OCA St. No. 3 at 20-21. Thus, Mr. Kahal's recommended 9.50% cost of common equity provides interest coverage and cash flow that is more than adequate. PPL's arguments that it will not be able to finance its operations, particularly construction, are simply

incorrect. As Mr. Kahal points out, the Company's construction outlays for the future test year are lower than in the recent past. OCA St. No. 3 at 20.

E. Mr. Kahal's Recommendation Is In Accord With The Commission's Recent Decision In The Aqua PA Proceeding

In its Main Brief, the Company argues that only PPL witness Moul's analysis is in accord with the most recent Commission ruling on return on equity in the Aqua PA proceeding. PPL M.B. at 71, 75, 76. The Company argues that Aqua PA has changed the Commission's reliance on the DCF model, and stands for the proposition that multiple cost of equity models must be relied upon to determine the cost of equity because the DCF model understates cost of equity. Id. The Company overstates the Commission's Order in Aqua PA.

In the Aqua PA proceeding, the Commission did not alter its long-standing policy of using the DCF model to determine cost of common equity rates. Rather, the Commission reasoned that other models are to be used "as checks upon the reasonableness of the DCF results." Pa. P.U.C. v. Aqua Pennsylvania, Inc., Docket No. R-00038805, Opinion and Order at 61-62 (August 5, 2004)(emphasis added)(Aqua PA)(relevant excerpt in OCA Main Brief in Appendix C). The Commission provides the following in the Aqua PA Order:

> We have often relied on the DCF methodology and informed judgment in arriving at our determination of the proper cost of common equity. *See Pennsylvania Public Utility Commission v. Philadelphia Suburban Water Company*, 71 Pa. PUC 593, 623-632 (1989); *Pennsylvania Public Utility Commission v. Western Pennsylvania Water Company*, 67 Pa. PUC 529, 559-570 (1988); *Pennsylvania Public Utility Commission v. Roaring Creek Water Company*, 150 PUR4th 449, 483-488 (1994); *Pennsylvania Public Utility Commission v. York Water Company*, 75 Pa. PUC 134, 153-167 (1991); *Pennsylvania Public Utility*

> *Commission v. Equitable Gas Company*, 73 Pa. PUC 345-346 (1990).
>
> ***
>
> The ALJ recommended a 10.0% cost of equity, relying too heavily on the DCF methodology. However, the ALJ failed to sufficiently consider the other standard financial models, including Comparable Earnings, the Risk Premium Model, and the CAPM, as checks upon the reasonableness of the DCF results. *See generally, PA P.U.C. v. Pennsylvania Suburban Water Company,* 219 PUR 4th 272 (2002).

Aqua PA Order at 61-62 (emphasis added). This is hardly a dismissal of the DCF model as the Company implies. The Commission simply reasons that cost of common equity models other than the DCF model are to be used as a check on the DCF model results. This in no way endorses any other model to replace the DCF model as the Commission's preferred method of setting rates. And, this in no way is an endorsement of Mr. Moul's methodology that averages the results of four different methods to arrive at a recommendation.[6] The Company is incorrect to assert otherwise.

The Commission has frequently rejected methods other than the DCF model as it did the CAPM and RP methods in the Company's previous rate proceeding in 1995. Pa. P.U.C. v. Pennsylvania Power and Light Co., 85 Pa. PUC 306 (1995)(PPL 1995 at 377, 388. When determining cost of equity in Pa. P.U.C. v. Pennsylvania Power Co., 67 Pa. PUC 91, 164; 93 PUR4th 189 at 266 (1988) the Commission discussed its reasons for rejecting the CAPM and RP approach. The Commission stated:

> [F]irst, we cannot accept that historic experienced earnings reflect the cost of capital. We know of no reputable analyst who would seriously argue that experienced earnings represent the cost of capital, except by pure happenstance. But, such is the inherent

[6] As the OCA demonstrates in its Main Brief at 73-99, Mr. Moul's four analyses are each severely flawed, inflated, and unreliable.

> assumption of each methodology [Risk Premium and CAPM]. Second, we cannot accept, even assuming that historic experienced earnings represented the cost of capital, that the average premium of an equity investment over a period as long as 50 years, represents the investor required premium in today's and tomorrow's market. Accordingly, we conclude that we can place *little credence in the results of these methodologies.*

See also, Pa. P.U.C. v. Pennsylvania Gas and Water Co., 79 Pa PUC 349, 393 (1993). Regarding PPL's request to use alternative methods in its 1995 rate proceeding, the Commission wrote:

> On the basis of the record before us herein we conclude that there is no reason for us to divert from our practice of considering the DCF method exclusively for equity rate of return determinations. Accordingly, PPL's Exceptions regarding this issue are denied.

PPL 1995 at 377, 388. The OCA points out that in Aqua PA the Commission did not adopt Mr. Moul's alternative cost of equity models or the multi-model technique advocated by the Company here.

OCA witness Kahal has performed an analysis that comports with the Commission's Aqua PA decision. Mr. Kahal performed a DCF analysis, and then checked that analysis with his CAPM model. Mr. Kahal devoted a substantial portion of his testimony to the CAPM model he used as a check on his DCF results. OCA St. No. 3 at 30-34. Given the Commission's reasoning in Aqua PA that other methods are to be used as a *check* on the DCF method, it is clear that Mr. Kahal's results are fully in accord with Commission precedent.

In contrast to Mr. Kahal's 9.50% result, the Company's 11.50% request is derived from averaging the result of multiple models. The Company's assertion that this is the method used by the Commission is incorrect. PPL M.B. at 75. Mr. Moul's testimony in support of his 11.50% cost of common equity request provides that "[m]y

recommendation is derived from the results of the four methods/models previously identified." PPL St. 9 at 4-5. Mr. Moul provides that the four methods are the "Discounted Cash Flow ("DCF") model, the Risk Premium ("RP") analysis, the Capital Asset Pricing Model ("CAPM"), and the Comparable Earnings ("CE") approach." PPL St. 9 at 3. The OCA points out that the DOD also developed its 10.75% recommendation using a multi-model technique. Neither the Company nor DOD offers legal support for this hodge-podge technique. Indeed, the Commission has not accepted this technique in the recent base rate cases cited throughout the Company's Brief, namely, Pennsylvania American Water Company and Aqua Pennsylvania. As such, the OCA submits that the Company's reliance on Aqua PA or PAWC to support its 11.50% return on equity is unfounded.

F. The Company's Criticism Of Mr. Kahal's CAPM Analysis And DCF Proxy Group Are Unpersuasive

1. Mr. Kahal's CAPM Analysis Is An Accurate Check On The OCA's Recommended 9.50% Cost Of Common Equity

PPL lists its criticisms of Mr. Kahal's model: 1) he uses actual and not forecasted Treasury yields; 2) he understates the equity premium; and 3) he does not make beta and size adjustments. PPL M.B. at 86. Mr. Kahal addressed these criticisms. First, Mr. Kahal testified that it is improper to use a published forecast of Treasury yields as a substitute for observed, objective market data in performing a cost of capital study. OCA St. No. 3-S at 6-7. Mr. Kahal testified that the forecasts used by Mr. Moul are readily available to investors, and investors still choose to price Treasury bonds to yield roughly 5.25%, and not 6% as Mr. Moul contends. OCA St. No. 3-S at 6-7. What Mr. Moul proposes on this point is incorrect. As Mr. Kahal testified, "[f]or cost of capital

purposes, it is imperative that we use actual, verifiable market data – not speculative forecasts that the market itself does not adopt." OCA St. No. 3-S at 7.

Regarding the appropriate equity premium, Mr. Kahal testified:

> According to the Zack's survey (July 28, 2004), the projected five-year growth rate in earnings for the S&P 500 is 10 percent. Since the S&P 500 dividend yield is about 1.7 percent, this implies a total return of less than 12 percent (about 11.8 percent), consistent with my stated range of 11 to 12 percent. However, as Mr. Moul points out, Blue Chip forecasts corporate profits growth on a long-term basis of about 7 percent (March 10, 2004), and thus even the 11.8 percent rate of return may be too high.

OCA St. No. 3-S at 20(footnote omitted). This clearly shows that Mr. Kahal has not understated the equity premium.

Next, regarding Mr. Moul's size adjustments, Mr. Kahal testified that Mr. Moul failed to show that size is a unique risk factor for electric utilities that must be singled out, and that he failed to understand that the size of the Company is already fully accounted for in the CAPM analysis. OCA St. No. 3-S at 19-20. The Company attempts to show that Mr. Kahal has used a procedure different from that of Mr. Moul to develop his recommendation – he has not. OCA St. No. 3-S at 19-20. What Mr. Kahal has not done is to make adjustments that result in a double count of the risk factors of the proxy group. As Mr. Kahal provides: "[i]f size is a (non-diversifiable) risk factor at all, it would be automatically captured in the published beta statistics for these companies and therefore embodied in the CAPM results. No additional risk adjustment is needed, and in fact, such an adjustment would double count risk." OCA St. No. 3-S at 19-20.

2. Mr. Kahal's Use Of United Illuminating In His Electric Proxy Group Is Appropriate

At page 10 of its Main Brief, the DOD makes the statement that Mr. Kahal added United Illuminating ("UIL") to his proxy group "despite uncertainty over its dividend as reported by Value Line. DOD M.B. at 10, fn. 33. In his direct testimony, Mr. Kahal clearly explained why he rejected Mr. Moul's decision to remove UIL from the proxy group:

> UIL is a delivery service electric utility operating in Connecticut and would qualify both for his and my proxy groups. He excluded it because Value Line indicated the possibility that UIL may reduce its dividend (response to OCA I-22). Specifically, Mr. Moul notes that Value Line reports a "split" dividend yield. It should be noted that Value Line's latest report on UIL (June 4, 2004) has discontinued the split dividend, so it now would be appropriate for Mr. Moul to include this company in his proxy electric group.

OCA St. No. 3 at 27. It is clear that this is no longer an issue with this company, and United Illuminating should be included in the proxy group the Commission uses to set PPL's cost of equity in this case.

G. The Company's 11.50% Cost of Common Equity Lacks The Support Of Commission Precedent and Credible Evidence

1. The Company's Proposed Leverage Adjustment Is Unwarranted And Is Against The Weight Of The Evidence

The Company argues that it is necessary to adjust the DCF model results upward to account for the divergence between the book value of the common equity in its proposed capital structure, and the market value of the common equity contained in the capital structure of the proxy group. PPL M.B. at 77. The OCA addressed the issue of the Company's proposed DCF leverage adjustments extensively at pages 79 through 94

of its Main Brief, and will not repeat that matter here. Nevertheless, the OCA will address several issues raised by the Company in its Main Brief on this topic.

The Company attempts to use the testimony of DOD witness Kincel to support its position regarding DCF model adjustments. PPL M.B. at 79. Mr. Kincel expressly rejected PPL's position on DCF model adjustments in the strongest terms. Mr. Kincel testified:

> I do not agree with the use of the "Leverage Adjustment" applied by Mr. Moul to both the DCF test and the betas used in the CAPM model test of ROE.
>
> ***
>
> There is no need for a further adjustment, as if the market value of a stock was determined with no recognition of the its relationship to book value, the leverage of the company, of the manner in which state commissions set ROE for purposes of computing rates during regulatory treatment

DOD St. at 18. In the DOD's Main Brief, it stated that "to set the record straight, the Commission should include in its final order in this proceeding a statement that in future rate cases brought before it, the application of such 'leverage' adjustments in any ROE analysis will be rejected." DOD M.B. at 13. Clearly, DOD does not support this adjustment as PPL implies. The OCA, OTS and the DOD are in agreement that the Commission should reject this adjustment outright. OCA St. No. 3 at 39; OTS St. No.1 at 25; DOD St. at 18.

In addition, the OCA notes that while the Commission made this adjustment in Aqua PA, the quote offered by PPL states that the Commission is making this adjustment for the purposes of *financial risk.* PPL makes no argument or showing in its Main Brief that it has additional financial risk for which it needs compensation. PPL

M.B. at 75-76. Indeed, it is clear that PPL's evidence shows that it has less financial risk than the companies in the proxy group. Comparing the Company to the proxy groups, Mr. Kahal testified:

> on average PPLEU is somewhat less leveraged. PPLEU has a 46 percent equity ratio (nearly 47 percent under Mr. Moul's recommendation) compared to 43 percent for the proxy group average. Thus, under accepted finance theory, if a leverage adjustment were to be considered, it would be a downward adjustment, not an upward adjustment.

OCA St. No. 3 at 40.

In addition, regarding adjustments to the DCF model results, there is absolutely no legal, credible, factual, or academic support for such adjustments. The Commission should disregard this wholly unsupported attempt on the part of the Company to yet again inflate its cost of equity award.

2. The Company And DOD Propose Growth Rates That Are Excessive And Are Based On Erroneous Data

The Company argues that Mr. Kahal's 3.5-4.5% growth rate is too low, and uses its proposed 5.5% growth rate to support its inflated DCF model results, PPL M.B. at 77, 80. The record contains no credible support for this inflated 5.5% figure; there is no objective criterion upon which this number is based. OCA St. No. 3 at 38. Mr. Moul admitted in cross examination that there is no concrete weighting factor or method used to derive this figure. Tr. at 575. Without some objective measure, this growth factor is no more than an unsupported guess. Mr. Kahal testified:

> This is very difficult to determine from his testimony, appendices or exhibits. His response to OCA I-7 seems to indicate that he assigns the most weight to published projections of earnings (as do I), but he is no more specific than that. His Schedule 11 shows the following proxy group projections of five-year earnings growth rates.

First Call/IBES	3.78%
Zacks	4.00
Reuters Multex	3.81
Value Line	5.72
Average	**4.33%**

> Please note that Value Line growth rates tend to be quite volatile and currently are much lower than the 5.72 percent that Mr. Moul reports. Value Line projections of other variable (dividends, cash flow, internal growth, book value) average only 3.3 percent and historical growth rates are even lower.
>
> Clearly, the available data could support a proxy group (midpoint) growth rate of about 4 percent, but not higher than that, and certainly nowhere close to 5.5 percent.

OCA St. No. 3 at 36-37.

The Company's evidence supporting this inflated growth rate is also incomplete. Mr. Moul provides a chart for projected dividend growth at page 17 of his rebuttal testimony that is missing data for C.H. Energy and UIL.[7] PPL St. No. 9-R at 17. These are two companies that are included in other aspects of Mr. Moul's proxy group. PPL St. No. 9, Exh. PRM-1 at 38. These missing data points have the effect of overstating his average growth rate; Mr. Moul acknowledged on cross examination that his growth rate would decline if these companies were included in the calculation. Tr. at 577-78.

In addition, both PPL and the DOD erroneously reflect a 16 percent growth rate for PEPCO in their growth rate analysis. PPL St. No. 9-R at 17; DOD Exh. KLK-6. This is an error in the reporting of the PEPCO dividend growth rate related to

[7] It is not clear why Mr. Moul cites to the dividend growth data since he purports to rely primarily on published earnings growth rates for DCF purposes. OCA St. No. 3 at 36-37.

the merger with Conectiv that closed in August 2002. OCA St. No. 3-S at 15. Mr. Moul and Mr. Kincel, citing Value Line, report this 16% growth rate. PPL St. No. 9-R at 17; DOD Exh. KLK-6. In reality, Value Line denotes a dividend of $1.04 in 2004 and $1.12 in 2007 - 2009 -- a growth rate of about 3%. OCA St. No. 3-S at 15. OTS Witness Deardorff also pointed out this error. OTS St. No. 1-SR at 5-6. When these missing data points and the correct PEPCO value are used to calculate a growth rate for Mr. Moul's proxy group the result is 3.3 percent, and not 5.5 percent as the Company contends. OCA St. No. 3-S at 14.

The testimony and evidence demonstrate that both Mr. Moul's 5.5% growth rate and Mr. Kincel's 4.8% to 5.5% growth rate range are overstated. In contrast, Mr. Kahal has developed a growth rate with a range of 3.5 to 4.5% based upon the objective criteria of his eight proxy companies. OCA St. No. 3 at 29. This comports closely with Mr. Deardorff's growth rates of 4.13 for his group of six barometer companies, and 4.03 for his group of nine barometer companies. OTS St. No.1, Exh. No 1-SR, Sch. 2 at 1-2. Given the serious problems with the testimony of Mr. Moul and Mr. Kincel on this point, the Commission should adopt Mr. Kahal's growth rate; it is properly supported by the evidence and is consistent with investor expectations.

3. The Company's Proposed Gas Proxy Group Should Not Be Used To Set PPL's Cost Of Equity

In its Main Brief, PPL urges the Commission to adopt Mr. Moul's gas proxy group to set PPL's cost of common equity. PPL M.B. at 78. PPL is alone in this request. The OCA points out that this incompatible proxy group comprises a substantial portion of the high range of Mr. Moul's 11.50% cost of equity. PPL St. No. 9 at 5. Not only is it clear that the parties have identified more appropriate electric proxy groups, but

it is also clear that the other parties reject the notion that this gas proxy group is required here. Regarding PPL's gas proxy group Mr. Kahal testified:

> gas utilities are from an entirely different industry with its own unique set of risks and business issues. These companies use a very different technology to provide their service and sell a different product. It would be appropriate to use the gas companies as a cost of capital proxy in this case only if an acceptable proxy group could not be obtained from the industry that PPLEU belongs to -- delivery service electric utility. Fortunately, both Mr. Moul and I have identified such a group, even though our two groups differ slightly. The gas utility proxy group simply is not needed and potentially may provide misleading results.

OCA St. No. 3 at 27. Likewise, Mr. Kincel testified:

> I did not use Mr. Moul's Natural Gas Group, because, despite similar cost-based regulation, I believe natural gas utilities are not sufficiently similar to electric utilities that an investor will seek the same ROE for both. Natural Gas utilities face different market risks and opportunities than electric utilities, deliver a very different commodity which can be used in applications that electricity cannot, and enjoy a deregulated environment for its commodity that is more well-established and stable throughout the country.
>
> ***
>
> I do believe gas utilities service different markets and confront different risks, and therefore are not directly comparable to PPL for purposes of computing a market-based ROE

DOD St. 2 at 7, 17. Mr. Deardorff also did not use Mr. Moul's gas proxy group to develop his recommendation.

The OCA submits that there is little problem identifying an electric proxy group for the purposes of this case. There is no need to develop proxy groups from

alternative industries that may not be similar to the electric distribution industry. A gas industry proxy group is simply improper and unnecessary here.

H. The Evidence Does Not Support The Company's $15 Million Increase To The Retained Earnings Portion Of Its Capital Structure

In its Main Brief, the Company argues that its proposed $15 million increase to retained earnings portion of its capital structure is justified by the fact that it claims to have $34 million of this amount in hand. PPL M.B. at 73. As Mr. Kahal pointed out, Mr. Moul's adjustment is contrary to PPL's cash flow statements during the past two years – they show that retained earnings have declined, not increased. OCA St. 3 at 13. Mr. Kahal explained:

> The Company's own cash flow statements show the projected retained earnings accumulation for 2004 to be unrealistic. In 2003, PPLEU earnings were $25 million compared to dividend payments of $29 million, and in 2002, earnings were $39 million compared with dividend payments of $63 million. Hence, retained earnings actually declined during both of the last two years. There is no convincing basis to accept the proposed 2004 retained earnings increase, and I have reversed that adjustment. Instead, I have adopted the reported actual common equity balance at year-end 2003.

OCA St. 1 at 13 (emphasis in original).

In cross-examination, Mr. Kahal explained that the Company's argument that it will under-earn if it does not have this adjustment is "not how ratemaking is done. We don't have an allowed return on book equity. We have a return on rate base. That's how rates are set." Tr. at 608. The OCA also stands by its conclusion that Mr. Moul's "higher net income due primarily to higher sales" is not a valid reason for including this adjustment and thus increasing rates. PPL St. No 9-R at 7. Finally, the Company suggests that Mr. Kahal agreed that "all else being equal" if it did not get this amount, then a 9.5% cost of equity would cause it to underearn. PPL M.B. at 74. The full text of

the discussion reveals, however, that Mr. Kahal pointed out that this evidence shows that PPL stands a substantial chance of over-earning on this adjustment because there is little likelihood that all else will be equal throughout the future test year. Tr. at 611.

PPL's criticisms of Mr. Kahal's testimony on this point are without merit. The Commission should adopt the recommendation of the OCA and exclude this additional $15 million from the Company's retained earnings in its proposed capital structure.

VIII. RATE STRUCTURE

A. Introduction

The OCA detailed its position on the Company's cost of service study, allocation of any revenue increase awarded in this proceeding, and rate design for Rate RS and RTS in its Main Brief. Those arguments will not be repeated here. However, the parties raised several issues that warrant a response as set forth below.

B. PPL's Cost Study Overstates Customer Costs

PPL submits that its cost study has been consistent over time and should be accepted on those grounds. However, the Company has significantly modified the way that it implements those methodologies. Specifically, the Company has changed the way that it calculated customer costs based on its minimum system by increasing the size of components that it uses in its minimum system. The Company attempts to downplay this change, calling it of minor significance. PPL M.B. at 165. As OCA witness Galligan explained, however, this change is not minor. OCA St. 4 at 14. By changing the size of the components used to determine its minimum system, PPL increased the customer-related costs of line transformer investment from 23% in its last base rate case to 63% in this proceeding. Id.

The Company also claims that the NARUC manual requires that the Company use the smallest size components that it has decided to install on its system. OCA witness Galligan explained that the NARUC manual does not require that the Company's current minimum size components be used:

> At page 95, comparing customer cost determination methodologies, the NARUC Manual states:

> The results of the minimum-size method can be influenced by several factors. The analyst must determine the minimum size for each piece of equipment: "Should the minimum size be based upon the minimum size equipment currently installed, historically installed, or the minimum size necessary to meet safety requirements."
>
> Clearly, the NARUC Manual does not uniquely define the minimum size distribution system. The Manual itself raises several alternatives.

OCA St. 4-S at 5-6. The OCA submits that the choice of equipment significantly impacts the amount of customer costs in PPL's study.

Additionally, the Company argues that a minimum sized distribution system must have some load-carrying capability. The underlying purpose of a minimum system study, however, is to separate customer-related costs from demand-related costs. PPL M.B. at 162. As OCA witness Galligan explained:

> ...the customer cost PPL is trying to measure with its minimum sized system is supposed to be independent of any capacity related cost, and indeed, would theoretically contain no capacity related cost. This relationship in PPL's cost of service studies between capacity size and resultant customer cost determinations, coupled with PPL's proposed increase in the capacity of its minimum sized system, simply produces incredible customer cost determinations.

OCA St. 4 at 14-15. The OCA submits that the Company's cost study overstates the customer component of costs and is not the best guide for setting rates presented in this proceeding.

C. The Parties' Criticisms Of The OCA's Peak And Average Methodology Fail To Recognize How PPL Electric Incurs Costs To Provide Electric Delivery Service

The Company has criticized OCA witness Galligan's cost study for allocating "customer distribution costs only based upon demand instead of identifiable

customer components, a procedure that is entirely inconsistent with established industry standards." PPL M.B. at 161. The study performed by OCA witness Galligan and supported by the OCA allocates Common and Primary Distribution costs on a 50% peak basis and a 50% average usage basis. OCA St. 4 at 16-20; OCA M.B. at 111-119. However, Mr. Galligan's study did not re-allocate Service and Meter costs on a demand basis. This methodology of allocating shared distribution facilities on a combination of average and peak usage has been adopted by many jurisdictions (including Pennsylvania) in the natural gas industry, and the reasoning behind its use in those proceedings applies equally to the present distribution-only cost study. See OCA M.B. at 115-118; Pa. P.U.C. v. National Fuel Gas Distribution Corp., 1994 Pa. PUC LEXIS 134, 321 (1994); Pa. P.U.C. v. National Fuel Gas Distribution Corp., 121 PUR4th 434 (1990); Pa. P.U.C. v. Equitable Gas Co., 73 Pa. PUC 301 (1990); Pa. P.U.C. v. National Fuel Gas Distribution Corp., 72 Pa. PUC 1 (1989); Pa. P.U.C. v. Peoples Gas Co., 69 Pa. PUC 138 (1989); Central Ill. Pub. Service Co. Proposed General Increase In Natural Gas Rates, et. al., 2003 Ill. PUC LEXIS 824, 231-232 (2003); In The Matter Of The Applications Of Ark. Western Gas Co. For Approval Of A General Rate Change In Rates And Tariffs, Docket No. 02-227-U; Order No. 17, 2003 Ark. PUC LEXIS 397, 69 (2003).

The basis of the Company's disagreement with the OCA's study is its argument that distribution facilities do not vary based on the amount of energy consumed by customers. PPL M.B. at 163. The OCA submits that the Company's assessment fails to address the threshold question of why the distribution system was built in the first place. The very existence of PPL's distribution system is premised on the sustained

annual demands placed on the system by customers. OCA St. 1 at 17-19. OCA witness Galligan addressed the Company's criticism of this point as follows:

> The issue that Mr. Kleha and I differ on is not that peak demands are responsible for a portion of capacity costs, since we both allocate a portion of capacity costs on peak demands. The issue is whether the non-peak related portion of capacity costs relates to the existence of a customer or to the existence of the customer's demand for energy over the course of a year (annual demands, or the customers' average demands). Ironically, Mr. Kleha associates no cost responsibility to the demands on which PPL owes its very existence. I do.

OCA St. 4-R at 5.

PPL built and financed its distribution system to provide service to meet year-round demands. OCA M.B. at 111-114. The OCA's cost study, which recognizes this reality, provides a better guide for setting rates in this proceeding.

The OSBA also criticized Mr. Galligan's cost study, calling it an "extreme proposal." OSBA M.B. at 6 n.6. The OSBA has also abandoned its own cost study in order to focus on correcting the class rates of return found in the Company's study. Id. at 7. As demonstrated above and in the OCA Main Brief, there is nothing extreme in the OCA's proposal. See OCA M.B. at 116-117. The Peak and Average methodology has been utilized by this Commission when allocating distribution plant in the natural gas industry, and recently has been called "one of the methods accepted by regulators for allocating demand costs." OCA M.B. at 117 (citing In The Matter Of The Applications Of Ark. Western Gas Co. For Approval Of A General Rate Change In Rates And Tariffs, Docket No. 02-227-U; Order No. 17, 2003 Ark. PUC LEXIS 397, 69 (2003)).

In preparing his cost of service study, OCA witness Galligan utilized an accepted ratemaking methodology that accurately reflects the principle of cost causation. For the reasons above and those forwarded in its Main Brief, the OCA submits that Mr. Galligan's study is an appropriate guide for setting rates in this proceeding.

D. The Company's Allocation Of Any Revenue Increase Fairly Recognizes The Total Bill Impacts That Will Be Experienced And Moves All Classes Closer To The System Average Rate Of Return

1. Introduction

While the OCA and PPL disagree on the appropriate cost study to be used as a guide when setting rates in this proceeding, both parties agree that the allocation of any distribution rate increase should be accomplished in a manner that accounts for how the total bill will be impacted. In order to achieve a fair result, the Company recognized the traditional ratemaking principle of gradualism and limited each rate schedule's overall increase to no more than 10% while moving each class closer to the system average rate of return. PPL St. 4 at 27; PPL M.B. at 166. The OCA supports the Company's allocation of distribution revenue as a fair and appropriate allocation during this transitional period.

2. The OSBA's Allocation Produces Rate Shock And Should Be Rejected

The OSBA argues that Rate RS must receive a significantly larger percentage rate increase than the commercial GS-1 and GS-3 classes. OSBA's argument, however, is based on PPL's flawed cost of service study that seriously understates the contribution of residential class. Additionally, OSBA's argument completely ignores the transition that PPL is undergoing while generation rates remain capped. The OSBA's discussion of subsidies refers to distribution costs only. However, the 9.94% increase

Rate GS-1 receives under the Company's allocation includes transmission as well. PPL's proposal provides Rate GS-1 with a transmission revenue reduction of 4.1%. This must be considered when reviewing the raw dollar amounts of any alleged subsidies that Rate GS-1 pays on the distribution portion of the Company's proposed revenue allocation. PPL properly recognized these factors in its allocation process and sought to take appropriate steps while recognizing the principle of gradualism.

The OSBA also argues that the class rate of return metric used by the Company as a guide is "necessarily defective" and should be rejected. OSBA M.B. at 13. The OSBA instead looks at the actual dollar amounts that a customer class is paying, relative to the dollar amount it would be paying if that class were recovering exactly its costs as determined by the cost of service study adopted in this proceeding, and to allocate any increase in a manner that reduces that dollar amount. OSBA M.B. at 13, 15.

The OCA submits that the time-honored use of measuring each rate class' average return is an appropriate metric that should not be rejected. Measures of a class' "subsidy" should not be in absolute dollar figures as OSBA proposes, but should reflect the proportional contribution that each class makes toward overall costs. OCA witness Galligan rebutted the OSBA's concern with the class rate of return metric as follows:

> [OSBA Witnesses] Mr. Knecht/Ewen's stated concern that indexed rates of return at present and proposed rates are not necessarily indicative of progress toward cost based rates is incorrect. In this case, for example, as Mr. Knecht/Ewen state, using PPL's cost of service studies the Residential RS indexed rate of return goes from 40.9 percent at present rates to 60.2 percent at proposed rates, based on PPL cost of service study results. I do not endorse PPL's cost studies, but the policy prescription inherent in PPL's proposal is to move Residential RS indexed returns from essentially 40 percent to 60 percent. If this policy were continued, Residential RS indexed rates of return would

> increase from 40 percent to 60 percent in this case, would be at 80 percent of system return in PPL's next case, and 100 percent of system return in the succeeding case. Clearly, adjusting class rates so the class rates of return move toward the system rate over time, consistent with the indexed rate of return standard and the principle of gradualism, is a measure of progress toward rates based on allocated costs of service. Contrary to Mr. Knecht/Ewen's assertions, progress towards cost based rates is exhibited at PPL's proposed rate spread, and such progress is not reliant on Mr. Knecht/Ewen's proposed adjustments to PPL's proposed rate spread.

OCA St. 4-R at 12-13. The OCA submits that the OSBA's argument that class rates of return do not accurately reflect movement toward cost-based rates is not accurate. Despite the OSBA argument to the contrary, the Company's allocation effectively moves classes closer to the system average rate of return.

3. PPLICA's Proposed Allocation And Phase-In Procedure Fail To Take Into Account The Total Bill Impact And Transition That PPL Is In, Represent Bad Policy, Are Illegal, And Should Not Be Adopted By The Commission

PPLICA makes a similar argument to OSBA. PPLICA submits that the Company should allocate any rate increase in a way that reduces the dollar subsidies that each class pays, not the relative rate of return index. PPLICA M.B. at 93. In order to bring each rate schedule's cost recovery in line with the Company's flawed cost study, PPLICA proposes that each rate class (with the exception of Rate IS-T and LP-6) that is paying above the system average return reduce the "subsidies" by 50%. Id. at 95. The remaining 50% would be reduced in 25% increments over the following two years. Id. at 96.

As the OCA argued in its Main Brief, PPLICA's proposal mechanically adheres to the Company's flawed cost of service study. OCA M.B. at 131. If approved,

PPLICA's proposal will produce repeated rate shock. Due to their imprecise nature, cost of service studies should be used as guides only. Additionally, PPLICA does not acknowledge that cross-subsidies existed between distribution and generation rates from PPL's operations as a bundled service provider. Cross-subsidies that affect generation will remain in place until 2010, when the PPL generation rate cap expires. OCA M.B. at 122-125.

PPLICA attempts to isolate distribution rates from all other aspects of PPL's costs and rates, and eliminate any alleged cross-subsidies in a three-year period.[8] Such a procedure ignores the impact unbundling has had on the different elements of electric service. PPLICA's proposal to eliminate all subsidies that exist in Distribution service over a three-year period will produce rate shock, and fails to recognize the cross-subsidies that are contained in capped generation rates that will continue for the next five years.

Finally, PPLICA's phase-in proposal fails on legal grounds. See OCA M.B. at 133-134. PPLICA offers a recent Commission Order approving a settlement that allowed Trigen-Philadelphia Energy Corporation ("Trigen") to increase base rates over a two year period. PPLICA M.B. at 99 (citing Pa. P.U.C. v. Trigen-Phila. Energy Corp., Docket No. R-00016941, Order (June 28, 2002). This phase-in is similar to those in proceedings cited by the OCA in its Main Brief. OCA M.B. at 133. For example, in Pa. P.U.C. v. Duquesne, the Commission established that a just and reasonable rate increase, the full amount of which was known at the time of the Order, could be phased-in where

[8] PPLICA argues the Company's "total-bill" approach to allocating any revenue increases that result from this proceeding is a violation of the Choice Act. The OCA submits that this narrow view is not required under the Act, and addresses that issue in Section IX below in the Transmission Service Charge section of this Reply Brief.

the Company agreed to take less of a rate increase in the early years to avoid rate shock. Pa. P.U.C. v. Duquesne Light Co., 66 Pa. PUC 518, 701 (1988). In Trigen, the Commission approved a similar phase-in. In each of these cases, the Company voluntarily postponed revenue recovery in order to reduce rate shock. In this proceeding, the Company has not volunteered to alter rates in future years. In Trigen, the Commission did not approve the type of phase-in proposed by PPLICA in this proceeding.

4. The OTS, DOD, and PEC/Wal-Mart Revenue Allocation Proposals Should Be Rejected

OTS, DOD, and PEC/Wal-Mart have all proposed revenue allocations that are based on the Company's cost of service study. As stated above, the Company's cost of service study should not be adopted as a guide for setting rates in this proceeding. Additionally, the DOD proposed allocation would result in considerable rate shock for residential classes. The PEC/Wal-Mart proposal, while accepting the Company's allocation, argues for an inequitable scale back of any revenue increase that is less than that proposed by the Company. The PEC/Wal-Mart proposal is tied directly to the Company's cost of service study. The OCA submits that these parties' proposed allocations should not be accepted.

5. Conclusion

The Company's revenue allocation produces fair results. The vast majority of PPL's customer's pay their bills on a "total bill" basis. The Company properly recognized this fact in order to allocate increases that do not produce rate shock. The OCA submits that PPL's approach is reasonable. For reasons set forth here and in the

OCA's Main Brief at 119 through 134, the OCA supports the adoption of PPL's allocation of the rate increase in this proceeding.

E. Rate Design

The Company's rate design for Rate RS captures costs other than those the Commission has found should be included in the customer charge and improperly includes usage in the customer charge. OCA M.B. at 135-138. [9] As a result, PPL's proposed customer charge increase from $6.55 to $12.20, an 86% increase, must be rejected. OCA St. 4 at 23. Including costs other than the meter, service drop, meter reading and billing in the customer charge is inconsistent with the Commission's past customer charge determinations. See OCA M.B. at 136; Pa. P.U.C v. West Penn Power Co., 59 Pa. PUC 552, 69 PUR4th 470, 521 (1985). Additionally, the first 200 kWh of usage should not be included in the customer charge. As OCA witness Galligan stated, "Costs of PPL's delivery system do not commence with the delivery of a customer's 201st kWh, but are applicable to all energy deliveries." OCA St. 4 at 24.

The Company has argued that its proposal is superior to the OCA's rate design because it would keep 90% of PPL's Rate RS bills below a 10% increase, compared to 65% under the OCA's proposal. PPL M.B. at 169. However, PPL's proposal achieves its objective by imposing severe increases that are contrary to Commission precedent on low usage customers. The Company tries to argue that a "high percentage" of low usage bills are associated with vacation homes (PPL M.B. at 169), basing this assertion on the testimony of PPL witness Kasper, who testified, "that about 37% of bills for usage of 200 kWh or less per month have a billing address that is

[9] The OCA opposes the Company's proposed customer charge increase for Rate RTS on similar grounds. See OCA M.B. at 139-140.

different from the service address whereas only about 11% of bills for usage greater than 200 kWh per month have a billing address that is different from the service address." PPL St. 6-R at 10. First, even if these are vacation homes, this is not justification for assessing a charge contrary to Commission precedent. Additionally, under the Company's own analysis, 63% of bills for less than 200 kWh per month use the service address for billing purposes. Even some customers with usage of over 200 kWh per month have different billing addresses. The fact is we do not know that these are all vacation homes.

The Company does not explain why rate shock is an acceptable alternative for low usage customers who will see dramatic increases in their distribution rates. Even when viewed on a total bill basis, a Rate RS customer using 50 kWh would see a 44% increase in rates, a 100 kWh customer would experience a 26% increase on a total bill basis. PPL Exh. Regs. § 53.53 Part IV, Attach. IV-D-1 at 4. The Company's proposed customer charge is simply too high and should be rejected.

F. Conclusion

The OCA submits that the Company's cost of service study is a less reliable guide for setting rates than OCA witness Galligan's study. Despite the differences in cost study methodologies, however, the OCA supports the Company's proposed overall allocation of any distribution revenue increase. The OCA further submits that the Company's residential rate design is seriously flawed and should be rejected. The OCA has applied appropriate cost of service and rate design principles. For the reasons listed above and set forth in the OCA's Main Brief, the Commission should adopt the OCA's cost of service, revenue allocation and rate design proposals.

IX. TRANSMISSION SERVICE CHARGE

A. Introduction

Several parties have opposed the Company's proposed uniform transmission rate for the collection of PJM-imposed transmission charges. OSBA M.B. at 16; PPLICA M.B. at 61; DOD M.B. at 23; PEC/Wal-Mart at 10; PPL PLUG at 18. As detailed in the OCA Main Brief, each of the alternative proposals submitted by parties introduces volatility into transmission rates and should be rejected. OCA M.B. at 146-151. A uniform transmission rate will eliminate the risk of substantial variations in rates that result from PPL alternating between a summer and winter peaking utility. See PPL M.B. at 100. The Company's proposed uniform transmission charge is reasonable and should be adopted. A uniform rate allows the Company to apply the principle of gradualism as it relates to the overall rate impact of its request. OCA M.B. at 151-152. Several of the parties, however, argue that transmission service should be viewed in complete isolation from the overall proceeding. In support of this view, parties have offered alternative proposals for collecting transmission revenue needed to pay PJM for transmission service. This view, and the supporting proposals, ignore the reality of the Company's transition that is still underway, and ignore the impact that such a view would have on overall rates.

For the reasons given in the OCA Main Brief, these alternative proposals should be denied. However, PPLICA raised some arguments in its Main Brief that the OCA will further address below.

B. PPLICA's Claim That A Uniform Transmission Charge Would Hinder Competition And Violate The Choice Act Are Flawed

1. Introduction

PPLICA makes two key arguments in its Main Brief regarding transmission pricing. First, PPLICA argues that how PPL charges for transmission will have an impact on shopping. PPLICA M.B. at 62-63. Second, PPLICA argues that the Company's uniform TSC improperly sets transmission rates because it is overly simplistic and designed to achieve an improper end goal of limiting each rate schedules overall allocation to 10%. Id. at 70. Each of these arguments is erroneous, and should be rejected.

2. Competition Will Not Suffer Due To A Uniform Transmission Charge

PPL witness Krall testified that the potential distortions that might be caused by a uniform transmission rate for all retail customers should have very little, if any, effect on competition. Tr. at 910-911, 941-942; See also, OCA M.B. at 149-151. The only party in this proceeding representing the interests of competitive suppliers supports the Company's uniform transmission rate proposal. MAPSA M.B. at 1-3. Additionally, PPL witness Krall explained that a competitive supplier will be unable to know the precise transmission charges for most of the customers it serves. According to Mr. Krall:

> ...in my experience, shopping has generally been a September to May event, which means it goes across two years for transmission calculation purposes. So if an EGS is offering a price to a customer...in, say, July, to sign the customer up for start of service in September, he would have knowledge of the current transmission obligation that that customer would create and its current effect, but the impact of that customer from January 1 to the end of the

> term of the contract would be, to some extent, unknown because it would be a function of what the calculation would be for the coming year...

Tr. at 910-911.[10] In actual practice, a uniform rate does nothing to harm an actual customer who wants to shop.

PPLICA also attempts to couch this argument in terms of the precedential impact it will have on transmission service across all of Pennsylvania. PPLICA M.B. at 62. PPLICA does not recognize that this is the proposal in this proceeding while generation rates remains capped. PPL has acknowledged that this filing is a step in the process of eliminating cross-subsidies that remain from the Company's history as an integrated utility. PPL St. 4 at 27. The Company will have an opportunity to continue this process as the generation rate cap expires on December 31, 2009, and possibly in the interim period. Tr. at 907. Additionally, PPLICA fails to take into account the fact that PPL has seen very little shopping while it continues to operate under a generation rate cap during this transitional period. The OCA submits that PPLICA's argument against a uniform TSC, for the sake of competition, must fail.

3. The Commission Has A Legal Obligation To Ensure That PPL's Transmission And Distribution Rates Are Affordable

PPLICA also argues that a uniform transmission service charge violates cost causation principles. PPLICA M.B. at 69. PPLICA argues that the simplicity of a uniform rate is irrelevant in this case. While it may appear somewhat simplistic, the use of a uniform rate is a part of this rate proceeding. The Company has properly viewed the overall rate impact as the proper measure for applying traditional ratemaking principles,

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[10] PPLICA acknowledges that the PJM billing methodology for wholesale transmission service cannot be replicated exactly for retail POLR customers. PPLICA M.B. at 63 (...should use a demand allocator *similar* to the one used by PJM to assess transmission charges.) (emphasis added).

such as gradualism and understandability, to design appropriate rates during this transitional period. A uniform rate proposal is simple only if viewed in isolation. In the context of this proceeding, the uniform transmission service charge proposal is appropriate.

PPLICA continues its argument against a uniform TSC, arguing that the Choice Act requires that transmission rates must be set in complete isolation from distribution rates. PPLICA argues that the Choice Act requires that "the Commission must examine each component on a stand-alone basis to determine whether it is just, reasonable and consistent with the applicable statutory requirements." PPLICA M.B. at 71. PPLICA's reading of the Choice Act improperly limits the Commission's jurisdiction over distribution and transmission retail rates.

It is appropriate for the Commission to set regulated rates that adhere to traditional ratemaking principles by limiting the overall impact of rates in this proceeding to 10% as the Company proposes. The overall retail rates proposed by PPL and supported by the OCA achieves this result. PPLICA's attempt to separate out retail transmission rates from this process is not required under the Choice Act. The Act was clearly designed to remove the generation of electricity from traditional regulatory proceedings like this one. The General Assembly declared that, "The generation of electricity will no longer be regulated as a public utility function except as otherwise provided for in this chapter." 66 Pa.C.S. § 2802(14). The Act does not remove retail transmission recovery from the Commission's purview. PPLICA's contention that transmission service must not be reviewed with distribution, and that transmission service

should reflect only PJM's wholesale billing procedures despite the fact that it may produce unreasonable overall retail rates, must be rejected.

PPLICA also argues that the Choice Act recognized the importance of adopting transmission rates that are comparable with how PJM bills an Electric Distribution Company. PPLICA cites 66 Pa.C.S. § 2804(6) to support this argument. PPLICA M.B. at 79. However, the Act does not support this contention. Section 2804(6) requires that:

> a public utility that owns or operates jurisdictional transmission and distribution facilities shall provide transmission and distribution service to all retail electric customers in their service territory and to electric cooperative corporations and electric generation suppliers...on rates, terms of access and conditions that are comparable to the utility's own use of its system.

66 Pa.C.S. § 2804(6).

The passage is designed to prohibit discrimination, not to track wholesale transmission rates into retail rate design. In addition, it is entirely unclear how an EGS bills a shopping customer for transmission service. As the Company pointed out in its Main Brief, there is no evidence as to how an EGS prices transmission service for its customers. PPL M.B. at 103. PPLICA's assertion that customers must be indifferent with regard to transmission service as provided by PJM and billed to each load serving entity is not required under the Choice Act, and should be rejected.

4. Conclusion

The OCA submits that PPLICA's proposed transmission allocation produces highly volatile rates and does not adhere to the accepted ratemaking principle of gradualism. The Commission has authority under the Public Utility Code to regulate the

allocation and design of both distribution and transmission retail rates. PPLICA's assertion that competition in general, and the Choice Act in particular, requires that the Commission abandon its responsibility to ensure that overall transmission and distribution rates are reasonable, violates sound ratemaking principles, and is not required under Pennsylvania law. The OCA submits that PPLICA's modifications of the Company's uniform rate proposal should be rejected.

C. Conclusion

The Company's uniform rate proposal properly balances the recovery of transmission revenues associated with PJM billing to PPL in order to serve retail customers, with traditional ratemaking principles. The impact of the potential total bill increases that may result from this proceeding must be taken into consideration when setting rates. In addition, setting a uniform rate will not hinder competition. For these reasons and those detailed in its Main Brief, the OCA supports PPL's proposed uniform transmission service charge, and recommends that the TSC be set at 0.564 ¢/kWh for all customer classes effective January 1, 2005.

X. UNIVERSAL SERVICE ISSUES

A. Program Modifications Are Necessary To Ensure That PPL's Universal Service Programs Meet The Statutory Mandate

1. Placing Low Income Customers In Arrears On A Standard Payment Plan Will Benefit Customers And The Company And Will Assist In Ensuring That The Program Is Available To The Maximum Number Of Customers In Need Within The Budget

At pages 140-143 of its Main Brief, the Company addresses the OCA's proposal that low-income customers in arrears be placed on a standard payment plan in May of each year. The standard payment plan recommended by the OCA consists of a budget billing component for current charges and an arrearage payment equal to the amount contained in the BCS informal payment plan guidelines for the income level of the customer. The customer can opt out of the standard payment plan by contacting the Company to negotiate an alternative plan. OCA St. 5 at 13-14. The Company opposes the recommendation arguing that it will cause customer dissatisfaction, will increase costs, and will not increase arrearage payments. PPL M.B. at 140-143. The Company also argues that it already communicates with customers in arrears, so there is no need to take any further steps. PPL M.B. at 143. The OCA submits that these arguments do not support rejection of the OCA's recommendation. The standard payment plan can provide benefits to both customers and the Company and will assist in ensuring that PPL's universal service programs are available to the maximum number of customers.

The Company argues that it does not need to take further steps to address low-income customers in arrears since it already communicates with customers in arrears. PPL M.B. at 143. PPL witness Dahl testified that these communications are in the form of letters and termination notices. Tr. 716-717. He did not indicate whether these

communications occurred often or routinely. As OCA witness Colton testified, however, the regular contacts that the Company refers to are in response to shut-off notices. OCA St. 5 at 9-10. Although the Company has some communications with customers in arrears when they are threatened with termination, the OCA submits that the Company should not rest on these efforts. As the record demonstrates, more than 30,000 low-income customers are in arrears and these arrearage amounts are growing rapidly, even though rates have not increased for these customers. In 2001, the average arrearage for a low-income customer was $318 but by 2003, the average arrearage was $528. OCA St. 5 at 11. As OCA witness Colton demonstrated, PPL is seeing an increase in both the level of arrears and the number of low-income customers in arrears. OCA St. 5 at 18. It is clear that PPL's current efforts are not addressing this problem.

These growing arrearages subject customers to the risk of termination and force the customers to make quality of life choices. OCA St. 5 at 12. See also, OCA M.B. at 159-161. For the Company, these growing arrearages impact the Company's revenues as well as increase its costs for credit and collection activities. These growing arrearages also significantly impact the costs of the On-Track program as customers enter the program with high arrearage amounts. As the program becomes more expensive to serve each entering customer, it is less able to maximize the program benefits across a broad range of customers. The standard payment plan will provide valuable assistance in addressing these problems.

The Company argues that the standard payment plan should be rejected because customers will receive unexpectedly high bills and will be dissatisfied. PPL M.B. at 142-143. The Company's argument misses a key point. As OCA witness Colton

stated, prior to implementation of the program, there will be customer education efforts designed to inform customers of the new procedures and policies. OCA St. 5 at 16. The Company's concern that customers will receive unexpectedly high bills when placed on the program, as well as its concern about customer dissatisfaction, can be addressed or mitigated through such education and information efforts.[11] The OCA does not expect that these efforts will address all customer dissatisfaction, but it must be remembered that the customers that will be placed on the program are customers with arrears who have not contacted the Company to begin to address this situation. The customers will be equally dissatisfied if they receive a termination notice and, with large arrears, are unable to maintain their service.

PPL also argues that the standard payment plan would not guarantee that customers will make payments toward their arrears. The fact of the matter is these are customers who are not making payments today and have had no contact with the Company about these arrearages. As Mr. Colton discussed, research he conducted in Iowa shows that what budget billing will do, for the Company and the customer, is increase the dollars paid by the customer each month during the non-heating months, thus reducing arrears in both the short- and long-term. OCA St. 5-S at 4. PPL witness Dahl acknowledged on cross-examination that, at this time, the Company does not expect these

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[11] The Company also refers to customers being "slammed" onto the standard payment plan since they are placed on the plan without their consent. PPL M.B. at 142, n.40. The OCA submits that the Company's suggestion is incorrect. The OCA's proposal has none of the characteristics of slamming. Slamming involves a customer being placed on a different service, or having additional services added to their account, without their knowledge or consent. Here, the customer's service is not being changed. The customer in arrears is being given three choices: 1) they can pay their bill in full; 2) they can contact the Company and negotiate an individual payment plan; or 3) they can accept the standard payment plan. The only option that the customer does not have is to do nothing and continue accruing large arrears. The OCA would also note that education and information will precede this initiative so that there will be awareness of the changes.

customers, on their own initiative, to use the lower May bill to catch up.[12] Tr. 717. It is clear that proactive steps by the Company are needed to address this growing problem.

The Company further argues that the standard payment plan approach will increase costs as the Company responds to calls related to customer dissatisfaction. The Company did not present any evidence that call center volume would increase as a result of this program or that the costs, if any, would outweigh the benefits to the customer and the Company. Mr. Colton found that the additional calls generated by the standard payment plan could easily fall within the normal variation in call center volume.[13] After analyzing the potential for increased calls, OCA witness Colton summarized his analysis of the potential for increased costs as follows:

> Moreover, the costs of increased calls would be minimal. A reasonable cost per call by PPL is $5. With 15,600 calls, and assuming that none of these calls would have been made in the absence of the budget billing program, there would be an additional cost of $78,000. Assuming that customers contracting the Company succeed in completing their payment plans at the same rate as other Company payment plans (13.5%), this $78,000 in increase call center costs would generate a reduction in outstanding arrears of $1.1 million in completed payment plans. Additional payment plans, even if only partially successful, would

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12 The Company, in its oral rejoinder, indicated that a budget bill for a low-income household using electric heat would be about $160 to $165 per month. Tr. 713. The Company then added to this a $40 arrearage payment to argue that the household would receive a bill for $200 to $205 instead of the expected bill of $45 in May. Tr. 713-714. First, the OCA recommended that the average payment under the BCS informal guidelines be used for the arrearage payment. For customers at Level 1, *i.e.* with incomes less than 110% of the Federal Poverty Level, that amount would be $1 to $15 for the arrearage payment not the $40 the Company assumes. For a Level 2 customer, with income between 110% and 150% of Federal Poverty Level, the arrearage payment would be between $15 and $40. Second, a $160 to $165 budget bill implies an annual electric bill of almost $2,000 per year. This bill level appears to be based on an electric heating bill for a typical customer, not a low-income customer. There is no indication by the Company as to how many low-income customers rely on electric heat. OCA witness Colton analyzed the bills for PPL low-income customers and found that the average annual bill for a low-income customer was $1,127. OCA St. 5 at 11. That annual bill implies a budget bill in the range of $95 per month ($1,127 â 12 = $93.90) rather than the $160 to $165 identified by the Company.

13 The OCA would also note that the education and information efforts can mitigate any increase in call center volume.

> reduce the arrears further. Moreover, the reduction in arrears that is generated without a customer calling to enter into a payment plan will reduce the arrears even further. The $78,000 investment will more than pay itself back in reduced arrears.

OCA St. 5-S at 6.

The OCA submits that the Company's criticisms of the standard payment plan program are without merit. The Company's reluctance to implement a program that addresses the growing arrearage problem among its low-income customers should not stand in the way of bringing the benefits of this program to PPL's customers, as well as to the Company. For the reasons set forth in the OCA's Main Brief at 158-165, the OCA submits that the standard payment plan program should be adopted. The OCA stands ready to work with the Company in the implementation of the program and in the education efforts necessary for the program to be a success.

2. The EITC Pilot Program Will Provide Benefits To Low-Income Customers With Wage Income And To The Company

Although the Company has agreed to implement a pilot Earned Income Tax Credit ("EITC") outreach program to assist low income customers with wage income qualify for tax credits to which they are entitled, the Company continues to express reservations regarding the program in its Main Brief. See, PPL M.B. at 142. OCA witness Colton has offered specific design components in his testimony that address the concerns and challenges identified by the Company. As stated in the OCA's Main Brief, the OCA is committed to participating in a process of designing and implementing a program that brings these important benefits to low-income households and the Company.

3. A Plan To Increase Operation HELP Contributions Is Needed

At pages 145-147 of its Main Brief, the Company argues that further steps to increase contributions to Operation HELP are not necessary. The Company disputes that contributions are declining, and argues that since Operation HELP is a mature program, little more can be expected. The OCA submits that the Company's arguments do not overcome the need for new initiatives to further stimulate contributions to Operation HELP. Operation HELP is a vital universal service program and the Company should pursue steps to increase contributions to this program.

Importantly, the Company argues that overall contributions to Operation HELP have not declined since employees and retirees have stepped up their contributions. The OCA commends employees and retirees for stepping up their contributions to this vital program, but more is needed from other stakeholders--a point the Company ignores. The Company ignores the fact that shareholder contributions have declined from $655,643 in 2001 to $438,138 in 2002. OCA St. 5 at 41. Ratepayer contributions have also declined from a peak of $392,625 in 2001 to a level of $378,640 in 2003. OCA St. 5 at 39. As Mr. Colton explained, PPL's Operation HELP has declined in all of its major attributes since 2000. Operation HELP: 1) provides smaller grants, even though arrears are higher; 2) has fewer contributors, even though the total number of customers has increased; 3) receives fewer investor-contributed dollars; 4) raises less total money from customers; and 5) raises less money on a dollars-per-customer basis. OCA St. 5-S at 13-14.

The OCA submits that more is needed to ensure that Operation HELP remains a vital program within PPL's array of universal service programs. As set forth in the OCA's Main Brief, the OCA submits that PPL should be directed to submit a plan to increase contributions to Operation HELP, including soliciting contributions from non-traditional sources such as its vendors, as well as increasing shareholder contributions. See, OCA M.B. at 168-170. PPL's arguments against a new initiative should be rejected.

B. The OCA's Recommended Universal Service Expense To Be Included In The Company's Revenue Requirement Is Based On The Company's Own Stated Budgets For 2005 And 2006

At pages 53-54 of its Main Brief, PPL argues that the OCA and OTS have proposed a reduction in the On-Track and WRAP funding for PPL. PPL M.B. at 53-54. PPL's characterization of the OCA's and OTS' adjustment is incorrect. Neither the OCA nor the OTS has proposed *any* reduction in the amount of money that PPL proposes to spend on its universal service programs. Rather, the OCA and the OTS have proposed that PPL's revenue requirement be established to reflect the normalized level of expenditures for 2005 and 2006 that PPL itself has said it will spend in those years. PPL, on the other hand, seeks to include a level of expenditures reflecting a normalization of its costs through 2011, even though it has no intention of spending this higher level of revenues in the near term. Based on the Company's own testimony that it expects another base rate filing in two years, a normalized level of expenditures for those two years is appropriate. Future funding should be addressed in future base rate cases.

For the reasons set forth in the OCA's Main Brief, and above, the OCA submits that PPL's revenue requirement should be established to reflect a normalization of expenditures based on PPL's proposed budgets for 2005 and 2006. This adjustment reflects no reduction in the level of expenditures proposed by PPL for those years. The adjustment reflects a more reasonable planning horizon, the amount that PPL says it will spend in those years, and PPL's own expectations regarding a future base rate filing. A normalization over the more extended period of time proposed by PPL, simply includes $1.9 million in rates that the Company acknowledges it will not spend before its next anticipated base rate case. As such, the OCA submits that PPL's claimed expense in this case should be reduced by $1.9 million to reflect the normalization of the amount that PPL proposes to spend in 2005 and 2006. OCA M.B. App. A., Table II, Sch. LKM-13S.

C. PPL's Proposal To Allocate Universal Service Costs Solely To The Residential Classes Should Be Rejected

1. Introduction

In their Main Briefs, PPL and PPLICA argue that the Company's universal service programs should be supported solely from the rates charged to the Company's residential customers. PPL M.B. at 151-153; PPLICA M.B. at 39-46. OSBA also raised this issue in its Rebuttal Testimony, but did not provide argument on this point in its Main Brief. OSBA St. 3 at 16-19. OSBA's arguments contained in its Rebuttal Testimony were the same as those raised by PPL and PPLICA. PPL and PPLICA make three basic arguments. They argue that: 1) cost causation principles require that only the residential classes fund these programs; 2) that the costs of universal service programs are not a public good, the costs of which should be shared by all customers; and 3) that the intent of the Customer Choice Act was to allocate these costs to residential customers.

As explained in the Main Brief of the OCA and below, these arguments must fail. PPL's universal service programs benefit all customers, have been established as a public good by the Customer Choice Act, and should be allocated to all customer classes under the Customer Choice Act. The OCA will address each of these points below.

2. Cost Causation Principles Do Not Require That The Costs Of The Universal Service Program Be Allocated Only To Residential Customers

PPL and PPLICA argue that cost causation principles dictate that only the residential classes should contribute to the continued funding of the Company's universal service programs because only the residential class can participate in the program and only residential customers benefit from the program. PPL M.B. at 151-153; PPLICA M.B. at 39-40. This line of reasoning ignores the many benefits of these programs to all customer classes. As discussed in detail in the OCA's Main Brief at pages 177-182, the benefits of PPL's universal service programs are system-wide, substantial and extremely important to PPL, its customers and its service territory. OCA witness Colton explained the economic benefits that accrue to local commercial and industrial customers from electric affordability programs:

> In sum, we know that increasing employee productivity directly contributes to the increased profitability of firms. We know that with low-wage employees, in particular, unaffordable home energy directly contributes to lowered productivity. Increased personal illness, increased employee turnover, and increased family care responsibilities are but three factors contributing to lower employee productivity. The provision of affordable energy through the Company's proposed universal service program positively affects each of these productivity factors.

OCA St. 5 at 30.

Other examples of benefits identified by OCA witness Colton included the relationship between small businesses and low-wage employees who utilize the universal service programs, the economic stimulus created by the program providing the household with additional disposable income, and the efficiencies gained by the Company in all areas of operations when employees are not burdened with credit and collection activities. OCA St. 5 at 30-35. It cannot be argued that other customer classes do not derive benefits from PPL's universal service programs.[14]

Additionally, PPL's and PPLICA's assertion that all universal service costs should be assigned to residential customers because only residential customers benefit from the program, or can participate in the program, proves too much. As OCA witness Colton testified:

> If we assume that only low-income customers benefit, and we follow the rule that costs in this case should be allocated only to those who directly benefit, we are brought to the conclusion that universal service costs should be directly assigned pro rata to customers who participate in the universal service programs. Clearly this would be an absurd result, and one that could not logically have been intended by the legislature. In addition, there is no more reason to allocate costs to non-low-income residential customers under this reasoning than there is to allocate them to non-residential customers.

[14] PPLICA argues at pages 42 to 44 of its Main Brief that the general Company benefit of a reduction in uncollectibles and call center expense does not have an impact on the industrial rate schedules since they do not pay residential uncollectibles or call center costs. PPLICA argues that industrial customers have their own hotline and do not make use of the customer call center. PPLICA misses the point of the efficiencies that are gained by the programs. The ability to reduce credit and collection activities frees up staff so that these workers can be redirected to other necessary jobs for the Company. These jobs need not be limited to credit and collection activities for residential customers.

OCA St. 5 at 36. When taken to its logical conclusion, such an allocation would have only low-income customers support the cost of these programs – a result, which is untenable.[15]

The OCA submits that PPLICA's and PPL's argument that cost causation principles support an allocation of these costs only to the residential customer class is mistaken. Under PPLICA's and PPL's arguments, there is no basis to have non-participating residential customers support the costs of the program. An argument that results in only the low-income customers supporting program costs cannot be sustained.

3. PPL's Universal Service Programs Represent The Public Good

In their Main Briefs, the Company and PPLICA argue that the requirement to allocate universal service costs on the basis of cost causation principles cannot be overcome by suggesting that the universal service programs are a "public good" from which all customers derive an indirect benefit. PPLICA M.B. at 40. PPLICA and PPL argue that these programs do not represent a "public good". PPL M. B. at 152-153. PPLICA M.B. at 40-43. As set forth, in the OCA's M.B. at 182-184, PPL's universal service programs have, in fact, been designated as a public good by the General Assembly. Additionally, PPL's universal service programs fall within the appropriate definition of a "public good" that has been utilized in the regulatory arena.

[15] PPLICA also argues that the program is open to *all* residential customers. PPLICA M.B. at 40, 43-44. The programs, however, are only open to a residential customer whose income is at or below 150% of the Federal Poverty Level and is in arrears by $150 or more. The programs also have participation limits, meaning they are not available to any and all customers that might be in need at any point in time. OCA witness Colton identified over 30,000 low-income customers in arrears, but the realistic program enrollment at this time is between 15,000 and 17,000. PPLICA's argument that all residential customers can participate in the program is incorrect.

The General Assembly in Pennsylvania has clearly recognized low-income universal service programs as a public good. Section 2802(17) reads:

> (17) There are certain public purpose costs, including programs for low-income assistance, energy conservation and others, which have been implemented and supported by public utilities' bundled rates. The public purpose is to be promoted by continuing universal service and energy conservation policies, protections and services, and full recovery of such costs is to be permitted through a nonbypassable rate mechanism.

66 Pa.C.S. § 2802(17). The General Assembly declared universal service programs to be a "public good" when it stated in Section 2802(17) that the public purpose is to be promoted by continuing universal service and energy conservation policies, protections and services. OCA St. 5 at 28-29. As OCA witness Colton testified, a well-accepted tenet of utility ratemaking is that due to the nature of public goods; the costs of such goods are spread over all customer classes. OCA St. 5 at 27-28.

PPLICA tries to overcome this clear statutory directive by forwarding its own definition of "public good." PPLICA M.B. at 41. As OCA witness Colton testified, however, the definition of a "public good" from the National Regulatory Research Institute ("NRRI") is the most appropriate in this regulatory setting. NRRI provides as follows:

> A public good can be defined as "any publicly induced or provided collective good" that "arise[s] whenever some segment of the public collectively wants and is prepared to pay for a different bundle of goods and services than the unhampered market will produce."

OCA St. 5-S at 17.

The universal service costs at issue here fit squarely within this definition.[16] OCA witness Colton explained in detail the applicability of this definition to the issue at hand:

> ➢ First, universal service is a "publicly induced or provided collective good" as described by the NRRI.
>
> ➢ Second, it is clear from the very testimony of the industrial and OSBA witnesses, that NRRI was correct in referring to such a "collective good" as one which not all ratepayers would choose to pay for. Indeed, the fact that the Pennsylvania legislature mandated that a universal service charge be "nonbypassable" indicates that the legislature understood this aspect of a "public good" and that it affirmatively decided that all ratepayers should help pay for this collective good.
>
> ➢ Third, the Pennsylvania universal service programs are consistent with NRRI's statement that the emphasis is on "the *total* societal benefits." Indeed, these benefits include not simply the benefits to participating customers (as OSBA and PPLICA wish to limit the discussion), but also, in the words of NRRI, the benefits "both direct and indirect." In my Direct Testimony, I clearly document how universal service, as a public good, fits this notion of generating not only direct social benefits, but a wide range of indirect social benefits to all customer classes.
>
> ➢ Fourth, contrary to what Mr. Baron suggests, the finding that universal service is a "public good" has cost allocation implications to it. As NRRI points out, "the costs of achieving and supporting a modern, state-of-the-art network infrastructure are ultimately borne by the general body of ratepayers." While OSBA and PPLICA would limit the allocation of costs only to those customers who "use" the service

[16] ALJ Rainey, in his Recommended Decision issued August 13, 2004 in the Investigation Into PGW's Credit and Collections Activities, Docket Nos. P-00042090, R-00049157, M-00021612, P-00032061 (Recommended Decision pending at the Commission), recognized the fact that universal service programs are a public good. ALJ Rainey, in addressing a proposal that universal service costs be borne solely by residential customers, stated: "Universal service programs are designed to fulfill the "public good" and therefore the costs associated with those programs should be shared by all customer classes." PGW Investigation, R.D. at 32.

> of a universal service program, accepting this decision is at fundamental odds with universal service being determined to be a "public good." As NRRI points out, having the costs of universal service be "borne by the general body of ratepayers" is "opposed to limited subsets of customers who exhibit a high demand for specific new services."
>
> ➢ *Finally, while OSBA and PPLICA claim that the* multi-class benefits arising from universal service are largely unmeasurable, this very fact is one of the reasons that universal service should be found to be a public good with costs allocated to all ratepayers. As NRRI points out, the public good approach applies "for the very reason that those [market] forces break down. . .because of. . .the intangible or unmeasurable society benefits which are not valued by the marketplace."

OCA St. 5-S at 18.

It is clear that PPL's universal service programs represent the public good. All customer classes of PPL benefit from the existence of universal service programs. The fact that the quantifiable benefits accrue to low-income, payment-troubled customers does not alter the classification of these programs as serving the public good, nor does it alter the need to properly allocate these costs to all customer classes.

PPL also argues that the OCA has cited no authority or other state regulatory jurisdiction that considers universal service programs to be a public good. PPL M.B. at 152. PPL ignores the testimony of OCA witness Colton on this point. In response to a similar argument by PPLICA witness Baron, Mr. Colton testified:

> Mr. Baron argues that universal service is not a public good and, even if it were, that conclusion would not imply a cost allocation decision. His conclusion that universal service is not a public good is not generally accepted. Public utility commissions (including commission staffs) have generally recognized universal service as a public good. The states

> of Iowa, Michigan and Utah are examples of states that have found universal service to be a public good.

OCA St. 5-S at 16-17.

Finally, PPLICA argues that designating universal service programs as a "public good" could lead to a "slippery slope" and open a "public goods cookie jar." PPLICA M.B. at 42. In support of this argument, PPLICA identifies claims by other witnesses seeking to have other costs designated a public good. The OCA submits, however, that there is no "slippery slope" or "cookie jar" here. The General Assembly specifically expressed its intent in Section 2802(17) that universal service programs are a public good that must be continued. 66 Pa.C.S. § 2802(17). The OCA has demonstrated that this designation is fully consistent with the definition of a public good as forwarded by NRRI. The other claims in this proceeding will be evaluated on their own merits, not by the decision regarding PPL's universal service programs.

PPL's and PPLICA's argument that universal service programs do not represent the public good is erroneous. Therefore, these arguments should be rejected. Instead, the Commission should recognize that all customer classes should contribute to the continued funding of these programs as they serve an important public purpose.

4. The Public Utility Code Provides That All Customer Classes Should Contribute To PPL's Universal Service Program Funding

PPLICA argues that the Public Utility Code provides for the allocation of universal service costs only to residential customers. PPLICA M.B. at 45-46. This argument is incorrect. The general statutory framework for recovery of universal service costs is set forth in Section 2804(9) of the Public Utility Code. This provision reads as follows:

> (9) The commission shall ensure that universal service and energy conservation policies, activities and services are appropriately funded and available in each electric distribution territory. Policies, activities and services under this paragraph shall be funded in each electric distribution territory by nonbypassable, competitively neutral cost-recovery mechanisms that fully recover the costs of universal service and energy conservation services.

66 Pa.C.S. § 2804(9). There is no reference in the Act to funding of these programs by residential customers.

Rather, as OCA witness Colton explained, the use of the term "nonbypassable," indicates the General Assembly's intent to ensure that *all* customers making use of any part of the utility's system should help pay for universal service costs. To limit the cost allocation to only the residential class as PPL and PPLICA have proposed, is to render the term "nonbypassable" meaningless in the Statute. The Act must be read in a manner that gives meaning to all of its provisions. 1 Pa. C.S. § 1921.

PPLICA argues, though, that "nonbypassable" refers to the notion that customers will contribute whether they "shop" for generation supply or take service under POLR rates from an EDC. PPLICA argues that only those customers who paid for universal service programs in their bundled rates before restructuring are prohibited from bypassing these costs. PPLICA M.B. at 45-46. This narrow interpretation of Section 2804(9) is not supported by the plain language of the Act. Section 2804(9) does not refer to unbundling, it does not refer to customer's rates prior to restructuring, and it does not refer to allocating universal costs to only one class of customers. Rather, it is a broad statement that these costs be funded in a nonbypassable manner linked to the requirement that the programs be adequately funded and costs be fully recovered. This suggests the broadest allocation, not the most limited as PPLICA argues.

PPL also argues that the Commission previously rejected allocation of universal service costs across all customer classes in the Company's Restructuring Proceeding under the Act. PPL M.B. at 153. The reasoning behind the Commission's determination in that proceeding, however, centered around the prohibition against cost-shifting contained in the Competition Act, not the appropriate allocation of these costs on a going-forward basis. Re: Pennsylvania Power & Light Co., 89 Pa. PUC 587, 658 (1998). PPL's Restructuring Settlement clearly states that universal service cost allocation would be addressed in the instant proceeding. OCA St. 5-S at 11.

Contrary to the arguments of PPL and PPLICA, the Act does not serve as a bar to allocating these costs to all customer classes. The Act supports such an allocation. The ALJ and the Commission should find that these costs should be allocated to all customer classes.

5. Allocation Of PPL's Universal Service Costs To All Customer Classes Will Not Overly Burden Other Classes

PPL argues that the OCA's recommendation should not be adopted since the OCA has not made a specific proposal for allocating the costs of the programs. PPL M.B. at 153. PPLICA similarly argues that if these costs are allocated across all customer classes the allocation should not be done in a way that unfairly burdens large industrial customers. PPLICA M.B. at 46-47. As the OCA pointed out in its Main Brief, in this case, the importance of this issue is to properly allocate costs in the Cost of Service Study so that the results of the study better reflect the indexed rate of return of each customer class. OCA M.B. at 114, fn. 36; 175, fn. 52. A cost of service study that properly reflects the assignment of costs to each customer class makes a better guide for the Commission in establishing rates. In this case, as OCA witness Galligan testified, if PPL had allocated

universal service costs to reflect a broad sharing of those costs, it would increase the indexed rate of return for the residential customers somewhat. OCA St. 4 at 21. In other words, the residential class is bearing more of its cost responsibility than the cost of service studies show. Reflecting this more accurate indexed rate of return is important in this case as other parties seek to shift more of the burden of this rate increase onto residential customers.

In this case, the OCA has accepted the Company's proposed allocation of the rate increase to the customer classes, and has agreed with the Company that a proportional scale back would be appropriate if less of an increase is granted. Since the OCA has not proposed to change the Company's distribution of the rate increase across customer classes, it was not necessary for the OCA to make a specific proposal for allocating universal service costs to the customer classes. As OCA witness Galligan explained, either an energy basis or a total revenue basis would be appropriate, but the effect of either method would not significantly alter Mr. Galligan's cost of service study results. OCA St. 4 at 21. The OCA submits that the principle that all customer classes should share in these costs must be recognized so that the cost of service study results can be viewed in the proper context.

XI. DISTRIBUTION SYSTEM IMPROVEMENT CHARGE

A. PPL's DSIC Proposal Is Unreasonable And Contrary To Applicable Law

In its Main Brief, PPL argues that its DSIC proposal is allowable under Section 1307(a) of the Public Utility Code, capable of legal implementation, and properly designed. PPL M.B. at 112-132. As set forth in detail, in the OCA's Main Brief at 187-205, there is no provision in the Public Utility Code, which supports implementation of a DSIC for an electric distribution Company. The DSIC constitutes impermissible single issue ratemaking, guarantees continual rate increases without regard to whether such an increase is needed or not, and is contrary to Commonwealth Court precedent regarding the recovery of certain costs through Section 1307. Moreover, PPL's proposed DSIC is flawed in that it fails to provide for adequate Commission review or oversight. There is no legal or policy basis for approving PPL's proposed DSIC.

1. Section 1307(a) Cannot Be Used As Support For PPL's Proposal

The heart of PPL's argument is that Section 1307(a) permits implementation of a DSIC by an electric utility. PPL M.B. at 112-115. PPL argues that Section 1307(a) provides the Commission broad authority to fashion a rate adjustment mechanism. PPL asserts that this broad authority was not limited by the later enactment of Section 1307(g), which granted the Commission specific authority to implement a DSIC for water utilities. PPL M.B. at 112-120. PPL's arguments, and discussion, fail to recognize several key points.

While the OCA agrees that Section 1307(a) is an exception to the traditional, Section 1308 base rate proceeding, PPL fails to recognize that the Courts have found Section 1307(a) to be limited to the recovery of expenses, not the fixed costs that PPL seeks to include in its DSIC. Specifically, in Pennsylvania Indus. Energy Coalition v. Pa. P.U.C., 653 A.2d 1336 (Pa. Commw. 1995), *aff'd per curiam*, 543 Pa. 307, 670 A.2d 1152 (Pa. 1996)(PIEC), a case which the Company cites, the Commonwealth Court held that Section 1307(a) recovery was limited to the recovery of expenses and may not be used to recover the costs of physical facilities, return or incentives. PIEC Id. at 1353. The Court emphasized that an automatic adjustment clause typically "flows through only *expenses* and *changes to those expenses* without including any profit or other recovery." PIEC, Id. at 1341. PIEC is clear that the costs of physical facilities and the return that PPL seeks to recover through its DSIC cannot be included in a Section 1307(a) surcharge mechanism.

PPL also tries to suggest that Section 1307(g) cannot be read to limit the Commission's authority under Section 1307(a). PPL M.B. at 115-120. PPL argues that Section 1307(g) was just a codification of existing law. PPL M.B. at 119. PPL's argument, however, fails to take into account the Commonwealth Court's ruling in PIEC. PIEC is clear that Section 1307(a) can be used for the recovery of expenses only, not items of rate base or return. PIEC was decided in 1985 and Section 1307(g) was added to the Public Utility Code in 1985. Section 1307(g) did not codify existing law. Section 1307(g) specifically allowed for the recovery of fixed costs by *water utilities*, a departure from existing law. Section 1307(g) does establish a special recovery method for certain fixed costs for water utilities only, and not for any other type of utility. Under the rules

of statutory construction, the exception created for water utilities under Section 1307(g) cannot be used to support a similar exception for an electric utility.[17] 1 Pa.C.S. § 1924.

Moreover, testimony at the public input hearing on behalf of the Northeast Democratic Delegation, which includes Representative Phyllis Mundy, Representative Kevin Blaum, Representative Todd Eachus, Representative Jim Wansacz, Representative, Tom Tigue, and Representative Bob Belfanti is enlightening on this point. The testimony provided:

> We believe the DSIC that PPL is proposing is unlawful. While water companies are permitted by law to impose a DSIC, electric and gas companies have not been authorized by the State Legislate to impose such a charge.
>
> * * *
>
> [A]s State Legislators, stress that it was not the intent of the Legislature in 1996 to give broad authority to the PUC to authorize a DSIC for all utilities but rather limit the DSIC to water companies.
>
> Consistent with this is the fact that the House of Representatives has twice rejected the legislation that would impose a DSIC for gas companies. Not only do we believe that a DSIC approved only by the PUC is unlawful, we think it is bad public policy.

Tr. at 254.

The OCA submits that PPL has failed to identify any provision of the Public Utility Code that supports its request for a DSIC. In fact, a fair reading of the

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[17] Moreover, the distinction created for water utilities by Section 1307(g) can be seen by a review of the other subsections of Section 1307. The other subsections of Section 1307 identify specific items of expenses, such as taxes and fuel costs that can be recovered under Section 1307. See 66 Pa. C.S. §§ 1307(c), (f), (g.1). *These Sections comport with the Court's discussion in PIEC that only expenses are* to be recovered through surcharge mechanisms. Section 1307(g) clearly establishes an exception for water utilities.

Public Utility Code, and Court decisions interpreting the Code, clearly demonstrate that PPL's DSIC runs afoul of the law.

2. PPL's Reliance On The Commission's 2003 Order Dealing With A Collections System Improvement Charge Is Misplaced

PPL also relies upon the Commission's Order in Pa. P.U.C. v. Pennsylvania-American Water Co., Docket No. R-00027982 (November 7, 2003) (CSIC Order). PPL M.B. at 120-121. However, such reliance is misplaced. The OCA addressed this Order in detail in its Main Brief at 200-201. Importantly, the Commission's CSIC Order, which is currently on appeal to the Commonwealth Court, allows Pennsylvania American Water Company to implement a surcharge mechanism for infrastructure improvement costs due to the health and safety problems related to deteriorated wastewater facilities. CSIC Order at 17. Even if the Public Utility Code could be read to allow such a surcharge, the Company has made no similar showing here. Although the Company tries to argue that its infrastructure is aging, the Company's capital investment, which it has recovered through depreciation of existing plant, actually has exceeded the amount which it has reinvested in its distribution system since restructuring. OCA St. 2 at 6-7. The Company's proposal is out of step with the reality of its own capital projects. The OCA would also note that the Company has not asserted, nor should it, that there is a matter of health or safety at issue here. The Company cannot shoehorn its case into the CSIC Order by simply saying that its facilities are getting older.

Additionally, the Commission's vote on the CSIC case was not unanimous. The significant legal problems associated with the Order were identified by Commissioner Pizzingrilli in her dissent where she stated:

> In 1996, the General Assembly enacted Section 1307(g), which specifically permits water utilities to recover certain infrastructure improvement costs through implementation of a sliding scale of rates or other method for the automatic adjustment of rates. However, the General Assembly did not include any other utilities in this provision and, as a result; I do not believe that the statute provides the authority to adopt the CSIC.

CSIC Order, Statement of Commissioner Kim Pizzingrilli, Docket No. R-00027982 (September 5, 2003). Commissioner Thomas also dissented from this decision.

The OCA submits that the Commission's CSIC Order is not a decision that should be relied upon in this case.

3. PPL's DSIC Proposal Constitutes Impermissible Single Issue Ratemaking And Is Not In The Public Interest

PPL argues that its DSIC proposal is in the public interest. PPL M.B. at 120-122. The OCA submits, however, that a proposal that continuously raises rates to customers, whether needed or not, and ignores all offsetting cost savings is not in the public interest. In particular, OCA witness Catlin summarized the key problems of a practical and technical nature necessitating rejection of the DSIC as follows:

- The DSIC would constitute improper single issue ratemaking and would provide a means of guaranteeing increases in rates to recognize certain cost increases without recognizing offsetting cost savings.
- Verification of the eligibility of projects for inclusion in the DSIC would be problematic.
- The proposed annual process for establishing the amount of the DSIC surcharge is unrealistic.
- The DSIC would reduce or eliminate certain essential aspects of the review and oversight of PPL Electric's rates.

OCA St. 2 at 5. These concerns, as well as lack of Commission legal authority to permit such an implementation, strongly support the conclusion that this proposal is not in the public interest.

PPL has argued that these practical and technical issues do not warrant rejection of its proposal. PPL M.B. at 122-132. The OCA disagrees. The problems identified with the proposal by numerous parties to this proceeding are significant. The Company's proposal to adjust one element of its base rates, without considering any offsetting cost savings, would disassemble the ratemaking process, calling into question the justness and reasonableness of any rate set through such a clause. OCA witness Catlin identified at least four areas of cost offsets that would not be recognized in PPL's proposal, including offsetting ADIT associated with the plant included in the DSIC, reduced depreciation expense, reduced maintenance costs, and increased revenues from customer growth. See, OCA St. 2 at 7-9. The result of this single issue process could lead to excess earnings by the Company.[18]

The Company also attempts to argue that there is sufficient regulatory review built into its process to overcome any concerns. PPL M.B. at 130-131. The regulatory review, which the Company envisions, however, is extremely short. The Company's proposal is to file its DSIC on December 1 of each year and have it go into effect on January 1 – one month later. This stands in stark contrast to the 9-month time period provided for the base rate review of such capital investment in a traditional base

[18] At pages 125-126, the Company argues that the Commission should not worry about excess earnings since there are safeguards in place such as the Chapter 71 reports. The Company seeks to place the burden on the Commission and other parties to determine if it is over-earning and to take steps to prevent that. In such a circumstance, the burden of proof falls on the parties with the least access to the information needed to make a case. This is not an appropriate response to such an important problem.

rate proceeding. In that one month, the Commission Staff and the parties would, at a minimum, have to evaluate the purpose of the projects, audit whether the projects met the eligibility criteria for inclusion in the DSIC, and determine if the projects were non-revenue producing. See, *e.g.*, OCA St. 2 at 7-8. PPL's proposal provides little meaningful opportunity for review, thus reducing or eliminating proper oversight of PPL's rates.

When taken together, these problems with PPL's proposal cannot be overcome. PPL's DSIC proposal is contrary to sound ratemaking principles and cannot be found to be in the public interest.

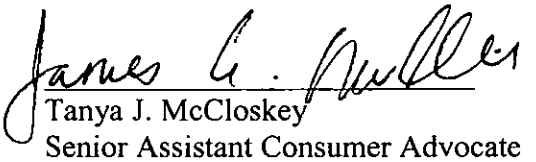
4. Conclusion

For the reasons set forth above, and for the reasons set forth in the OCA's Main Brief at 187-205, the OCA submits that PPL's proposed DSIC must be rejected. The DSIC is not permitted under the Public Utility Code, is impermissible single issue ratemaking, and is technically and practically flawed. There is no basis to approve this DSIC mechanism for PPL.

XII. CONCLUSION

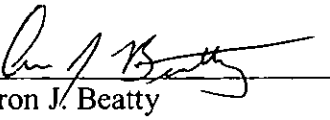
For the reasons set forth in its Main and Reply Briefs, the OCA respectfully submits that PPL's request for a distribution rate base increase of $164.4 million should be denied and PPL's rates should be increased no more than $115.2 million.

Respectfully Submitted,



Tanya J. McCloskey
Senior Assistant Consumer Advocate
James A. Mullins
Assistant Consumer Advocate

Lori A. Herman
Assistant Consumer Advocate



Aron J. Beatty
Assistant Consumer Advocate

Shaun A. Sparks
Assistant Consumer Advocate

Counsel for:
Irwin A. Popowsky
Consumer Advocate

Office of Consumer Advocate
555 Walnut Street 5th Floor, Forum Place
Harrisburg, PA 17101-1923
(717) 783-5048

DATED: September 13, 2004
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CERTIFICATE OF SERVICE

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Re: Pennsylvania Public Utility Commission, et al
v.
PPL Electric Utilities Corporation
Docket No. R-00049255

I hereby certify that I have this day served a true copy of the foregoing, Office of Consumer Advocate's Reply Brief, upon parties of record in this proceeding in accordance with the requirements of 52 Pa. Code § 1.54 (relating to service by a participant), in the manner and upon the persons listed below:

Dated this 13th day of September 2004.

SERVICE BY E-MAIL AND HAND DELIVERY

Richard A. Kanaskie, Esq.
PA Public Utility Commission
Office of Trial Staff
P.O. Box 3265
Harrisburg, PA 17105-3265
For: Trial Staff

Honorable Susan D. Colwell
Administrative Law Judge
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street
Harrisburg, PA 17120

SERVICE BY E-MAIL and FIRST CLASS MAIL

Steven Gray, Esquire
William Lloyd, Jr, Esquire
Office of Small Business Advocate
Suite 1102 Commerce Building
300 North Second Street
Harrisburg, PA 17101

Daniel Clearfield, Esq.
Kevin J. Moody, Esq.
Wolf, Block, Schorr, and Solis-Cohen LLP
212 Locust Street
Suite 300
Harrisburg, PA 17101

Michael Gang, Esquire
John H. Isom, Esquire
Morgan, Lewis & Bockuis LLP
One Commerce Square
417 Walnut Street
Harrisburg, PA 17101

Thomas Niesen, Esquire
Patricia Armstrong, Esquire
Thomas, Thomas, Armstrong & Niesen
212 Locust Street
Suite 500
P.O. Box 9500
Harrisburg, PA 17108

James P. Melia, Esquire
Kirpatrick & Lockhart, LLP
240 North Third Street
Harrisburg, PA 17101

David M. Kleppinger, Esq.
Pamela Polacek, Esq.
Karen Miller, Esq.
McNees Wallace & Nurick, LLC
100 Pine Street
P.O. Box 1166
Harrisburg, PA 17108

Louise A. Knight, Esq.
Joseph J. Malatesta, Esq.
David P. Zambito, Esq.
PPL Public Lighting User Group
2 North Second Street
Harrisburg, PA 17101

David B. MacGregor, Esq
Morgan, Lewis & Bockius LLP
1701 Market Street
Philadelphia, PA 19103

Paul E. Russell, Esquire
Associate General Counsel
PPL Electric Utilities Corporation
Two North Ninth Street
Allentown, PA 18101-1179

Mark C. Morrow
Counsel for UGI Utilities, Inc.
460 North Gulph Road
King of Prussia, PA 19406

David A. McCormick, Esquire
Regulatory Law Office
U.S. Army Legal Services
DAJA-RL 4120
901 N. Stuart Street, Room 713
Arlington, VA 22203

SERVICE BY E-MAIL AND OVERNIGHT DELIVERY

Honorable Ember S. Jandebeur
Administrative Law Judge
Pennsylvania Public Utility Commission
Scranton State Office Building
100 Lackawanna Ave.
Basement, B-3
Scranton, PA 18503

Honorable Allison K. Turner
Administrative Law Judge
Pennsylvania Public Utility Commission
1302 Philadelphia State Office Building
1400 West Spring Garden Street
Philadelphia, PA 19130

SERVICE BY FIRST CLASS MAIL

Mr. Eric Epstein
4100 Hilsdale Road
Harrisburg, PA 17112

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

Scott Rubin
Counsel
International Brotherhood Electric Works
Three Lost Creek Drive
Selingsgrove, PA 17870

Mr. Stephen J. Baron
J. Kennedy and Associates, Inc.
570 Colonial Park Drive
Suite 305
Roswell, GA 30075

Michael Fiorentino, Esq.
Attorney for Clean Air Counsel
135 S. 19th Street
Suite 300
Philadelphia, PA 19103

Kent D. Murphy, Esq.
Exelon Business Services Company
PECO Energy Company
2301 Market Street S23-1
PO Box 8699
Philadelphia, PA 19101

Roger E. Clark, Esq.
Sustainable Development Fund
718 Arch Street
Suite 300N
Philadelphia, PA 19106

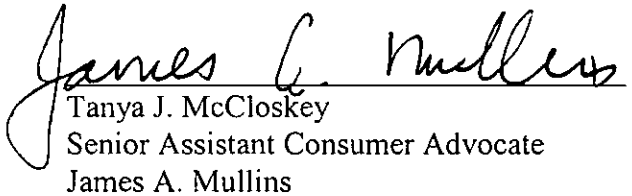
Joseph L. Vullo, Esq.
Commission on Economic Opportunity
1460 Wyoming Avenue
Forty Fort, PA 18704

Richard S. Herskovitz, Esquire
Duquesne Light Company
411 Seventh Avenue
8th Floor
Pittsburgh, PA 15219

Eugene M. Brady
Commission on Economic Opportunity
165 Amber Lane
P.O. Box 1127
Wilkes-Barre, PA 18703

Michael G. Wolfe, Esq.
Attorney for FirstEnergy
2800 Pottsville Pike
P.O. Box 16001
Reading, PA 19612

Peter Adels, General Counsel
Charley McPhedran, Senior Attorney
PennFuture
Suite 1801
117 S. 17th Street
Philadelphia, PA 19103



Tanya J. McCloskey
Senior Assistant Consumer Advocate
James A. Mullins
Lori A. Herman
Shaun A. Sparks
Aron J. Beatty
Assistant Consumer Advocates

Counsel For:
Office of Consumer Advocate
555 Walnut Street
Forum Place - 5th Floor
Harrisburg, PA 17101
(717) 783-5048
79537

McNees Wallace & Nurick LLC
attorneys at law

ORIGINAL

PAMELA C. POLACEK
DIRECT DIAL: (717) 237-5368
E-MAIL ADDRESS: PPOLACEK@MWN.COM

September 13, 2004

VIA HAND DELIVERY

DOCUMENT FOLDER

James J. McNulty, Secretary
Pennsylvania Public Utility Commission
The Commonwealth Keystone Building
400 North Street, 2nd Floor
Harrisburg, PA 17120

RE: Pennsylvania Public Utility Commission, *et al.*, v. PPL Electric Utilities Corporation; Docket No. R-00049255 C0001-0015

Dear Secretary McNulty:

Enclosed please find the original and nine (9) copies of the Reply Brief of the PP&L Industrial Customer Alliance ("PPLICA") in the above-referenced proceeding.

As evidenced by the attached Certificate of Service, all parties to the proceeding are being served with a copy of this filing. Please date stamp the extra copy of this transmittal letter and kindly return it to our messenger for our filing purposes. Thank you.

Very truly yours,

McNEES WALLACE & NURICK LLC

By Pamela C. Polacek
Pamela C. Polacek

Counsel to the PP&L Industrial
Customer Alliance

PCP/smd
Enclosures
c: Administrative Law Judge Allison K. Turner (via e-mail and First Class Mail)
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ORIGINAL

BEFORE THE

PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission, *et al.*,	:	
Complainants,	:	
v.	:	Docket No. R-00049255 C0001-0015
	:	
PPL Electric Utilities Corporation,	:	
Respondent.	:	

ORIGINAL

REPLY BRIEF OF THE PP&L INDUSTRIAL CUSTOMER ALLIANCE

Agere Systems, Inc.
Air Products and Chemicals, Inc.
ALCOA, Inc.
Anvil International, Inc.
Armstrong World Industries
Binkley & Ober, Inc.
BOC Gases
Certainteed Corporation
Cinram Manufacturing
Hercules Cement Co. LP,
d/b/a Buzzi-Unicem USA
Hershey Foods Corporation
Lafarge North America
Magee Rieter Automotive Systems
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DOCUMENT
FOLDER

David M. Kleppinger
Pamela C. Polacek
Charis Mincavage
Vasiliki Karandrikas
McNEES WALLACE & NURICK LLC
100 Pine Street
P.O. Box 1166
Harrisburg, PA 17108-1166
Phone (717) 232-8000
Fax (717) 237-5300

Counsel for the PP&L Industrial Customer Alliance

Dated: September 13, 2004

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TABLE OF AUTHORITIES

Cases: (cont'd) Page

Other Authorities:

I. INTRODUCTION

On September 2, 2004, parties filed Main Briefs in this proceeding.[1] Pursuant to the established procedural schedule, the PP&L Industrial Customer Alliance ("PPLICA") hereby submits this Reply Brief to respond to limited issues that were not fully addressed in PPLICA's Main Brief. Specifically, PPLICA responds to the following arguments raised in other parties' Main Briefs:

- PPLICA's Transmission Service Charge ("TSC") proposal is the optimum allocation and recovery mechanism for the flow-through of PPL Electric Utilities Corporation's ("PPL" or "Company") transmission and ancillary service costs; parties' arguments regarding the need to reject or modify PPLICA's proposal due to potential annual variability for some rate schedules, the impact of the proper allocation on the "total bill" increase to residential customers and the alleged "overstatement" of the impact on competitive generation supply shopping decisions are unfounded.

- PPLICA's proposal to decrease the subsidies in distribution rates is the only proposal that definitively addresses and resolves the intraclass subsidies that have been documented to exist in PPL's present and proposed distribution rates; arguments to delay addressing subsidies because of the "transition period" ignore the applicable statutory provisions and inappropriately rely on the assumption that cross-subsidies in other unbundled rate elements will offset the necessary increases in distribution rates for certain customer classes.

- PPLICA's witness Mr. Baron did not testify that street lighting is a "public good" and PLUG's request to excuse customers on Rates Schedule SL/AL from bearing a full and fair share of the distribution rate increase must be rejected.

- The Company's reading of the Commonwealth Court decision in ARIPPA is inaccurate; rather, as articulated by the Commonwealth Court, the transmission

[1] PPLICA received Main Briefs from the following parties: PPL Electric Utilities Corporation ("PPL or "Company") (hereinafter, "PPL M.B."); the Office of Consumer Advocate ("OCA") (hereinafter, "OCA M.B."); the Office of Trial Staff ("OTS") (hereinafter, "OTS M.B."); the Office of Small Business Advocate ("OSBA") (hereinafter, "OSBA M.B."); the Department of Defense and Federal Executive Agencies ("DOD") (hereinafter, "DOD M.B."); Wal-Mart Stores East, LP, Pennsylvania Energy Consortium and Pennsylvania Retailers Association (collectively, "Wal-Mart/PEC/PRA") (hereinafter, "Wal-Mart/PEC/PRA M.B."); Penn Future Parties ("Penn Future") (hereinafter, "Penn Future M.B."); Clean Air Council ("CAC") (hereinafter, "CAC M.B."); Sustainable Energy Fund of Central Eastern Pennsylvania ("SEF") (hereinafter, "SEF M.B."); PPL Public Lighting Users Group ("PLUG") (hereinafter, "PLUG M.B."); the Commission on Economic Opportunity ("CEO") (hereinafter, "CEO M.B."); and Mr. Eric Epstein (hereinafter, "Epstein M.B.").

and distribution rate caps clearly prohibit the deferral of costs for future recovery outside of the rate cap period; as a result, the Company's request to recover an amortized amount of the Hurricane Isabel and Automated Meter Reading ("AMR") severance costs incurred during 2003 must be rejected.

- The Company's proposal to implement a Distribution System Improvement Charge ("DSIC") is illegal and unsupported.

- The OCA has not established that a factual or statutory basis exists to reallocate universal service costs to non-residential customers.

- The Company's assertion that it is "uncontroverted" that the SEF provides benefits to all PPL ratepayers is in error; parties do contest the alleged benefits of the SEF to all ratepayers and the proponents of mandatory ratepayer funding have not fulfilled the burden of proof to include such costs in distribution rates.

PPLICA addresses each topic in subsequent sections of this Reply Brief.

II. TRANSMISSION SERVICE CHARGE

One of the most important issues in this proceeding is the proper allocation of, and recovery mechanism for, PPL's requested flow-through of transmission and ancillary service costs. This is the first time that the Pennsylvania Public Utility Commission ("PUC" or "Commission") will establish retail transmission rates for customers in the restructured environment. The restructuring initiatives in the electric industry have a two-fold impact on this decision. First, the restructuring of the wholesale electric industry resulted in PJM Interconnection, L.L.C. ("PJM"), becoming the entity that administers the tariffed prices for transmission and ancillary services for all load-serving entities ("LSEs") in PPL's service territory, including PPL as the Provider of Last Resort ("POLR"), and electric generation suppliers ("EGSs"). Second, the restructuring of the retail electric industry makes transmission costs a component of the price to compare in the shopping equation. These changes impact not only the allocation of transmission and ancillary costs among PPL's rate schedules, but also the proper rate design to recover transmission and ancillary "flow-through" costs from retail customers.

As PPLICA explained in detail in its Main Brief, the optimum allocation and recovery mechanism is Mr. Baron's TSC. See PPLICA M.B., pp. 61-86. PPLICA responded in full to the primary criticisms of Mr. Baron's proposal in Main Brief. Based on the arguments raised in other parties' Main Briefs, a limited further response is necessary, as set forth below.

A. The 10% "Total Bill" Increase Goal of PPL and OCA, as well as the Purported Need to Consider Alleged Cross-Subsidies in Other Unbundled Rate Elements as Advocated by PLUG and OCA, are Inappropriate and Contrary to the Competition Act.

The OCA and PPL argue that the Company's per kilowatt-hour ("kWh") allocation of transmission and ancillary service costs should be adopted to ensure that the increase to residential customers remains below 10% when viewed on a "total bill" basis, including distribution, transmission, generation supply and stranded cost charges. PPL M.B., pp. 100-102; OCA M.B., pp. 150-151. Similarly, OCA and PLUG assert that purported embedded cross-subsidies in generation and stranded cost charges must be considered. PLUG M.B., pp. 13-15; OCA M.B., pp. 123-125. These arguments, however, are contrary to the statutory system established in the Electricity Generation Customer Choice and Competition Act, Act of 1996, Dec. 3, P.L. 802, No. 138 § 4 (1996) codified at 66 Pa.C.S. §§ 2801-2812 ("Competition Act").

As discussed in PPLICA's Main Brief, the Competition Act requires the unbundling of the various elements of electric service. Under the Competition Act, each unbundled element must hereafter be judged as an independent rate, based on the particular criteria for that rate element set forth in the statute. For transmission rates, the applicable provisions are:

> (6) Consistent with the provision of section 2806, the commission shall require that a public utility that owns or operates jurisdictional transmission and distribution facilities shall provide transmission and distribution service to all retail electric customers in their service territory and to electric cooperative corporations and electric generation suppliers, affiliated or nonaffiliated, on rates, terms of access and conditions that are comparable to the utility's own use of its system.

[...]

> (10) The commission shall establish rates for jurisdictional transmission and distribution services and shall continue to regulate distribution services for new and existing customers in accordance with this chapter and Chapter 13 (relating to rates and rate making).

66 Pa.C.S. §§ 2804(6), 2804(10). The Competition Act does not reference the "total bill" impact, including all of the previously bundled rate elements as a relevant criteria in establishing the retail transmission or distribution rates after the transmission and distribution rate caps expire. See PPLICA M.B., pp. 61-86.

The Competition Act also places rate caps on the various elements that end at different times, with the transmission and distribution rate cap expiring before the cap on the generation component (generation supply and stranded cost charges). Compare 66 Pa.C.S. § 2804(4)(i), with id. § 2804(4)(ii). The only reasonable inference that can be drawn from the inclusion of different expiration dates for the two rate caps is that the General Assembly intended for transmission and distribution rates to be viewed on a "stand alone" basis at the expiration of the transmission and distribution rate cap.

The Commission must implement the statutory scheme created by the General Assembly by establishing distribution rates that are just, reasonable and non-discriminatory, as well as an appropriate transmission charge. See id. § 2804(10). The Commission cannot insert into this provision an additional requirement for a "holistic" or bundled review of whether the total charges to customers will be just and reasonable. This would be contrary to the plain language of Sections 2804(6) and 2804(10), and would render the different rate cap on transmission and distribution services under Section 2804(4)(i) of the Competition Act surplussage. See Ambrosia v. Yerage, 392 Pa.

Super. 233, 237, 572 A.2d 777, 779 (1990) ("In interpreting a statute, the words of the statute must be construed according to their plain meaning and usage..."); Phila. Gas Works v. Commonwealth, 741 A.2d 841, 845, 1999 Pa. Commw. Lexis 884, 7-8 (Pa. Commw. 1999) (citing the Statutory Construction Act of 1972 for the proposition that "every statute shall be construed, if possible, to give effect to all its provisions").

Similarly, the arguments of the OCA and PLUG that the Commission should consider the existence of undefined "cross-subsidies" in other rate elements are equally inappropriate. See OCA M.B., pp. 123-125; PLUG M.B., pp. 13-15. The OCA's own testimony demonstrates that, in the last bundled Cost of Service Study ("COSS"), the charges for Rate Schedule RS were established to earn only 80% of system average return. See Direct Testimony of Richard S. Galligan at 22 (hereinafter, "OCA Statement No. 4"). In other words, on a bundled basis, the residential class was being subsidized by other classes. Similarly, service for customers on Rate Schedule SL/AL was being subsidized for all unbundled elements. See OSBA Cross-Exhibit 2. Thus, even if other embedded "cross-subsidies" are relevant, it does not appear that this factor would weigh in favor of allocating lower increases to these customer classes.

Moreover, the only reasonable inference that can be drawn from the assertion that further subsidies in transmission or distribution rates should await elimination concurrent with the end of the generation rate cap is that the OCA believes that the generation component of residential rates will decrease at that time, making room available under the 10% theory for additional increases to residential transmission and distribution rates. However, nothing in the Competition Act guarantees that residential generation rates will decrease when the rate cap expires; rather, at that time, the generation rates for residential

customers will be established based on prevailing market prices. See 66 Pa.C.S. § 2807(e)(3). The Commission cannot determine now whether prevailing market prices will be above or below the current total generation component of residential customers' charges. As a result, the Commission cannot rely on the belief that "rate shock" can be avoided if the parties wait until the end of the generation rate cap period to eliminate the subsidies in distribution and transmission rates or that additional adjustments to transmission and distribution rates can be implemented at that time within the 10% criteria.

Given the unprecedented nature of the Company's request to flow-through transmission and ancillary service costs and the rate unbundling implemented by the Competition Act, the Commission must examine the distribution and transmission proposals in this case separately, and without any consideration of the generation element of customers' rates. For transmission rates, the Commission's decision to approve the flow-through and annual reconciliation of these costs by PPL will be equally as precedent setting as the Commission's decision on the method of allocating and recovering these costs. The Commission's action here to reject the proper allocation and recovery of transmission and ancillary service costs for PPL's ratepayers based on the existing subsidies that must be also be corrected in PPL's distribution rates will establish legal and policy precedent for many upcoming distribution rate cases, where this issue may have a countervailing impact. The Commission should seize this opportunity to ensure that PPL's transmission rate is allocated and designed on a cost causation basis from the beginning, thereby avoiding the establishment of additional cross-subsidies among and within customer classes. The appropriate action is for the Commission to adjudicate each

issue separately, based on the applicable statutory criteria for each unbundled rate element, rather than using an artificial 10% "total bill" goal.

B. Although Traditional Ratemaking Principles May Not Require Absolute Adherence to the Cost of Service Study, the Appropriate Allocation of PPL's Transmission and Ancillary Service Costs Must Recognize Cost Causation.

PPL attempts to defend the Company's per kWh allocation of transmission and ancillary service costs to rate schedules based on the argument that a COSS is only one factor that should be used to set rates. See PPL M.B., pp. 101-102. Even if the COSS for transmission costs will not be followed with strict adherence for this precedent-setting decision, the actual nature of the underlying costs to be recovered through the TSC must be recognized and considered in allocating costs to rate schedules and designing retail rates. The Company's proposed per kWh allocation of transmission and ancillary service costs bears little relation to a proper COSS for transmission and ancillary service costs, and will actually represent a departure from the current kilowatt ("kW") allocation of transmission costs.

The undisputed evidence in this proceeding indicates that the majority of the transmission and ancillary service costs to be collected through the TCS are demand (i.e., "kW") related. See Direct Testimony and Exhibits of Stephen J. Baron at 16 (hereinafter, "PPLICA Statement No. 1"); see Rebuttal Testimony of Douglas A. Krall at 21-22 (hereinafter, "PPL Statement No. 4-R"). As a result, when costs are functionalized and allocated to rate schedules, the proper allocation must recognize the demand-related nature of the underlying costs. Surrebuttal Testimony of Stephen J. Baron at 10 (hereinafter, "PPLICA Statement No. 1-S"). There is no evidence to support the allocation of more than 30% of the transmission and ancillary service costs on an energy

(i.e., "kWh") basis, which is the approximate percentage of the costs that the PPLICA proposal allocates on an energy basis. Id. at 5 (stating that, until there is a change in the PJM Open Access Transmission Tariff ("OATT"), it is appropriate to charge retail customers pursuant to the allocation that PJM currently utilizes, i.e., approximately 30% on a kWh basis and 70% on a kW basis). At this point in the proceeding, there should be no dispute that the PPLICA analysis represents an appropriate, cost-causation based study and allocation of the transmission and ancillary service costs to PPL's rate schedules. See Hearing Transcript at at 905 (Krall) (hereinafter, "Tr."); id. at 1034 (OCA); and id. at 1059 (Yocca). No party has identified any error in Mr. Baron's analysis.[2]

A COSS may be only a "guide" for ratemaking, but it clearly is an important element of the ratemaking process. The primary parties challenging the importance of cost causation related to the transmission rates have expended many resources in this proceeding arguing about the assumptions for the distribution COSS. See OCA Statement No. 4 at 15-16 (characterizing PPL's COSS as inadequate and claiming that the COSS results do not present a useful guide for the PUC); Rebuttal Testimony of Joseph M. Kleha at 2-3 (hereinafter, "PPL Statement No. 5-R"). For example, in PPL's Main Brief, the Company makes the following statement related to the distribution COSS and rates:

> The Commission has repeatedly recognized that cost of service is only a guide to designing rates and is only one factor, albeit an important one, to be considered in the rate setting process. *See, e.g., Pa. P.U.C. v. Pennsylvania Power & Light Co.*, 55 PUR 4th, 185, 249 (1983) (describing cost of service of service [sic] study as a

[2] The OCA objects to the PPLICA proposal on the basis that it allegedly does not "perfectly" assign individual customer transmission and ancillary service cost responsibility for non-interval metered customers. See OCA M.B., pp. 143-144. PPLICA will address this issue in the next subsection of this brief.

> "useful tool" for testing reasonableness of a proposed allocation). Moreover, cost of service analysis is not an exact science, and there is no single, absolutely correct method. *See id.* (describing cost of service study as "engineering art"); PPL Electric St. 5-R, p. 2. But consistency in cost allocation is indisputably important for PPL Electric and its customers, and PPL Electric has used the same methods of cost allocation here which have been approved by the Commission in prior PPL Electric rate proceedings.

PPL M.B., pp. 161-162. In contrast, for transmission rates PPL not only proposes to change the allocation methodology, but also to adopt an allocator that is less consistent with cost causation.

Similarly, the OCA argued in Main Brief:

> The cost of service study serves as a guide used to set rates consistent with the principle of cost causation. It is critical that the cost of service study relied upon to guide the setting of rates be as accurate as possible. The OCA submits that there are significant flaws in the Company's study making it an unreliable indicator of the cost to serve any particular class. As discussed below, the OCA has proposed an alternative to the Company's cost of service study that more accurately reflects the cost to serve the various classes. The OCA's cost of service study should be used as the guide in this proceeding.

OCA M.B., p. 103 (emphasis added). In addressing a perceived flaw in PPL's minimum system analysis, the OCA noted: "The problem with this approach is that it misallocates a significant amount of capacity costs on a customer basis, thus overstating the cost to serve customer classes, particularly the residential class." Id. at 107. Yet, for transmission rates, the OCA denies that rates should be based on a cost of service study that more accurately reflects PPL's costs to serve the various classes, and endorses a proposal that significantly misallocates demand-related costs on an energy basis, thus overstating the cost to serve the Large Commercial and Industrial ("Large C&I") class.

Ironically, the OCA actually urges the Commission to reject the DOD's and OSBA's transmission proposals for allocating all costs on a demand (i.e., "kW") basis because the proposals fail to account for the 30% of energy-based transmission costs, when the proposal supported by the OCA allocates all costs on an energy (i.e., "kWh") basis and ignores that 70% of the costs to be collected through the TSC are demand-related. See OCA M.B, p. 146, n.44; PPLICA Statement No. 1 at 16. If the nature of the underlying costs and an appropriate COSS are not important in setting distribution and transmission rates, then the OCA's objections to the Company's distribution COSS and to the DOD and OSBA transmission rate allocations are irrelevant. Obviously, this is not the case and cost causation is an important and guiding factor for both transmission and distribution ratemaking.

The Commission previously has determined that rates should be move towards cost of service. See Pa. Pub. Util. Comm'n v. Phila. Gas Works, 2001 WL 1704791 (2001), 213 P.U.R. 4th 280 (Pa. P.U.C.); Barasch v. Pa. Pub. Util. Comm'n, 101 Pa. Commw. 76, 515 A.2d 651 (1986); Pa. Pub. Util. Comm'n v. PECO, 56 Pa. P.U.C. 155, 47 P.U.R. 4th (1982); Pa. Pub. Util. Comm'n v. Pa. Power & Light Co., 1995 Pa. P.U.C. Lexis 189 at 285, 85 Pa. P.U.C. 306 at 394 (1995); Pa. Pub. Util. Comm'n v. Trigen-Phila. Energy Corp., Docket No. R-00016941, Order (June 28, 2002). In addition, although the Commission may not be required to establish rates solely on the basis of a COSS (see PPL M.B., pp. 101-102), other "automatic adjustment rates" such as purchased gas cost rates under Section 1307(f) are designed based on cost causation. See, e.g., Pa. Pub. Util. Comm'n v. T.W. Phillips Gas & Oil Co., 1997 Pa. P.U.C. Lexis 121 (1997). The Commission also has previously approved a demand allocator (12 CP)

for all transmission costs. See Tr. at 985 (Kleha); id. at 1065 (Yocca) (noting change in allocation methodology). Even if the COSS is only a "guide," it clearly has been relied upon in the past to allocate transmission costs to rate schedules on a demand basis. OCA's and PPL's assertions that the PUC should essentially ignore this factor and adopt an allocation that distorts costs causation are inappropriate. The Company's proposal to shift cost responsibility to Large C&I customers must be rejected.

In addition, the Public Utility Code requires that retail customers' transmission charges be comparable to the charges incurred by PPL for its use of the transmission system. Specifically, Section 2804(6) states:

> Consistent with the provision of Section 2806, the Commission shall require that a public utility that owns or operates jurisdictional transmission and distribution facilities shall provide transmission and distribution service to all retail electric customers in their service territory...on rates, terms of access and conditions that are comparable to the utility's own use of its system.

66 Pa.C.S. § 2804(6). Unless the Commission adopts PPLICA's TSC, this section will be violated because rates and service to POLR customers would not be comparable to PPL's own use of the system.

Furthermore, the proper allocation of transmission and ancillary service costs to rate schedules (and the proper retail rate design) will encourage customers to efficiently use electricity and the transmission system. For example, PPLICA member Anvil International Corporation ("Anvil") has undertaken a facility-wide effort to reduce on-peak demand. See Direct Testimony of Aaron P. Croop at 7-8 (hereinafter, "PPLICA Statement No. 5"). As Mr. Croop explained:

Q. Does Anvil undertake efforts to minimize its usage during peak periods?

A. Yes. Anvil has installed equipment that limits our electricity usage during on-peak periods. Our on-peak demand is generally about 1/3 that of our off-peak demand. In order to accomplish this, we tailor our regular production schedule to match PPL's off-peak hours. This has consequences for our other production costs because, according to our labor agreement with the union, the company is required to pay hourly nightshift premiums for a majority of the hours we are in production. Additionally, strict power management must be employed during on-peak hours in order to slowly "melt-in" steel scrap, in preparation for the next production shift, and we must avoid any other activities that would produce an unexpected increase in on-peak demand. When PPL bills us for distribution service, generation supply service and the transition charges, the Company uses our highest on-peak fifteen minute demand as the "Billing KW" to calculate the charges. Under the rate structure in the tariff and our contract, keeping our Billing KW as low as possible results in lower electricity costs.

Under our contract, we also have the opportunity to use the "Demand Free Days" option in Rate Schedule LP-5. This allows us to annually pre-select three workdays a week (from Tuesday through Friday) during which our on-peak demands will not be used in the determination of the monthly Billing KW. PPL has the opportunity to cancel the Demand Free Day by providing us with notice by 2:00 P.M. on the day before. Demand Free Days are canceled when demand on the power grid is high and/or generation is low. When PPL cancels a Demand Free Day, Anvil cancels or modifies production shifts on that day to ensure our electric load remains low during the on-peak hours.

Q. Does PPL's proposed transmission rate design recognize Anvil's demand control activities?

A. No. We will be charged the same rate as all other customers regardless of when we use the electricity or whether Anvil took steps to minimize its usage during on-peak periods. As PPLICA's expert witness Mr. Baron testifies, although the current transmission charge is also assessed on a kWh basis, the allocation of the transmission costs to the various rate schedules was at least accomplished on a kW basis, which would provide some recognition of the demand

control activities of any customers within that rate schedule.

Q. Would Mr. Baron's proposed per-kW Transmission Service Charge ("TSC") provide an incentive for Anvil to continue demand controls?

A. Yes.

Id. In addition, Mr. Rooney described how PPLICA's TSC would provide Armstrong World Industries ("Armstrong") with additional incentive to pursue demand management:

> A per KW transmission charge provides an incentive for Armstrong to control our demand during on-peak hours improving our load factor to help increase transmission capacity at peak time. This benefits Armstrong (through lower costs), provide[s] lower costs to the transmission owner by minimizing their investment and provides a benefit to the entire electric grid by giving Armstrong and other large users an incentive to minimize our usage during peak demand periods. A flat kWh transmission charge as proposed by PPL does not provide the same incentive to avoid using electricity at peak demand time. PPL's per kWh proposed transmission charge also will not provide a demand-side response signal to participate in demand-side response programs offered by PJM and endorsed by FERC.

Direct Testimony and Exhibits of James H. Rooney at 11-12 (hereinafter, "PPLICA Statement No. 4").

The demand control activities of companies such as Anvil and Armstrong benefit not only PPL's generation costs for serving the facility, but also reduce the Company's overall transmission charges (assuming that the demand reduction occurs coincident with the zonal peak or the 5 zonal coincident peaks). If this occurs, then it is appropriate for Anvil or Armstrong to recognize the benefits of these activities through the proper cost-based allocation of transmission and ancillary services to rate schedules, and then through

a rate design that passes those benefits through to the ratepayers that produced the benefits. The preparation of a proper COSS and the establishment of retail rates based on that COSS are necessary to reward individual customers for the beneficial impact that customer demand reduction activities can have on the transmission and ancillary service costs incurred by PPL.[3] Instead, as the Company recognizes, PPL's proposed kWh allocation actually penalizes customers such as Armstrong and Anvil. See PPL M.B., p. 101 (acknowledging that kWh allocation harms large, high load factor customers).

The Commission's action in establishing a TSC for PPL will be precedent setting. For transmission rates, the Commission can either commence this new "flow-through" reconcilable rate based on an appropriate cost-based allocation of the underlying costs, or approve a rate that includes obvious and proven interclass subsidies. Given the Commission's traditional goal to establish rates that reflect the underlying costs to serve each customer class, the prudent action is to begin this process with a proper allocation from the beginning, as PPLICA's TSC proposal does.

C. PPLICA's Cost-Based Allocation of Transmission and Ancillary Service Costs Tracks PPL's Own Procedures to Determine Obligations for Customers That Access Competitive Generation Supply, Which is the Best Method Available At this Time to Allocate Responsibility for the Costs to Rate Schedules and Customers.

The OCA urges the Commission to reject PPLICA's TSC proposal for not "perfectly" assigning individual customer transmission and ancillary service cost

[3] The parties have expended considerable resources debating the purported benefits of the demand control projects sponsored by the SEF. See, e.g., PPLICA M.B., pp. 9-30; SEF M.B., pp. 1-35; Penn Future M.B., pp. 1-10. In comparison to the evidence presented in support of mandatory customer funding for the SEF, however, the demand control activities of interval metered customers such as Anvil have been identified, are supported by evidence and can be readily tracked and quantified through PJM billing procedures. Penalizing customers such as Anvil and Armstrong through an improper allocation and recovery mechanism for transmission and ancillary service costs will discourage demand control and other customer initiatives that could result in the more efficient use of electricity and the transmission system, which will degrade reliability.

responsibility for smaller customers that do not have interval metering. See OCA M.B., pp. 143-146. PPLICA's proposal, however, is based on the procedures adopted by PPL to determine the transmission and ancillary service responsibility that should be assigned by PJM to an EGS if a particular customer purchases competitive supply from the EGS. See PPLICA Statement No. 1 at 22-25; id. at Exhibit SJB-2. This is the best available methodology to allocate transmission and ancillary service cost responsibility to rate schedules and customers.

As PPL explained, to determine the allocation of transmission costs to rate schedules if a customer purchases competitive supply, the Company calculates the 5 CP average contribution for the customer class based on either actual demands during the 5 CP (for interval metered customers) or load profiles (for customers without interval meters). See PPLICA Statement No. 1 at Exhibit SJB-3. The OCA's objection appears to be related to the load profiles that are used by the Company. The impacted parties (OCA, OSBA, PPL) can review the allocation process and load profiles for the non-interval metered rate schedules, and make appropriate adjustments if those profiles are not representative of the "average" customer on each rate schedule. However, the perceived inadequacy of the load profiles for non-interval metered customers is not a sufficient reason to reject the use of actual information for the allocation and recovery of transmission and ancillary service costs from customers where such information is available (i.e., for interval metered customers). This clearly is superior to a per kWh allocation and recovery of costs, which bears a causal relationship to only 30% of the underlying costs.

The methodology developed by the Company to assign transmission and ancillary service cost responsibility to both interval metered and non-interval metered customers that purchase generation supply from an EGS is the appropriate allocation methodology for PPL's TSC. Due to the inherent limitations in the data available for non-interval metered customers, class average load profiles are the appropriate current methodology to approximate these customers' responsibilities for transmission and ancillary service costs. As better data becomes available (such as through the AMR system), then the Company may be able to refine the allocation process. The allocation of TSC costs among the rate schedules can be changed to reflect appropriate changes made by PPL or PJM. See PPLICA Statement No. 1 at 22, n.3. Until such time, however, the Commission should allocate transmission costs based on the best evidence available, which is the PPL methodology for assigning transmission and ancillary service cost obligations to customers that access competitive supply from an EGS.

D. Attempts by the Company and OCA to Minimize the Impact of the TSC Allocation and Rate Design on Customer Shopping, As Well As MAPSA's Argument that Customers Will Benefit from Adopting a Less Precise TSC Allocation and Rate Design, are Misguided.

In another attempt to persuade the Commission to ignore proper cost causation principles and to reject PPLICA's TSC, the OCA and the Company assert that the design of the TSC will not impact generation supply shopping decisions by customers. See PPL M.B., pp. 102-104; OCA M.B., p. 150. Rather than basing this argument on testimony by witnesses that actually negotiate competitive supply arrangements (such as the PPLICA witnesses), PPL and the OCA rely on Mr. Krall's assessment that the transmission element of the shopping credit will have minimal impact on the decision. In addition, Mid-Atlantic Power Supply Association ("MAPSA") argues for the first time in its Main

Brief that "simplicity" will assist customers in shopping for generation supply, rather than the preferences expressed by customers for transmission to be a transparent flow-through element of both POLR pricing and competitive pricing. These arguments are misguided and must be rejected.

Five witnesses testified regarding the impact of the transmission rate design on generation supply shopping decisions. Three of those witnesses are energy managers for major PPL customers that are responsible for negotiating competitive generation supply arrangements. See Direct Testimony and Exhibits of Jennifer Hunsperger at 6 (hereinafter, "PPLICA Statement No. 2") (Energy Manager, Northeast Region for Praxiar, Inc., testifying on impact of proper TSC allocation and design on generation supply shopping); Direct Testimony and Exhibits of Larry Stalica at 6-7 (hereinafter, "PPLICA Statement No. 3") (Manager, Energy and Regulatory Affairs for BOC Gases, testifying that Mr. Baron's TSC proposal would promote competition by simplifying the comparison of POLR rates and EGS offers); PPLICA Statement No. 5 at 9 (Mr. Croop testifying on behalf of Anvil regarding the ease of comparing POLR rates with competitive supply offers under PPLICA's proposed TSC). These witnesses testified based on their past experience and, more importantly, their future preference for transmission and ancillary service costs to be a transparent item in the generation supply negotiations—i.e., an item that is nearly identical regardless of whether the facility purchases POLR supply or competitive supply, as contemplated by Section 2804(6) of the Competition Act, 66 Pa.C.S. § 2804(6). If provided the opportunity through the appropriate transmission cost allocation and rate design, these customers will ensure that the transmission and ancillary service rates charged by EGSs are identical to the Federal

Energy Regulatory Commission ("FERC")-approved rates paid by the EGS, rather than allowing the EGS to include an unquantified assumption and risk factor for transmission and ancillary service costs as part of the EGS's margin in the competitive offer. This may be a reason that MAPSA has, without providing any testimony on the subject, decided to support the PPL kWh allocation and recovery proposal as a method to "promote competition." See MAPSA M.B., p. 1-3. By adopting a TSC that does not accurately track the PJM costs, customers will be deprived of information to make informed choices regarding generation supply offers provided by MAPSA members. This is not the type of "level playing field" that the Commission should construct for negotiations between customers and EGSs.

In addition, the PPL testimony (also relied on by OCA) that the TSC rate allocation and design will not impact the generation supply shopping decision is based on speculation, at best. Although Mr. Krall may be well versed on many topics, he admitted that he is not involved in the negotiation of competitive supply alternatives with customers. Tr. at 910-911 (Krall). The testimony of the PPLICA energy managers who are responsible for, and experienced in, negotiating supply contracts is more persuasive than Mr. Krall on this topic.

Finally, MAPSA inappropriately relies on the Commission's recent decision related to the Duquesne Light Company ("Duquesne") POLR Phase III proceeding to support the misallocation of transmission and ancillary service costs on a per kWh basis. See MAPSA Main Brief, p. 2. In actuality, the Commission's decision in the Duquesne POLR III proceeding regarding the POLR generation supply pricing for Large C&I customers relies on the available PJM markets and billing determinants, just like

PPLICA's TSC. For example, Duquesne's POLR III generation supply charges will use the PJM capacity obligation (which is roughly the equivalent to the customer's 5 CP "tagged" demand) as the "billing demand" for Large C&I customers under both the fixed price POLR option and the hourly priced POLR option, rather than customers' monthly or annual on-peak demands, or rather than rolling all costs into a "simple" uniform cents per kWh rate. See Duquesne Light Company Petition for Approval of Plan for Post-Transition Period POLR Service, Docket No. P-00032071, Order at 32 (attached as Appendix A). In addition, for the hourly priced POLR option, the rate relies on a pass-through of the prices from various PJM markets. Id. Although this decision is under reconsideration by the Commission, it clearly shows a preference to use the PJM markets and billing procedures to determine retail rates, when available and appropriate. PPL's precedent-setting TSC is clearly one such circumstance where use of the PJM billing determinants and procedures is appropriate. PPLICA's TSC should be approved.

E. *The Alleged Variability Issue Can Be Accommodated on a Rate Schedule Basis and Should Not Bar the Commission from Ensuring that Transmission and Ancillary Service Costs are Appropriately Allocated.*

OCA, PPL, and other parties object to the PPLICA TSC proposal because it may lead to changes in the relative allocations for various rate schedules depending on whether PPL experiences a winter or summer peak. See PPL M.B., pp. 104-106; OCA M.B., pp. 146-150. PPL and the OCA assert that this potential variability is a reason to completely reject the proper allocation of transmission and ancillary service costs to rate schedules, as accomplished in PPLICA's proposal. The OSBA, while generally endorsing PPLICA's proposal, requests to use a five year rolling average of the 5 CP demands for the allocation. See OSBA M.B., pp. 20-21.

The potential variability in the annual allocation of transmission and ancillary service costs among rate schedules properly reflects the change in cost causation that occurs if different customer classes cause the Company's zonal peak. See PPLICA Statement No. 1-S at 5. This sends proper signals to all classes of customers regarding the impact of their consumption decisions on the transmission system, and should encourage more efficient consumption decisions by all customers.

As shown on the PPL exhibits, the change from a winter peak to a summer peak results primarily in a shifting of cost responsibility between and among the residential rate schedules and the small commercial rate schedules. See PPL Statement No. 4-R at Exhibit DAK3; id. at Exhibit DAK4. Admittedly, the impacts of these shifts can be alleviated by establishing an allocation mechanism that does not follow cost causation or that allows one or more rate schedules to cross-subsidize each other. PPL's original TSC, its alternative TSC that develops three different transmission rates for the broad customer groups, and the OSBA's five year rolling average allocation all accomplish this result. These proposals, however, would violate not only cost causation principles, but also the concept that rates must not be unduly discriminatory between customer classes. See Phila. Suburban Water Co. v. Pa. Pub. Util. Comm'n, 808 A.2d 1044. Charging one customer group a disproportionately high rate that is not related to the customers' usage characteristics or the costs incurred by the utility, in order to accommodate the "stability" request of another group, constitutes undue discrimination.

The impact of the potential annual variability in TSC rates obviously is a more important issue for the smaller customers than it is for larger customers. To resolve the competing concerns, the Commission clearly could adopt one of the "smoothing"

proposals advanced by the Company or the OSBA for the residential and small commercial customers, while ensuring that the TSC allocation and rate design for large customers accurately tracks the annual changes in transmission and ancillary service cost obligation as proposed by Mr. Baron. This is the appropriate "middle ground" to accommodate all of the concerns expressed by the parties in this matter.

F. Conclusion

Although ratemaking may involve a multi-factorial analysis by the Commission, cost causation is a preeminent guiding factor. PPLICA's TSC proposal most accurately allocates and recovers the transmission and ancillary service costs on a cost causation basis and minimizes interclass and intraclass cost shifting. In addition, PPLICA's TSC is the only proposal that complies with the statutory requirement that transmission rates and service to POLR customers must be comparable to PPL's own use of the system. See 66 Pa.C.S § 2804(6). Furthermore, PPLICA's TSC advances other ratemaking goals, such as encouraging the efficient use of electricity and enabling customers to make informed decisions regarding future competitive generation supply offers from EGSs. As the OCA recognizes, this is a "first of its kind" case for the Commission in which it is appropriate to examine and implement the most appropriate manner in which to allocate costs. See OCA M.B., p. 117, n.117. Although PPLICA may not agree with the merits of the OCA's proposed changes to PPL distribution COSS, PPLICA does agree that the Commission should strive to ensure that its decisions in this proceeding are based on appropriate cost causation principles. PPLICA's TSC clearly is the superior proposal for the allocation and recovery of transmission and ancillary service costs and should be adopted in this precedent-setting proceeding.

III. DISTRIBUTION REVENUE INCREASE ALLOCATION

In testimony and Main Briefs, various parties have presented proposals regarding how any distribution revenue requirement increase granted to PPL should be allocated among the rate schedules. See, e.g., PPLICA M.B., pp. 95-101; OTS M.B., pp. 68-71; OSBA M.B., pp. 8-15. PPLICA will not respond in detail here to each of the proposals; however, PPLICA continues to assert, for the reasons set forth in its Main Brief, that Mr. Baron's proposal is the best method to commence the elimination of the established cross-subsidization that exists in both PPL's present and proposed distribution rates. PPLICA M.B., pp. 95-101. Mr. Baron's proposal recognizes the potentially competing goals of moving rates closer to cost and avoiding "rate shock" for customers on rate schedules whose distribution rates are currently artificially low and below cost of service.

The OCA and PPL oppose PPLICA's proposal because it may result in "total bill" increases for residential customers that exceed 10%. See OCA M.B., pp. 131-132; PPL M.B., p. 167. As set forth in the previous section, arguments that the "total bill" impact should be considered in establishing the transmission or distribution rates in this proceeding are without merit and contrary to the Competition Act. See Section II, supra. Distribution service is now an unbundled service and rates for distribution service must be just, reasonable and not unduly discriminatory. See 66 Pa.C.S. §§ 1301, 1304. The current distribution rates contain unreasonable differences between classes of service, with some rate schedules paying over double the allocated cost of service, while others are paying distribution rates that are well below the cost of service. See PPLICA Statement No. 1 at Exhibit SJB-6. The Commission must begin to correct the

inadequacies in PPL's current rates by taking definitive and scheduled steps, as Mr. Baron proposes, to rectify this undue and unlawful discrimination in PPL's distribution rates.

The OCA also opposes PPLICA's phase-in proposal by arguing that is not authorized by the Public Utility Code. See OCA M.B., pp. 132-134. In Main Brief, PPLICA addressed the statutory authorization to adopt a phased elimination of cross-subsidies to arrive at just and reasonable rates at the end of the process. See PPLICA M.B., pp. 98-100. As Mr. Rooney explained, it is critically important to move the distribution rates for manufacturers in PPL's service territory closer to cost.

Q. Please describe the current business environment in your business.

A. In order to be competitive in a worldwide market, industry in general, and Armstrong specifically, must eliminate all unnecessary costs. Given that I even believe that PPL's own cost of service based rates to Armstrong are too high based on the level of rate base investment, I urge the Commission not to accentuate the problem further by imposing costs on Armstrong above the cost of service.

Q. What should the Commission do to help Armstrong?

A. We are currently overpaying distribution charges to PPL for Lancaster, Marietta and Innovation Center accounts. While PPL proposes to reduce these charges, we will still be significantly overpaying the true cost of service for these facilities. The Commission must eliminate this unnecessary overpayment. We are not asking PPL or the Commission to make our facilities competitive, but we are asking PPL and the Commission not to overcharge our facilities for services PPL provides to us. In 2003, Armstrong spent $55 million on cost-reduction initiatives throughout Armstrong. Unless the Commission rejects PPL's proposals, some of these successful cost reduction efforts will be offset through excessive payments for the services PPL provides to us.

Q. What action would you like the Commission to take?

A. I would like the Commission to require PPL to decrease Armstrong rates to cost-of-service rates as calculated and suggested by PPLICA witness, Mr. Baron. I believe now is

> the time to immediately reduce PPL distribution costs to their true cost of service. To permit other classes a gradual transition, I accept Mr. Baron's three-year phase-in. But I ask the Commission to require the phase-in as part of its final order. We cannot wait any longer to get to cost of service. China and other developing countries are not waiting to compete with U.S. industry. They are taking business from United States companies, and the U.S. is losing manufacturing jobs to these countries. To pay PPL a premium above cost of service for the monopolistic distribution services adds unnecessary costs to all industry as we attempt to be competitive.

PPLICA Statement No. 4 at 7-8. Mr. Rooney further explained why PPLICA's phase-in proposal should be adopted:

> Mr. Baron's suggested three-year phase-in permits residential customers a transition, and I believe residential customers should fully pay for their cost of service. I propose it is more logical and beneficial to charge residential customers the correct cost of service and keep industrial companies such as Armstrong as competitive as possible in Pennsylvania. From 1994 to 2000, Pennsylvania lost over 100,000 manufacturing jobs. While cost of service distribution rate[s], will not, of themselves, stop job loss, PPL must not be allowed to continue to penalize industry with higher than justified charges.

Id. at 9-10. The Commission has the authority to implement a phase-in of rate changes to arrive at rates that are more reflective of cost of service and should exercise that authority to assist Pennsylvania manufacturers such as Armstrong in remaining competitive in the global marketplace. Distribution may be a relatively small portion of Armstrong's production costs; however, this is not a valid reason to artificially inflate Armstrong's distribution rates.

Distribution rates for customers such as Anvil and Armstrong will not be just and reasonable until the PUC eliminates all of the historic subsidies. See PPLICA Statement No. 1-S at 13. PPLICA's proposal to reduce and eliminate distribution cross-subsidies

through a systematic, scheduled approach constitutes a reasoned and gradual approach to resolve an obvious problem in PPL's current and proposed distribution rates.

IV. STREET LIGHTING SERVICE IS NOT A "PUBLIC GOOD"

In its Main Brief, PLUG argues that PPL's street lighting customers on Rate Schedule SL/AL should not be allocated any portion of the Company's requested increase to distribution rates. Rather, PLUG argues that Rate Schedule SL/AL rates should be frozen, regardless of the current substantial subsidies that other rate schedules are providing to the street lighting customers. PLUG supports this argument, in part, based on the assertion that street lighting is a "public good" and that, consequently, the street lighting customers should not have to bear their allocated cost of service. PLUG M.B., pp. 6-9.

PLUG's arguments are misleading and wholly unsupported by the record. Contrary to the implication by PLUG, PPLICA witness Mr. Baron did not testify that street lighting is a public good. See PPLICA Statement No. 1-S at 6. PLUG attempted to obtain testimony by witnesses for other parties that street lighting is a public good; however, PLUG never asked Mr. Baron a single question regarding "public goods." See Tr. at 1101-1107 (Baron). Except for the illustrative examples of public goods provided by Mr. Baron in his testimony (police, fire protection, and the military), Mr. Baron did not testify that any service constituted a "public good" that should be subsidized through the provision of discounted electric distribution service. Street lighting surely is a government function; however, this has no bearing on the appropriate treatment of distribution rates for street lighting. In fact, OSBA witness Mr. Ewen also rejected PLUG's premise when counsel for PLUG attempted to gain his admission that street lighting was a "public good" warranting special rate making treatment. See Tr. at 1051 (Ewen). The only testimony in support of the conclusion of PLUG's assertion that street

lighting customers deserve special treatment because of the purported "public goods" theory came from PLUG's own non-expert witnesses. This does not constitute persuasive or substantial evidence in support of the proposal. PLUG members and all street lighting customers must be allocated an appropriate share of the Company's distribution rate *increase to eliminate the historic subsidies that the COSS revealed in Rate Schedule* SL/AL distribution rates.

Moreover, PLUG's attempt to argue that electric distribution service provided to street lighting should be subsidized similar to the water service provided to fire hydrants is inappropriate. See PLUG M.B., pp. 8-9. The General Assembly enacted a specific statutory provision authorizing the Commission to approve discounted water rates for public fire hydrants. See 66 Pa.C.S. § 1328. The General Assembly has not enacted a similar provision authorizing a discount to electric distribution service rates for street lighting customers. Under principles of statutory interpretation, when an exception to generally applicable law is created in the statute for a particular type of situation or customer, the General Assembly did not intend to provide the same exceptions to other types of services or customers not enumerated. See PPLICA M.B., pp. 52-57. PLUG is free to lobby the Legislature for specific statutory subsidization of its service, just like the Legislature provided for fire hydrants in Section 1328. Until that statutory provision is enacted, street lighting rates should be treated like any other distribution service rate and be moved to full cost of service.

V. THE COMPANY'S DSIC PROPOSAL IS UNLAWFUL, UNWARRENTED AND MUST BE REJECTED

In the Main Brief, PPLICA set forth in detail its objections to PPL's proposal to implement a Distribution System Improvement Charge ("DSIC"). See PPLICA M.B., pp. 49-58. PPL devotes a large section of its Main Brief to the Company's argument regarding why the Commission has the authority pursuant to Section 1307(a) to approve the proposed DSIC. See PPL M.B., pp. 112-121. Regardless of the Commission's purported authority to approve the proposal (which, as PPLICA explained in its Main Brief does not exist), the Commission must also adhere to the Commonwealth Court's guidance in Pa. Indus. Energy Coalition v. Pa. Pub. Util. Comm'n, 653 A.2d 1336, 1349 (Pa. Commw. 1995), that Section 1307(a) should have limited application. As PPLICA explained in Main Brief, PPL has not demonstrated a need to depart from normal ratemaking processes for these costs. Approving PPL's request will clearly set precedent that will be relied upon by all of the EDCs (and likely by all natural gas distribution companies) to request approval of DSIC tariff mechanisms. This will not constitute a "limited application" of Section 1307. The Commission must consider this impact in ruling on PPL's proposal and reject the DSIC.

VI. THE COMPANY'S PROPOSAL TO AMORTIZE AND RECOVER COSTS FOR AMR SEVERANCE AND HURRICANE ISABEL VIOLATES THE RATE CAPS, AS INTERPRETED BY THE COMMONWEALTH COURT IN ARIPPA

PPLICA explained in detail in its Main Brief why PPL's proposal to recover costs incurred during 2003 for Hurricane Isabel and AMR severance violates the transmission and distribution rate caps under Section 2804(4)(i) of the Public Utility Code, 66 Pa.C.S. § 2804(4)(i). PPLICA M.B., pp. 31-37. PPL has inappropriately attempted to remove the requests from purview of the rate caps by arguing that traditional ratemaking principles would have allowed the Company to defer for recovery and amortize any extraordinary expenses. PPL M.B., pp. 32-37. PPL's arguments must be rejected.

The Legislature is presumed to enact any legislation with full knowledge of the historic precedent related to the topic. See Commonwealth v. Butler County Mushroom Farm, 449 Pa. 509, 517, 454 A.2d 1, 5 (1982) (examining, inter alia, the "former law or precedent" of a particular statutory provision to discern its meaning). In adopting the rate caps under Section 2804(4), the General Assembly clearly intended to supplant all traditional ratemaking principles and prerogatives during the rate cap period. The rate cap prevented the pursuit of the most obvious ratemaking activity during the rate cap period (i.e., filing for a rate increase to take effect prior to the end of the rate cap period, unless, of course, an exception could be established). If the General Assembly intended to grant an exception to the rate caps for deferrals of "extraordinary" expenses, then the General Assembly could have acknowledged this in the various rate cap exceptions set forth in Section 2804(4)(iii). See 66 Pa.C.S. § 2804(4)(iii). The failure of the Legislature to include an exception to the rate caps for a deferral of extraordinary costs, while also including various explicit exceptions in the statute that would have been proper under

traditional ratemaking, must be construed to indicate that granting a rate cap exception for "extraordinary" storm or severance costs was not intended by the General Assembly. See Cali v. Philadelphia, 406 Pa. 290, 305, 177 A.2d 824, 832 (1962) (applying the principle of statutory construction that provides, "the mention of a specific matter in a general statute implies the exclusion of others not mentioned, i.e., expression unius est exclusion alterias").

The Commonwealth Court has also ruled in ARIPPA v. Pa. Pub. Util. Comm'n that the rate caps prohibit other activities that would not explicitly increase rates during the rate cap period, but would defer for future recovery costs incurred during the rate cap period that were related to the capped functions. See ARIPPA v. Pa. Pub. Util. Comm'n, 792 A.2d 636, 663-666 (Pa. Commw. 2002). Just as the GPU Energy Companies could not defer for future recovery generation costs incurred during the generation rate cap period, so PPL cannot defer for future recovery distribution costs related to AMR severance and Hurricane Isabel incurred during the distribution rate cap period. Contrary to the Company's assertion, the Commonwealth Court's decision clearly prohibits the Commission from ruling that the amortized portion of the deferred AMR severance and Hurricane Isabel costs are recoverable through the distribution rates that will take effect on January 1, 2005.

VII. THE OCA HAS NOT ESTABLISHED A STATUTORY OR COST CAUSATION BASIS TO ALLOCATE UNIVERSAL SERVICE COSTS TO NON-RESIDENTIAL CUSTOMERS.

The OCA argues that responsibility for PPL's Universal Service Programs ("USPs") should be reallocated in this proceeding to all customers (both residential and non-residential). The OCA raises three primary arguments in support of this proposed interclass cost shift: (1) the Public Utility Code requires the allocation of USP costs to all customer classes; (2) cost causation requires the allocation of USP costs to all customer classes; and (3) the so-called "public goods" doctrine requires that USP costs be allocated to all customers. All three bases are flawed and should be rejected.

A. The Public Utility Code Does Not Require USP Costs to Be Allocated to All Customer Classes.

The OCA argues that the inclusion of the term "non-bypassable" in Section 2804(9) of the Public Utility Code means that all customer classes must be allocated USP costs. See OCA M.B., pp. 175-176. Contrary to the OCA's assertion, the "simple reading" of Section 2804(9) does not require allocation to all customer classes. Rather, in an industry structure where customers have the opportunity access competitive supply, the term "non-bypassable" means a charge that applies to both shopping and non-shopping customers. See PPLICA Statement No. 1-R at 5. Read in conjunction with Section 2803(17), it is clear that the Legislature's intention was to continue, at a minimum, the programs that have been supported by bundled rates and to ensure that customer classes which were already responsible for universal service costs in their bundled rates would pay those costs regardless of whether they purchase POLR supply or shop for competitive supply from an EGS. Id. The Competition Act did not change traditional ratemaking principles that costs should be allocated based on cost causation

(which, as explained subsequently, requires that only residential ratepayers pay USP costs).

In interpreting the Public Utility Code, the Commission must give meaning to all of the provisions. See Phila. Gas Works, 741 A.2d at 845. The only way to give effect to both Section 2803(17) and 2804(9) is to interpret "non-bypassable" as meaning applying to both shopping and non-shopping, rather than as meaning applying to all customer classes. See PPLICA M.B., pp. 45-46.

B. Cost Causation Requires USP Costs to be Allocated Only to Residential Customers because only Residential Customers Can Use USPs and Any Benefits of USPs Flow Primarily, If Not Only, to the Residential Class.

OCA next argues that, because the benefits of PPL's USPs extend to all customer classes and society in general, all ratepayers should absorb the cost. See OCA M.B., pp. 117-182. Although OCA alleges that economic development benefits will occur from PPL's USP's, Mr. Colton has no study of this purported benefit. Tr. at 858 (Colton). Rather, OCA relies on data from other areas of the country, and on strained analogies to child care, which obviously is not a service that is subsidized by all citizens or paid for thorough PPL's distribution rates. Mr. Colton's unsupported and contradicted testimony does not constitute substantial evidence of a demonstrable benefit supporting the allocation of USP costs to non-residential customers.

In addition, as PPLICA addressed fully in its Main Brief, any benefits of USPs flow solely to the residential class (i.e., because only residential customers can request assistance from the USPs and because any cost savings or efficiencies that PPL may achieve will be assigned to the residential classes in the COSS). See PPLICA M.B., pp.

39-48. The OCA's attempt to manufacture a benefit for non-residential customers to justify its allocation proposal must be rejected.

C. USPs are Not Public Goods Whose Costs Should Be Shared By All Customers.

Finally, the OCA argues that USPs have been designated by the General Assembly as "public goods" and that this requires assignment of the costs to all ratepayers. See OCA M.B., pp. 182-184. PPLICA addressed this issue in detail in its Main Brief. See PPLICA M.B., pp. 39-48. PPLICA continues to support Mr. Baron's conclusion that PPL's USPs do not qualify under generally recognized definitions of the "public good." PPLICA addresses two additional issues raised by OCA below.

First, contrary to the OCA's belief, the statement in Section 2802(17) that programs for providing low-income assistance are "public purpose costs" does not equate to a finding that PPL's USPs are "public goods." See OCA M.B., pp. 181-183. If the General Assembly intended to invoke the "public goods" doctrine, as OCA alleges, then the statute would explicitly do so. In fact, the General Assembly did specifically enact special ratemaking treatments for some utility services provided to programs that Mr. Colton and Mr. Baron appear to agree are public goods – fire hydrants and volunteer fire companies. See 66 Pa.C.S. §§ 1328, 1511. The General Assembly has not done so for USPs.

Second, Mr. Colton's argument based on the National Regulatory Research Institute's ("NRRI") description of a "public good" is logically flawed. The NRRI definition adopted by Mr. Colton is:

> "A public good can be defined, as 'any publicly induced or provided collective good' that arise[s] whenever some segment of the public collectively wants and is prepared to

> pay for a different bundle of goods and services than the unhampered market will produce."

Surrebuttal Testimony and Exhibits of Roger D. Colton at 17 (hereinafter, "OCA Statement No. 5-S"); see also OCA M.B., p. 184. Presumably, the "bundle of goods" involved is electricity. The flaw in Mr. Colton's argument, however, is that the "segment of the public" that wants electricity from PPL under the USPs is not prepared to pay for electricity unless it is at discounted and subsidized rates. When the "different bundle of goods and services" demanded is electric service at lower rates, then all customer segments can argue for a "publicly induced or provided collective good" to ensure that they can purchase electricity at the reduced rates that they want, but are not "prepared to pay." Even if the "bundle of goods" is defined as PPL's USPs, the OCA's proposal is based on the premise that the segment that wants the USPs (i.e., residential customer and advocates) is not willing to pay for the "bundle of goods" (resulting in the request for subsidization by other non-residential segments of the public). The OCA cannot fulfill the test that its own witness adopted for the "public goods" doctrine.

Finally, the analogy of PPL's USPs to the telecommunications network discussed in the NRRI document is inappropriate. At least one fundamental difference exists between the two. All customers (residential, commercial and industrial) have the right to access the telecommunications network; however, all customers (residential, commercial and industrial) do not have the right to request assistance from PPL's USPs. The OCA's attempt to convince the Commission to adopt and extend the "public goods" doctrine must be rejected.

VIII. THE PROPONENTS OF MANDATORY CUSTOMER FUNDING FOR THE SUSTAINABLE ENERGY FUND HAVE NOT ESTABLISHED THE REQUISITE LEGAL OR EVIDENTIARY BASIS TO INCLUDE THE COSTS IN DISTRIBUTION RATES.

Various parties, including the SEF and Penn Future, argue that funding for the SEF should be included in distribution rates at a level of 0.01 cents per kWh. See generally SEF M.B.; Penn Future M.B. The proponents of such funding continue to argue that, in general, energy conservation and distributed generation provide benefits to PPL customers through relief of congestion on the distribution system. None of the proponents of mandatory customer funding for the SEF has produced persuasive or substantial evidence that any project funded by the SEF has produced demonstrable distribution benefits for PPL ratepayers.

In briefs, the proponents of mandatory customer funding for the SEF continue to assert the non-specific and vague assertions of purported "ratepayer benefits" that were included in the SEF, PPL and PennFuture testimony. PPLICA has fully addressed the legal and evidentiary deficiencies of this showing in Main Brief and will not burden the record by repeating those arguments here. See PPLICA M.B., pp. 9-30. PPLICA provided the proponents of SEF funding with every opportunity to support the vague references with actual studies or information related to specific SEF-funded projects. See PPLICA Cross-Exhibits 13-14 (Hanger responses to PPLICA interrogatories); PPLICA Cross-Exhibits 8-11 (Tuffey responses to PPLICA interrogatories). Among the information requested by PPLICA in those interrogatories were the following items:

- For each SEF project authorized to date, please provide any and all studies conducted by or available to SEF demonstrating the resulting elimination or delay of a distribution system upgrade. Include the cost of the SEF project and the anticipated cost that PPL would have paid for the upgrade

absent the SEF project. If no such studies exist, state so. (PPLICA Cross-Exhibit 8)

- Please identify the specific PJM transmission line for which congestion is claimed to be remediated by Bear Creek Wind Park. (PPLICA Cross-Exhibit 10)

- Please provide any and all studies conducted by or relied upon by SEF demonstrating the difference in locational marginal prices across the constraint or otherwise supporting and quantifying the claimed congestion relief of Bear Creek Wind Park. If no such studies exist or have been conducted, so state. (Id.)

- For Bear Creek Wind Farm and the other wind generation resources located within PJM, please provide the following (for each individual project, if available): A. Nameplate capacities; B. Average capacity factors; C. Actual availability and capacity factors during each of the 2003 PPL zonal five coincident peaks. (PPLICA Cross-Exhibit 11)

- With regard to the testimony of John Hanger on page 6 at lines 8 to 11, please provide all economic studies performed by or for Penn Future or available to Mr. Hanger that measures the economic costs and benefits to PPL from any SEF investment or grant made to date. If no such quantification based study has been conducted, please so state. (PPLICA Cross-Exhibit 13)

- With regard to the testimony of John Hanger on page 6 at lines 8 to 11, please provide all economic studies performed by or for Penn Future or available to Mr. Hanger that measures the economic costs and benefits to PPL ratepayers from any SEF investment or grant made to date. If no such quantification based study has been conducted, please so state. (PPLICA Cross-Exhibit 14)

As the record indicates, little, if any responsive information was provided by Penn Future or the SEF in the responses. In addition, despite the purported importance of the SEF projects in helping to avoid distribution and transmission upgrades, none of the criteria listed in Dr. Tuffey's testimony for the review of projects relates to this "important" and "demonstrated" benefit. See SEF M.B., p. 7 (discussing project consideration and evaluation criteria).

The overall view of the SEF funding proponents on their obligation to support their case is best captured in the following portion of Mr. Hanger's testimony:

> There is no requirement to demonstrate these reliability benefits from SEF programs specifically for PPL customers or to any class of PPL customers, any more than the 'public goods' doctrine....

Surrrebuttal Testimony of John Hanger at 2 (hereinafter, "Penn Future Statement No. 1-S"). Apparently, the SEF proponents believe that neither the Commission nor the other parties have any right to question the "undeniable" benefits of the SEF projects. Despite this unprecedented request to place the primary funding for a private "entrepreneurial" organization in electricity rates, the SEF funding proponents are unwilling to support their generalized assertion of benefits with actual evidence. See Tr. at 745 (Dahl) (acknowledging that other independent businesses are not funded through PPL's distribution rates). This is, of course, contrary to applicable precedent regarding both the standard to include funding for social programs in rates[4] and the placement of the burden of proof on the proponents of the proposed rates. See PPLICA M.B., pp. 17-18 (summarizing "demonstrable benefits" standard); PPLICA M.B., pp. 18-19 (summarizing burden of proof); OCA M.B., pp. 6-8 (summarizing burden of proof); OTS M.B., pp. 5-8 (summarizing burden of proof). In short, the evidence presented does not demonstrate the existence of "demonstrable benefits" for PPL distribution ratepayers from the SEF-

[4] In its Main Brief, SEF criticizes Mr. Baron for purportedly expanding the test for the inclusion of mandatory SEF funding in customer rates by adding a cost/benefit analysis. See SEF M.B., p. 20 n.6. As Mr. Baron explained during cross-examination, the test that he set forth in direct testimony was the same as the test set forth in his rebuttal and surrebuttal testimony. See Tr. at 1108-1110 (Baron). More significantly, as discussed in PPLICA's Main Brief, the cost/benefit test is required by the applicable PUC precedent. See PPLICA M.B., pp. 17-18. PPLICA propounded discovery questions on SEF and Penn Future to elicit necessary information to evaluate the cost/benefit analysis. As the parties with the burden of proof that SEF funding should be included in customers' rates, SEF, Penn Future, PPL and other SEF proponents should not be excused from presenting and supporting their proposals.

funded activities, which renders funding of the SEF through rates paid by customers unlawful.

SEF asserts that the Commission has discretion in its determination of "just and reasonable" rates to include mandatory funding for the SEF. See SEF M.B., pp. 14-16. The primary thrust of the just and reasonable inquiry is a balance between: (a) the utility's ability to charge rates sufficient to recover its costs and provide a reasonable rate of return; and, (b) the customer's interest in obtaining service at the lowest reasonable rate. Pa. Pub. Util. Comm'n v. Phila. Elec. Co., 522 Pa. 338, 343-44, 561 A.2d 1224, 1226 (1989). The interests of a third party seeking funding for its organization through rates is not part of the "just and reasonable" inquiry and assuming, arguendo, that it is, it is not just and reasonable to increase the costs properly allocated to customers on rate schedules such as Rate Schedule IS-T by 28% to fund this private organization. See PPLICA M.B., p. 20.

The first issue for the Commission here is whether the proponents of mandatory ratepayer funding of the SEF have met the requisite legal and evidentiary burden to place the expense in the "just and reasonable" equation at all, not whether the ultimate distribution rates that will be charged to customers are just and reasonable by appropriately balancing the financial interests of the utility and the ratepayers. Presumably, if the Commission does not include the SEF in distribution rates, then the Company will not provide further funding. As a result, the financial situation of PPL will not be harmed by the PUC's decision. The SEF's attempt to invoke the more amorphous "just and reasonable" standard for this decision is legally flawed and must be rejected.

IX. CONCLUSION

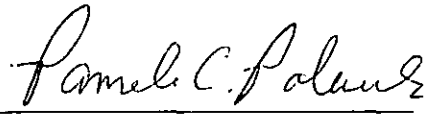
WHEREFORE, as articulated herein and in PPLICA's Main Brief and testimony, approval of PPL's proposed rate increase will be just, reasonable and otherwise lawful only if the following modifications are adopted:

- The allocation of the distribution increase among rate schedules is designed to immediately reduce interclass distribution subsidies by 50%, with subsequent annual adjustments to eliminate the remaining subsidies;
- PPL's proposed uniform cents per kWh transmission cost allocation and recovery is replaced with PPLICA's proposed transmission service charge, which appropriately allocates transmission and ancillary services cost based on the kW and kWh factors used by PJM and recovers the costs from Large C&I customers on a demand and energy basis;
- Mandatory customer funding of the Sustainable Energy Fund through distribution rates is eliminated;
- PPL's proposed Distribution System Improvement Charge is rejected;
- PPL's request to amortize and recover employee severance costs from 2003 related to its AMR program is denied;
- PPL's request to amortize and recover costs incurred during 2003 related to Hurricane Isabel is denied;
- The allowed rate of return on PPL's rate base is set at 7.85%; and

- The proposed changes to Tariff Rule 5A are rejected.

Respectfully submitted,

McNEES WALLACE & NURICK LLC

By 

David M. Kleppinger
Pamela C. Polacek
Charis Mincavage
Vasiliki Karandrikas
100 Pine Street
P.O. Box 1166
Harrisburg, PA 17108-1166
Phone (717) 232-8000
Fax (717) 237-5300

Counsel to the PP&L Industrial Customer Alliance

Dated: September 13, 2004

PENNSYLVANIA
PUBLIC UTILITY COMMISSION
Harrisburg, PA 17105-3265

Public Meeting held August 19, 2004

Commissioners Present:

Terrance J. Fitzpatrick, Chairman
Robert K. Bloom, Vice Chairman
Glen R. Thomas, Statement attached
Kim Pizzingrilli
Wendell F. Holland

Petition of Duquesne Light Company for
Approval of Plan for Post-Transition Period
Provider of Last Resort Service

P-00032071

OPINION AND ORDER

BY THE COMMISSION:

I. Introduction

Before the Commission are the Recommended Decision of Administrative Law Judge (ALJ) Michael A. Nemec issued May 26, 2004, and the separately filed Exceptions of the Office of Trial Staff (OTS), Reliant Energy, Inc. (Reliant), Direct Energy, Dominion Retail, Inc. (Dominion Retail), Citizens Power, Inc. (Citizens Power), Constellation Power Source, Inc. and Constellation Newenergy, Inc. (collectively, Constellation) and Strategic Energy, L.L.C. (Strategic Energy). The foregoing Exceptions were filed on June 9, 2004. Replies to Exceptions were filed by Strategic Energy, Reliant, the Duquesne Industrial Intervenors (DII), the Office of Consumer Advocate (OCA), the Office of Small Business Advocate (OSBA), and Duquesne Light Company (Duquesne or Company). The Replies to Exceptions were filed on

June 16, 2004. Also before the Commission is a Motion to Strike the Reply Exceptions of Reliant Energy, Inc. filed by Duquesne on June 23, 2004.

II. History of the Proceeding

On December 9, 2003, Duquesne filed a Petition requesting approval of its Plan for Provider of Last Resort (POLR) service for the period of January 1, 2005 to December 31, 2010 (Plan or POLR III Plan). The Plan is Duquesne's proposal for the provision of electric generation service to customers who do not choose an electric generation supplier (EGS) or who fail to receive service from an alternative supplier.[1] The Plan also seeks approval for the sale of POLR III energy and capacity to Duquesne from its affiliate, Duquesne Power; (2) Duquesne Power's acquisition of the Sunbury Station; and, (3) membership in PJM West.

On December 23, 2003, the OCA filed an Answer to the Petition. On December 29, 2003, the OSBA filed its Answer. On December 30, 2003, the OTS filed its Notice of Appearance. On December 31, 2003, DII filed its Petition to Intervene and Answer to Duquesne's Petition.

A Prehearing Conference was held in Harrisburg on January 14, 2004, to consider Duquesne's Petition. Extensive discovery ensued amongst Duquesne and the numerous other Parties that petitioned to intervene in this proceeding. By Prehearing Order issued January 16, 2004, ALJ Nemec granted the following Parties leave to intervene: Allegheny Power; AmeriNet Central; Citizen Power; Constellation; Energy America, LLC; Exelon Corporation; PECO Energy Company; DII; Dominion Retail;

[1] Duquesne's petition contains a history of the prior POLR I and POLR II filings. Also see *ARIPPA v. Pa. PUC*, 792 A.2d 636, 642-643 (Pa. Cmwlth. 2002), for a concise history of electric generation deregulation in Pennsylvania.

Green Mountain Energy Company; Ohio Edison Company, *et al.;* Pepco Energy Services, Inc.; PJM Interconnection, LLC (PJM); Reliant; and Strategic Energy.

Evidentiary hearings on the Petition were held in Pittsburgh on March 30, March 31, and April 1, 2004. On April 13, 2004 (revised on April 16, 2004), the OCA filed its Stipulation (OCA Stipulation). The OSBA and DII both filed their stipulations on April 16, 2004, (OSBA Stipulation and DII Stipulation, respectively). Various Parties objected to consideration of the Stipulations without an opportunity to examine the supporting witnesses. Following a telephone conference conducted on April 23, 2004, the litigation schedule was modified to provide for the serving of prepared testimony regarding the Stipulations. A hearing on the Stipulations was held on May 7, 2004. Supplemental Briefs on the issues raised by the Stipulation were filed on May 15, 2004.

Duquesne, OTS, OCA, OSBA, DII, PJM, Strategic Energy, Dominion Retail, Penn Futures, Direct Energy, Constellation, and Reliant filed Main Briefs. Citizen Power filed a Letter Brief. Duquesne, OTS, OCA, OSBA, DII, Strategic Energy, Dominion Retail, Direct Energy, Constellation, and Reliant filed Reply Briefs. Duquesne, OCA, OSBA, DII, Dominion Retail, Strategic, Direct Energy, Constellation, and Reliant filed Supplemental Briefs. The resulting record consists of 1,094 pages of testimony, as well as the numerous statements and exhibits of the Parties.

By Recommended Decision issued May 26, 2004, ALJ Nemec, *inter alia*, approved Duquesne's POLR III Plan, as modified by the DII Stipulation, the revised OCA Stipulation and the OSBA Stipulation. The Recommended Decision also granted the Calpine Corporation leave to intervene. We now consider the Exceptions and Reply Exceptions filed to the Recommended Decision. As noted above, on June 23, 2004, Duquesne filed a Motion to Strike Reliant's Reply Exceptions.

III. Overview & Legal Principles

A. Overview

On November 30, 2000, the Commission approved a settlement that provided for POLR service in Duquesne's service territory until December 31, 2004. *Public Utility Commission v. Duquesne Light Company*, Docket No. R-00974104 (Order entered November 30, 2000) (POLR II). The POLR II Plan spanned Duquesne's transition period and was designed to address Duquesne's POLR service while Duquesne continued to collect competitive transition costs (CTC) from a majority of its customers. In view of the fact that the terms and conditions of Duquesne's POLR II Plan expire on December 31, 2004, it is time to determine the parameters of Duquesne's POLR service post-December 31, 2004. To that end, Duquesne filed its Petition for Approval of the POLR III Plan.

B. Applicable Legal Principles

Before proceeding to a discussion of Duquesne's Plan, we will review the statutory considerations that will guide us as we review the Parties arguments in this proceeding. The primary section involved is Section 2807(e) of the Public Utility Code (Code), 66 Pa. C.S. § 2807(e). That Section relates to the obligation of an electric distribution company (EDC) to provide electric service as a result of the implementation of competition in the retail electric market in Pennsylvania. That Section provides:

> **66 Pa. C.S. §2807(e)** - An electric distribution company's obligation to provide electric service following implementation of restructuring and the choice of alternative generation by a customer is revised as follows:
>
> (1) While an electric distribution company collects either a competitive transition charge or an intangible transition charge or until 100% of its customers have choice,

whichever is longer, the electric distribution company shall continue to have the full obligation to serve, including the connection of customers, the delivery of electric service and the production or acquisition of electric energy for customers.

(2) At the end of the transition period, the Commission shall promulgate regulations to define the electric distribution company's obligation to connect and deliver and acquire electricity under paragraph (3) that will exist at the end of the phase-in period.

(3) If a customer contracts for electric energy and it is not delivered or if a customer does not choose an alternative electric generation supplier, the electric distribution company or Commission-approved alternative supplier shall acquire electric energy at prevailing market prices to serve that customer and shall recover fully all reasonable costs.

(4) If a customer that chooses an alternative supplier and subsequently desires to return to the local distribution company for generation service, the local distribution company shall treat that customer exactly as it would any new applicant for energy service.

On March 4, 2004, the Commission convened a POLR Roundtable at M-00041792 as a forum for the discussion of POLR issues. The Commission is now reviewing the results of that Roundtable with a view to crafting proposed regulations in accordance with Section 2807(e)(2). Until those regulations are promulgated, we must be guided by the more general pronouncements of policy in the Electricity Generation Customer Choice and Competition Act, 66 Pa. C.S. §§ 2801, *et seq.* (the Act). The following policy declarations of the Act will be particularly helpful in reviewing Duquesne's Petition.

Section 2802(3) - Because of advances in electric generation technology and Federal initiatives to encourage greater competition in the whole-sale electric market, it is now in the public interest to permit retail customers to obtain direct access to a competitive generation market as long as safe and affordable transmission and distribution service is available at

levels of reliability that are currently enjoyed by the citizens and businesses of this Commonwealth.

Section 2802(5) - Competitive market forces are more effective than economic regulation in controlling the cost of generating electricity.

Section 2802(9) - Electric service is essential to the health and well-being of residents, to public safety and to orderly economic development, and electric service should be available to all customers on reasonable terms and conditions.

Section 2802(16) - It is in the public interest for the transmission and distribution of electricity to continue to be regulated as a natural monopoly subject to the jurisdiction and active supervision of the Commission. Electric distribution companies should continue to be the provider of last resort to ensure the availability of universal electric service in this Commonwealth unless another provider of last resort is approved by the Commission.

Section 2807(c) - Subject to the right of an end-use customer to choose to receive separate bills from its electric generation supplier, the electric distribution company may be responsible for billing customers for all electric services, consistent with the regulations of the Commission, regardless of the provider of those services.

A primary innovation mandated by the Act was to provide customers with direct access to a competitive generation market. 66 Pa. C.S. § 2802(3). The reason for this change is the legislative finding that "competitive market forces are more effective than economic regulation in controlling the costs of generating electricity." 66 Pa. C.S. § 2802(5); *See, Green Mountain Energy Company, et al. v. Pa. PUC*, 812 A.2d 740, 742 (Pa. Cmwlth. 2002). Accordingly, a fundamental policy underlying the Act is that competition is more effective than economic regulation in controlling the costs of generating electricity. 66 Pa. C.S. § 2802(5).

The Act provides that electric service is an essential service and should be available to all customers "on reasonable terms and conditions." 66 Pa. C.S. § 2802(9). This is one of the fundamental goals of the Act. However, the means to accomplish that goal is competition, not regulation. It is against this statutory back drop that we examine Duquesne's Petition.

IV. Duquesne's POLR III Plan

A. Overview

There are three facets to Duquesne's Petition. The first facet is Duquesne's Petition as it relates to residential, small business and small commercial customers. The ALJ and the Parties have referred to this part of the Petition as the Small Customer Plan. The second part of Duquesne's Petition differs in many significant respects from the Small Customer Plan and is designed for Duquesne's large industrial and large commercial customers. This is the Large Customer Plan. Finally, Duquesne has requested approval from the Commission to join the regional transmission organization (RTO) operated by PJM Interconnection, LLC (PJM). We will discuss each of these facets of the Petition in turn. As we begin our discussion of the Petition, we recognize that Duquesne' membership in PJM is a crucial facet for the entire proposal before us. It will be helpful to note here that we will approve Duquesne's request to join PJM. That issue is discussed more fully below.

B. The Small Customer Plan[2]

1. Positions of the Parties

a. Duquesne's Proposal

Duquesne's Small Customer Plan provides for two consecutive three-year fixed rate periods. The first period runs from January 1, 2005, through December 31, 2007. The second period runs from January 1, 2008, through December 31, 2010. Duquesne proposed an average generation rate increase of 11.5% over current rates to commence in January 2005. As originally proposed, Duquesne proposed a second generation rate increase of 9.5% to commence in January of 2008. (R.D. at 9).

Duquesne will enter into a contract with an affiliate, Duquesne Power, for its POLR service power supply. Duquesne Power will obtain power to supply the POLR load through a combination of the proposed purchase of a generation asset, the Sunbury coal-fired electric generation station, and wholesale market purchases. Duquesne Power will provide all the capacity, energy and ancillary services necessary to serve Duquesne's POLR load. (*Id.*). The purchase of the Sunbury generating station was recently approved by the Federal Energy Regulatory Commission (FERC) at *Joint Application of Sunbury Generation, LLC and Duquesne Power, L.P., for Authorization to Transfer Facilities Under Section 203 of the Federal Power Act*, FERC Docket No. EC04-36 (Order issued August 6, 2004).

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[2] The Small Customer Plan applies to Rate Schedules RS, RH, RA, GS/GM, GMH, AL, SE, SM, SH, MTS and PAL.

b. Duquesne/OCA Stipulation

Duquesne's Small Customer Plan was modified by Partial Stipulations reached by Duquesne, the OCA, and the OSBA. The primary modifications to the original Plan as it affects residential customers on the RS, RH and RA rate schedules are as follows:

- POLR Service will be provided during the initial three-year term at the rates originally proposed, but with the addition of a PJM surcharge to defray the costs of Duquesne's membership in PJM.

- For the second three-year term (2008-2010), the rates shall be bounded by both a floor and a ceiling. The floor will be the rates in effect on December 31, 2007. The ceiling will be the rates as originally proposed by Duquesne in the Petition. If Duquesne wishes to set rates above the floor, it must file a request to do so on or before March 1, 2007, and support its request with market evidence or propose a market-based process to establish the necessary increase. If Duquesne does not elect to make such a filing, the rates in effect on December 31, 2007, shall remain in effect for the second three-year period.

- Duquesne will not seek a generation rate increase above the levels agreed upon unless (i) Duquesne Power defaults on its power contract with Duquesne, and (ii) Duquesne Holdings[3] defaults on its power contract with Duquesne, and (iii) these defaults threaten the

[3] Duquesne Holdings is the parent of Duquesne. (Duquesne St. No. 2 at 16).

financial stability of Duquesne to continue providing reliable service to its customers.

- Duquesne will not seek a distribution rate increase that would become effective prior to January 1, 2008, provided that there are no governmental or RTO directions for system upgrades, the cost of which would prevent Duquesne from earning a fair rate of return.

- Duquesne agrees to meet or exceed the reliability requirements for distribution service during the term of the distribution rate cap.

- Duquesne agrees to a specified PJM Surcharge without reconciliation during the six-year POLR term. The PJM Surcharge will be included in Small Customer generation rates to facilitate Small Customer shopping decisions.

- Duquesne agrees to provide renewable and environmentally beneficial energy resources as part of its Small Customer POLR supply portfolio consistent with any enacted law. If no such law is enacted, Duquesne will utilize renewable and environmentally beneficial resources for at least 2% of its small customer supply portfolio during the years 2005-2007, and for at least 4% of that portfolio during the years 2008-2010.

- Duquesne agrees to pursue cost-effective demand response programs for its Small Customers and agrees to meet with interested parties when developing and designing demand side response programs.

(OCA Stipulation).

The average residential generation rate, including the PJM Surcharge, for the initial three-year term under the proposal as revised is 6.24 cents/kWh. The average residential rate ceiling for the second three-year term is 6.86 cents/kWh. (*Id.*, Attachment A). Residential customers are subject to a twelve-month stay-out provision whereby customers returning to POLR service must remain on POLR service for twelve consecutive months. (*Id.*, at ¶ 4.a.).

c. Duquesne/OSBA Stipulation

The Stipulation between Duquesne and the OSBA also modified Duquesne's proposal as it relates to Rate Schedules GS/GM and GMH. The principal modifications are as follows:

- Small Commercial & Industrial (C&I) Customers will receive fixed rates as set forth in the OSBA Stipulation for the first three years of the POLR service term. Duquesne and the OSBA agree to modify the rate design for Small C&I Customers as set forth in the OSBA's direct testimony. There will be a reduction in demand charges by 10%, and a recovery of associated revenues in the tail block charge of each rate class. Duquesne and the OSBA agree that the rate redesigns are to be revenue neutral.

- For the second three years of the POLR service term, Duquesne agrees that the rates will be subject to a floor and ceiling as set forth in the Stipulation. If Duquesne wishes to raise rates above the floor, it must file on or before March 1, 2007 and support its request with market evidence, or propose a market-based process to establish the necessary increase.

- Duquesne and the OSBA have agreed to a fixed PJM Surcharge, not subject to reconciliation, which will be in place for the entire six-year POLR service term.

- Duquesne agrees not to seek generation increases other than as set forth in the Stipulation unless (i) Duquesne Power defaults on its power contract with Duquesne, and (ii) Duquesne Holdings defaults on its power contract with Duquesne, and (iii) those defaults threaten the financial ability of Duquesne to continue providing reliable service.

- Duquesne agrees to pursue cost-effective demand response programs for its Small C&I Customers and will meet with the OSBA when it develops or designs such programs.

(OSBA Stipulation).

Small C&I Customers are subject to a twelve-month stay-out provision if the customer returns to POLR service. However, the customer may exercise the option to move back into the market upon the payment of a Generation Rate Adjustment (GRA). (*Id.* at ¶ 4.a.).

2. ALJ's Recommendation

The ALJ recommended approval of the Small Customer Plan, as modified by the OSBA and OCA Stipulations. He did so for three primary reasons. First, he suggests that the Duquesne proposal was "the only comprehensible and complete plan presented in this record." (R.D. at 18). Second, the ALJ observed that the Plan will

provide for POLR service while the Commission completes the general POLR regulations that will further define POLR service. Finally, the Duquesne proposal provides for the recovery of Duquesne's costs associated with "joining and meshing its operations with PJM." (*Id.*).

The ALJ also discussed the pricing aspect of Duquesne's Plan as follows:

> The question of just what are prevailing market prices is an interesting one. It will be answered presumably by this Commission's regulations. In the meantime, Duquesne has set its small POLR prices based on the wholesale cost of power plus a margin to cover its costs, risks and provide a profit similar to what it was experiencing under the POLR II rates. It sounds to me like Duquesne has established a price at which it is willing to provide its services to the public. That those rates are set higher than the POLR II rates would seem to provide an opportunity to the suppliers/marketers to continue to persuade customers in the Duquesne service territory to shop. The switching rules under POLR II, that are proposed to be carried over to POLR III, do not seem to have hindered shopping.

(R.D. at 19).

3. Exceptions and Replies to the Approval of the Small Customer Plan, as Modified by the OCA and OSBA Stipulations

a. Overview

We note that any issue or Exception that we do not specifically address herein has been duly considered and will be denied without further discussion. It is well established that we are not required to consider expressly or at length each contention or argument raised by the parties. *Consolidated Rail Corporation v. Pennsylvania Public Utility Commission*, 625 A.2d 741 (Pa. Cmwlth. 1993); *also see, generally, University of*

Pennsylvania v. Pennsylvania Public Utility Commission, 485 A.2d 1217 (Pa. Cmwlth. 1984).

For purposes of organization, it can be fairly stated that the majority of the Exceptions to the approval of the Small Customer Plan fall into three broad areas. First, most of the Parties filing Exceptions cited error in the ALJ's discussion regarding market price. Constellation, Strategic Energy, Dominion Retail, Direct Energy, Reliant, the OTS and Citizens Power all raised this specific issue in their Exceptions. An issue closely related to market price is the six-year term established by the Small Customer Plan. Constellation, Reliant and the OTS discuss this issue and we will resolve those Exceptions in our discussion of market price. Also, Dominion Retail and Direct Energy raised the issue of Duquesne's cost recovery. The factors relating to cost recovery by Duquesne are related to our discussion of the market price issues and we will resolve those Exceptions in that context as well.

Second, Strategic Energy, Dominion Retail and Direct Energy raised the issue of switching restrictions. Third, Constellation, Strategic Energy and the OTS except to the ALJ's statement that Duquesne offered the only comprehensible and complete plan on the record and his use of that as a basis for his recommendation. We will address each of these three categories in turn, then we will consider the Exception relating to the proposed rate redesign for Small C&I Customers.

b. Six-Year Term, Cost Recovery, Market Price

The center piece of these issues is the Code's requirement that the POLR provider acquire energy to provide POLR supply at "prevailing market prices" and recover all "reasonable costs" in doing so. 66 Pa. C.S. § 2807(e)(3).

i. Six-year term

The OTS argues that the six-year term proposed by the Petition only serves to fix rates at higher than market levels for that time period. (OTS Exc. at 9). Also, the OTS argues that the basic concept of a fixed rate for a six-year period is anti-competitive and would discourage the development of a competitive market in Duquesne's service territory during that six year period. The OTS argues that the true issue here is "how long of a period is appropriate for these rates to be *fixed*." (*Id.*). The OTS states that the proper time period for fixed rates is one year, not six. According to the OTS, a one-year time period would enable POLR customers to experience price decreases during the time period of the POLR III Plan. Also, the OTS argues that an annual price term will permit the price to more closely track prevailing market prices, either up or down. (*Id.* at 9, 10).

Reliant argues that "the long-term capped POLR prices are a barrier to competitors' entry and will inhibit the development of the competitive market." (Reliant Exc. at 10). For Small C&I Customers, Reliant proposes to link POLR prices to market prices by permitting an adjustment to the POLR rate (up or down) twice each year based on changes in the average twelve-month NYMEX PJM forward price for energy. For residential customers, Reliant suggests that Duquesne's fixed rate be permitted for a three-year period, from 2005 to 2008. At the end of that period, Reliant states that the Commission can review the competitive landscape and determine if a fixed rate should continue or if some other mechanism should be employed for residential customers at that time. (*Id.* at 9-10).

Constellation argues that a six-year fixed price "cannot possibly reflect the prevailing market price intended by the legislation." (Constellation Exc. at 11). Constellation also argues that Duquesne's proposed membership in PJM will bring it into "the most competitive wholesale market in the country." (*Id.* at 9). Therefore, to the extent that the ALJ approved the six-year term out of concern that competitive electric

markets were in their infancy, that concern is not born out by the record. (*Id.* at 8-9). Dominion Retail argues similarly that a six-year term cannot reflect prevailing market prices. (Dominion Retail Exc. at 3-4).

Duquesne responds and argues that a six-year fixed rate term for residential and Small C&I Customers is appropriate given the fact that such a term aligns Duquesne's customers with other customers throughout the Commonwealth who remain on fixed rates for that period of time. Duquesne also states that it is not yet in a RTO and that the proposed Plan "comes on the heels of unprecedented change in retail and wholesale power markets. (Duquesne R.Exc. at 6-7). Duquesne argues further that Reliant's proposal for a three-year term is merely aimed at Duquesne's proposed purchase of the Sunbury generating station. Duquesne states that the Sunbury plant acquisition "is the 'lynchpin' of Duquesne's supply strategy to provide service for *six years*, not three. Duquesne is not offering fixed rate protection service under the terms proposed by Reliant." (*Id.* at 7).

The OSBA responds to the six-year term issue in a general fashion. According to the OSBA, nothing in the Act prohibits a fixed-rate term of six years. Also, the OSBA argues that none of the Parties filing Exceptions have guaranteed rates for the next six years that would be lower than those proposed by Duquesne. (OSBA R.Exc. at 13). The OCA does not specifically address the six-year term. It does agree with Duquesne's arguments that Duquesne customers should be aligned with other EDC customers who remain on fixed-rate POLR service for the next six years. (OCA R.Exc. at 3).

A six-year term is too long a period of time for the proposed POLR III Plan. The Excepting Parties are correct that one cannot establish a fixed price for a six-year term and comply with the Act's mandate that POLR supply must be acquired at *prevailing* market prices. Even with the proposed rate adjustment at the end of the first

three years, the adjustment mechanism provides for a floor and a ceiling, tied to the fixed-rate established in this proceeding.

For this proceeding, the appropriate time frame is a three-year period, at the end of which the Commission can review the POLR Plan in the context of the competitive market and regulatory landscape at that time. The three-year term for the Small Customer Plan is supported by testimony from several Parties. For example, Reliant states that for residential customers, a three-year plan avoids "unreasonable allocation of risk and reward...." (Reliant St. 1 at 11). Strategic Energy also suggests that a three-year planning horizon is an appropriate time frame. (Strategic Energy St. 2 at 5-6). In addition, Duquesne and the OCA each supported the concept that a prevailing market price can be determined for a three-year period. (Duquesne St. 2-S at 11; OCA St. 1-S at 2-3). As we have indicated, a six-year time frame is too long. However, the foregoing supports the determination that a three-year term is an appropriate period.

It is possible that a second three-year term with a price adjustment as proposed will be adopted. Conversely, Commission regulations may provide a different directive. As Reliant suggests, the competitive landscape at that time may provide new pricing tools better suited to POLR service. Given the state of the market and our intent to promulgate regulations in this area, any foundation for a six-year term is too speculative. We also note that a similar term was recently approved for a POLR Plan in another EDC's service territory, although the initial price terms were set for two years, not three. *Public Utility Commission, et al. v. UGI Utilities, Inc. – Electric Division*, R-00017033 (Tentative Order entered May 28, 2004).

In making this disposition, we are cognizant of Duquesne's and the OCA's arguments which seek to align Duquesne's customers with those customers of EDCs that remain in transition. However, Duquesne will have completed its CTC collection by early 2005, on a system-wide basis. (R.D. at 4, Duquesne M.B. at 1). For purposes of

reviewing the proposed POLR III Plan, Duquesne is no longer in transition and all aspects of Section 2807(e)(3) of the Act apply. Accordingly, while the Commission is cognizant of the industry as a whole and will review the POLR III Plan in the context of the state of the industry, the fact that other EDC's remain in transition does not mandate extension of Duquesne's transition period concomitant with that of the other EDCs.

We are also aware of Duquesne's statements that the fixed price stated in the POLR III Plan is based upon a six-year term. Duquesne and the OCA have gone to great lengths to establish that the proposed rate for the first three years is properly justified as the prevailing market rate over the initial three-year term. In addition, the OCA has forcefully argued that the market remains in a developmental state, subject to significant price fluctuations. (*See*, OCA M.B. at 39). Given that record, we reject Duquesne's position that the stated price must be fixed for a six-year term. The OCA, the OSBA and Duquesne have all agreed that there should be some form of pricing review at the end of three years. We agree, but given the record before us, there is no support for the proposition that a specific rate band will reflect the prevailing market price at that time.

ii. Reasonable Costs

Dominion Retail and Direct Energy filed Exceptions citing error in the determination that Duquesne's proposal will permit it to recover reasonable costs in providing POLR service. Dominion Retail argues that an additional .5 cents/kWh must be added to the proposed rates. Dominion Retail asserts that Duquesne failed to account for "costs that suppliers are likely to face in the Duquesne market." (Dominion Retail Exc. at 7). Dominion Retail also states that a substantial portion of POLR related costs, bad debt, is currently embedded in Duquesne's distribution rates and must be transferred to the POLR Plan. (*Id.*). Direct Energy argues that Duquesne has failed to "quantify" all the risk premiums associated with providing POLR service. (Direct Energy Exc. at 5).

The OCA responds that Dominion Retail is actually seeking an analysis based upon a hypothetical EGS's costs. However, the OCA states that the test is that a POLR provider must recover all reasonable costs, not a hypothetical cost build-up for an electric generation supplier. (OCA R.Exc. at 9). The OCA also argues that Direct Energy's argument is unsupported in the record and is an issue "best left to the POLR Roundtable discussions." (*Id.* at 17).

We will deny these Exceptions. This record does not support a finding that substantial POLR costs are currently embedded in distribution rates. Given the state of the record, we agree with the OCA that the issue is better left to other proceedings. Similarly, we agree with the OCA that on this record, we will not engage in a hypothetical build up of an EGS's costs and require Duquesne to match those costs in its rate development.

iii. Market based price

In our review of the proposed POLR III Plan, we have rejected the six-year fixed rate term in favor of a three-year term. Thus, to the extent that Parties have excepted to the proposed Small Customer Plan rates on the basis that they have been set over too great a period of time, those Exception have been granted. Most of the Parties excepting to the proposed Small Customer Plan rates have also argued that the development of the rates is flawed and the rates cannot properly be deemed "prevailing market prices" for purposes of Section 2807(e)(3) of the Act.

Constellation argues that Duquesne's proposed rates are not "reflective of any particular analysis of market prices," but were designed to recover the costs of acquisition of the Sunbury generating station and the costs associated with the risks of a proposed fixed price subject to regulatory approval. (Constellation Exc. at 10).

Constellation asserts that Duquesne never submitted information which would support the argument that the proposed rates are based on costs, rather the rates were set with the objective of producing savings. (*Id.* at 11). Constellation also argues that the proposed rates are actually too high based upon a comparison of rates in other jurisdictions. (*Id.* at 12). Direct Energy makes similar arguments. (Direct Energy Exc. at 3-5).

Strategic Energy states that Duquesne's Small Customer Plan rates have as their main goals long-term fixed rate protection and producing rate cuts below pre-Act levels. (Strategic Energy Exc. at 13). Strategic also argues that there is a profit built into the proposed rates. Strategic Energy states that Section 2807(e)(3) of the Act provides for the recovery of reasonable costs, which may include risk premiums, but not profit. According to Strategic Energy, inclusion of profit in such rates is anti-competitive since that provides incentive to the POLR provider to keep customers on POLR service to the detriment of the market. (*Id.* at 13-15).

Dominion Retail argues that the record establishes that the proposed rates have no relationship to actual market prices. According to Dominion, the record establishes that long before the proposed rates are to go into effect, the rates are over 1 cent/kWh below market rates. Further, to the extent that Duquesne and the OCA argue that other jurisdictions reveal pricing similarities, the rates in those jurisdictions reflect time periods and points in time that are substantially different from the relevant data here. (Dominion Retail Exc. at 3-7).

The OTS argues that "only an annual wholesale auction will produce the market rates envisioned by the Competition Act." (OTS Exc. at 5). The OTS states that an annual auction will allow customers to experience higher or lower rates based upon the condition of the supply market at that time. (*Id.* at 7). Citizen Power asserts that the record reveals that there is no viable wholesale market for POLR supply. Citizen Power also argues that the record contains no evidence regarding costs of supply sufficient to

enable the Commission to determine the appropriate prevailing market price. On those bases, Citizen Power argues that the Commission should condition approval of the Plan on Federal Energy Regulatory Commission (FERC) approval of a wholesale rate, after which this Commission could establish a retail rate. (Citizen Power Exc. at 4-8).

We will deny these Exceptions. To a large extent, the objections to the proposed rates are intertwined with the proposed six-year term which we have rejected in favor of a three-year term. To the extent that arguments focus on what an appropriate market based price is, some of the excepting Parties argue that the proposed rates are too low and some Parties argue that they are too high.

Duquesne argues that the proposed rates were set in a fashion which reflects increases in market prices as well as the costs of Duquesne joining PJM, and properly compensate for Duquesne Power's acquisition of the Sunbury plant. More significantly, Duquesne asserts that when the proposed rates are tested against recent supply auctions held in a neighboring jurisdiction within PJM, the proposed rates were "virtually identical." (Duquesne Exc. at 9).

The OCA framed this issue in an interesting fashion:

> The fact of the matter is that there are a multitude of products in the PJM markets, both short term and long term products, a multitude of market prices for these products at any given point in time, and a multitude of methods to acquire these products. All of these products and all of these prices play a role in the acquisition of energy at "prevailing market prices" by the POLR to provide reliable service on reasonable terms and conditions.

(OCA R.Exc. at 7).

According to the OCA, several market price analyses are in the record which support the proposed rates. The OCA argues that we should examine a portfolio of resources rather than focus on one particular source. (OCA R.Exc. at 21). The OCA also argues that when examined in this context, the record supports a finding that the proposed rates reflect prevailing market prices. (*Id.*).

Clearly, Duquesne is required to show that the proposed rates for the Small Customer Plan reflect prevailing market prices. 66 Pa. C.S. § 2807(e)(3). In our view, they have done so for the initial three-year term. We note Duquesne's testimony regarding the comparison to a neighboring jurisdiction within PJM. (Duquesne St. 3-R at 8-22). We also note the OCA's testimony regarding testing the proposed rates and the rate which is proposed here. (OCA St. No. 2 at 18-22 as modified by OCA St. No. 2S at 3-5). The Parties opposing these rates are far more convincing in their arguments against the second three-year period of the proposal. Accordingly, we find that based upon the record before us, Duquesne has established, by a preponderance of the evidence, that its proposed rates for the Small Customer Plan satisfy the Act's requirements that such rates reflect prevailing market prices for the three-year term period beginning January 1, 2005, through December 31, 2007.

c. Switching Restrictions

The Small Customer Plan proposes a twelve-month minimum stay requirement on residential customers, requiring customers who return to POLR service to stay with POLR service for one year before being allowed to move back into the competitive market. Customers who have never switched to an alternative supplier are permitted to leave POLR service at any time with no restriction. (Duquesne M.B. at 27).

Small C&I Customers have an annually renewing twelve-month minimum stay requirement, but with the opportunity to opt out of the minimum stay requirement

upon paying a GRA. The GRA is anniversary based, meaning that, after the first twelve months that a customer is on POLR service, the GRA renews for another twelve months. The GRA is based on the difference in supply costs between the spot prices for supply and the POLR service rate during the period when the customer starts POLR service. The customer is only assessed a GRA fee when the spot price for supply service exceeds the POLR rate. (Constellation M.B. at 5).

Constellation, Strategic Energy, Dominion Retail and Direct Energy all filed Exceptions to the proposed switching restrictions. Direct Energy argues that the twelve-month mandatory stay-out provision for residential customers and the Small C&I customer twelve-month stay-out provision with the GRA violate the Act in two ways. First, the switching restrictions violate the Act by failing to treat shopping customers returning to POLR service the same as new customers. 66 Pa. C.S. § 2807(e)(4). Second, the restrictions violate the requirement that EDCs provide comparable access to their transmission and distribution systems. 66 Pa. C.S. § 2804(6). (Direct Energy Exc. at 6). Direct Energy also argues that there is no record evidence that switching restrictions are needed in Duquesne's service territory in order to prevent "gaming" by residential customers. (*Id.*). Direct Energy asserts that if any protection is necessary, it should take the form of seasonal rates, not restrict a customer's access to the competitive market. (*Id.* at 7).

Like Direct Energy, Dominion Retail also argues that the proposed switching rules violate Sections 2807(e)(4) and 2804(6) of the Act. Dominion Retail acknowledges that elimination of switching restrictions may impose higher costs on a POLR supplier, but argues that those costs are legitimate and should be included in POLR rates. However, Dominion Retail argues that such costs may be avoided by imposing rules on suppliers that remove any profit from a supplier by not allowing a supplier to take back a customer from POLR service for a full year after the customer has

switched. The customer is free to switch to another supplier, but any supplier that attempts to game POLR rates has no incentive to do so. (Dominion Retail Exc. at 8-9).

Strategic Energy argues that the proposed switching restrictions are "anticompetitive and illegally discriminatory." (Strategic Energy Exc. at 7). Strategic Energy states that there are ways to address seasonal switching problems in a pro-competitive manner, such as requiring that only the customer can initiate a switch and providing for seasonal rates for small and large business customers. (*Id.*). Like Dominion Retail and Direct Energy, Strategic Energy argues that the proposed switching restrictions violate the Act's requirements for direct access and comparable use of the transmission and distribution system. Further, Strategic Energy asserts that there is no evidentiary basis for the switching restrictions. (*Id.* at 7-10).

Constellation argues that the proposed switching restrictions violate Sections 2802(3) and 2804(2) of the Act which provide that customers should have direct access to the market place. Switching restrictions expressly limit that access and also discriminate "against the rights of a customer of an EGS to access the distribution system of [Duquesne]." (Constellation Exc. at 27). Constellation also argues that the switching restrictions unnecessarily add to the level of complexity for residential customers and small business owners attempting to enter the market. (*Id.* at 28).

In addition, Constellation argues that the switching restrictions will result in high levels of switching activities in a short period of time. This will affect the ability of EGSs to provide tailor-made product solutions since they will be restricted to marketing within limited time frames. Also, this will create a boom and bust marketing activity which will increase costs. (*Id.* at 29). Constellation argues that seasonal pricing with refreshed rates for returning customers would better control seasonal switching than the restrictions proposed. (*Id.* at 30, 31 and 32). Constellation also suggests that a volumetric price adjustment such as that adopted in Maryland, which adjusts the POLR

price if a certain percentage of load simultaneously returns to POLR service, would serve the purpose. (*Id.* at 33).

The OCA and the OSBA both support the switching restrictions as proposed. The OCA argues that nothing in the Act precludes imposing switching restrictions. The OCA asserts that the proposed restrictions "balance the need for shopping restrictions designed to prevent gaming with the need to allow new customers opportunities to shop." (OCA R.Exc. at 10). The proposed restrictions provide "modest protections" and "allow Duquesne to provide a stable rate...." (*Id.*).

The OSBA argues that the Exceptions on this issue do not adequately address the problems which led to the development of the switching restrictions proposed here. The OSBA also acknowledges that several Parties proposed seasonal rates as a method to manage switching problems, but no formula or procedure to develop such rates has been proposed. Similarly, there has been no other unified proposal which addresses the issues justifying the switching restrictions. (OSBA Exc. at 16).

Duquesne asserts that there is no prohibition in the Act against switching restrictions. In this context, Duquesne argues that switching restrictions apply equally to all customers, thus rebutting arguments regarding discrimination and comparable access to the transmission and distribution system. (Duquesne R.Exc. at 14-16). Duquesne further argues that substantial evidence supports the need for switching restrictions. In addition, Duquesne argues that there is no evidence of record to support the theory that switching restrictions have reduced or hampered shopping in its service territory. (*Id.* at 17).

Duquesne also argues that Exceptions which label the GRA onerous or too complex ignore the fact that the mechanism has worked in the past. Duquesne has also committed to ensuring that information necessary to perform GRA estimates will be

available to customers and EGSs in order to enable the customer to make informed choices. Access to the information will also permit the EGSs to market customers subject to the GRA provisions. (Duquesne R.Exc. at 18).

We believe the record before us establishes that there are seasonal contracting risks faced by the POLR provider, commonly referred to as the "beach" phenomenon – i.e., EGSs switch customers back to POLR service in the summer when market prices are high then switch them back to competitive service in other months when market prices are low. (Duquesne M.B. at 27). We agree with the OCA and Duquesne that the Act does not preclude the use of switching rules to adequately address this problem. Nonetheless, we will grant the Exceptions for several reasons.

First, we find that the proposed switching restrictions improperly discriminate between new and returning customers. In light of Section 2807(e)(4) of the Act, the proposed switching restrictions treat returning customers to POLR service differently than new applicants for service. Section 2807(e)(4) states:

> If a customer that chooses an alternative supplier and subsequently desires to return to the local distribution company for generation service, the local distribution company shall treat that customer exactly as it would any new applicant for energy service.

66 Pa. C.S. § 2807(e)(4).

Duquesne argued, "It is only when the customer returns to POLR service, then seeks to leave again, that the switching rules come into play." (Duquesne M.B. at 27). The minimum stay requirement imposed on small customers prohibits a customer returning to POLR service from freely accessing the market for an entire year. A new customer, on the other hand, confronts no such restriction. The new customer is able to

freely switch to an alternative supplier at any time. This restriction clearly discriminates against the returning POLR customer.

Similarly, the GRA mechanism treats Small C&I Customers returning to POLR service differently than new customers by charging existing Small C&I Customers who return to POLR service an exit fee for switching to an alternative supplier. New Small C&I Customers have no POLR exit fee, nor should one be imposed. There is simply no basis upon which to discriminate against returning customers by requiring them to remain on POLR service for one year or charging them exit fees, while new customers are free to choose competitive suppliers. Thus, we find that the restrictions as proposed violate the anti-discrimination provisions of Section 2807(e)(4) of the Act.

Second, competitive generation markets can only develop and mature if consumers have free and direct access to the competitive market, as contemplated by the Act. Section 2802(3) of the Act states, in pertinent part, that it is "now in the public interest to permit retail customers to obtain direct access to a competitive generation market" while Section 2804(2) states, in pertinent part, that "the Commission shall allow customers to choose among electric generation suppliers in a competitive generation market through direct access." 66 Pa. C.S. §§ 2802(3) and 2804(2). Clearly, the Act contemplated that the essence of a competitive market is the ability to choose. Minimum stay provisions and exit fees do just the opposite; they act as barriers to the marketplace.

Additionally, the complexities involved with the proposed switching restrictions, particularly with the GRA exit fee, will impose additional costs to the shopping customer. (*See, e.g.,* Tr. at 705, 779-780; Constellation M.B. at 8-9). The end result may be to potentially chill the development of the competitive retail marketplace. It also imposes additional costs to the utility in terms of customer service cost and to the EGS in terms of generation administration costs. (Constellation M.B. at 8). The

foregoing also supports our determination that the proposed restrictions are at odds with the Act.

Optimally, the Commission should seek market-based solutions to address the problem of seasonal gaming. The record demonstrates the existence of market-based solutions, including seasonal rates and volumetric risk mitigation measures. Other states have adopted such market-based solutions and they should be considered in Pennsylvania. Nonetheless, the record in this case has not been sufficiently developed to permit the implementation of such market-based approaches at this time. Rather, these solutions shall be more fully considered and addressed in the context of state-wide regulations for POLR service.

The record in this case does provide substantial support for two measures in order to protect against seasonal gaming. First, an EGS should not be able to initiate a switch. Strategic Energy suggested that if the Commission provides that the *customer* is the only entity who can initiate a switch, then EGSs cannot game POLR rates in the high-cost summer months. Strategic Energy correctly argues that there is little likelihood that a large number of residential customers would engage in coordinated, timed switching. (Strategic Exc. at 10). Accordingly, we will direct that Duquesne alter the POLR III Plan to provide that only customers can initiate a switch back to POLR service.

Second, Duquesne shall be able to seek relief from the Commission in the event it believes that an EGS is exploiting the seasonal variations of the market. Duquesne shall carefully monitor the migration of consumers between POLR service and EGSs. In the event that Duquesne observes a significant migration of consumers from an EGS to POLR service, and has reason to believe that the EGS will seek to reacquire those consumers in an effort to exploit the seasonal variations in the market, then Duquesne may petition the Commission for any appropriate relief. In such a proceeding, the Commission shall consider, *inter alia*, whether to prohibit the EGS from reacquiring

those consumers for a period of up to 12 months from when they commenced POLR service.

These two rules are consistent with the intent of the Act as well as Commission policy to further competitive retail markets. The combination of these proposals eliminates the opportunity for an EGS to initiate customer migration and removes the financial incentive for an EGS to engage in seasonal gaming. At the same time, the proposals result in similar treatment for *all* customers, allowing returning customers, new applicants, and existing customers to have free access to the competitive market. These two rules address the actual harm (EGS gaming) with the least impact on customer access to the market, rather than anticipate the potential for harm and preemptively act on the customer's ability to access the market.

For the foregoing reasons, we will grant the Exceptions of Constellation, Strategic Energy, Dominion Retail and Direct Energy consistent with our discussion of this issue. We stress that we prefer market based approaches to this type of problem. Thus, our decision here should not be interpreted to foreclose options such as seasonal pricing or volumetric bands in the future.

d. Comprehensible and Complete Plan

Constellation, Direct Energy and the OTS all argue that the ALJ erred when he based his approval of the POLR III Plan, in part, on the determination that it was the only comprehensible and complete plan offered on the record. (Constellation Exc. at 4-7; Strategic Energy Exc. at 18-21; OTS Exc. at 4-5). Constellation argues that it presented a plan that provided for a competitive procurement process similar to those now in place in New Jersey and Maryland. (Constellation Exc. at 4). Strategic Energy notes that it described a "Better Choice Plan" that was complete and fairly supported on the record. (Strategic Energy Exc. at 18). The OTS argues that it would be incongruous to challenge

opposing Parties to present a complete plan when Duquesne has the burden of proof to show that its POLR III Plan meets the statutory requirements. (OTS Exc. at 5).

We will grant these Exceptions to the extent that the ALJ erred when he stated that no other comprehensible plans were presented on the record. Our determinations relating to the POLR III Plan, and modifications thereto, are not based on whether other Parties proposed competing plans. Nor should our action here be interpreted as forever precluding concepts such as seasonal rates and different forms of switching rules in future POLR proceedings. Our decision in this proceeding is grounded in both the statute and the record, with the full recognition that Duquesne bears the burden of proof. 66 Pa. C.S. § 332(a). In similar fashion, the record as developed also does not support adoption of any of the alternative plans in their entirety.

e. Rate Redesign for Small C&I Customers

Strategic Energy excepts to the ALJ's approval of the proposed rate redesign for Small C&I Customers which has the effect of shifting revenue requirement responsibility from low load factor customers to high load factor customers. Strategic Energy argues that the effect of the rate redesign will be to diminish the low load customers' interest in shopping by further reducing their generation rates and thus reducing their competitive options in the marketplace. According to Strategic Energy, there is no evidentiary support for the change. Strategic Energy argues that since it costs more to serve low load customers, it is inappropriate to reduce their rates. Strategic Energy also argues that the rate redesign runs counter to the Act's mandate that the Commission encourage a fully competitive market. (Strategic Energy Exc. 15-16).

Duquesne responds that the proposed rate redesign produces shopping credits for smaller customers in the 9 cents/kWh to 11 cents/kWh range. Duquesne argues that no opposing Party submitted evidence that contends that those prices are

below market. In addition, Duquesne asserts that even with the rate redesign, the low load factor customers will still pay rates in excess of those paid by higher load factor customers. Duquesne also argues that any suggestion that the rate redesign will reduce incentives for these customers to shop is too speculative. (Duquesne R.Exc. at 10).

The OSBA argues that the rate redesign and other modifications (such as the demand charge reduction and tail block increase) proposed in the OSBA Stipulation are supported by substantial evidence. The OSBA asserts that the smaller customers will see a slight reduction in rates, "bringing them incrementally closer to a market-based rate. The larger GS/GM and GMH customers will have their generation rates raised, not only bringing them closer to the market, but also making them more inviting targets for Marketers." (OSBA R.Exc. at 18).

We will deny this Exception. The OSBA is correct in its argument that the record supports the rate redesign proposed in the OSBA Stipulation. On this issue, we are particularly persuaded by the OSBA's evidence regarding the alignment of intra-class generation rates and the effect of the current Duquesne demand charge. (OSBA R.Exc. at 19; OSBA St. No. 4 at 3).

C. Description of the Large Customer Plan[4]

1. Position of the Parties

Duquesne's Large Customer Plan sets forth the terms and conditions under which Duquesne will provide POLR III service beginning on January 1, 2005, through Duquesne's "first planning period following the effective date of statewide post-CTC POLR regulations...." (DII Stipulation ¶ I 4.). Duquesne proposes to offer two Large

[4] The Large Customer Plan applies to Rate Schedules GL, GLH, L and HVPS.

C&I Customer POLR products during the term of the POLR III Plan. One product will be an hourly priced service (HPS) and the other product is to be a fixed price default service (FPDS). (R.D. at 21). Of the two product offerings, the FPDS is the default service to which customers will be assigned if they do not affirmatively chose HPS or competitive supply from an EGS. (*Id.* at 22).

For the FPDS, Duquesne will obtain bids in a wholesale request for proposal (RFP) process for the entire Large C&I load, then translate that wholesale price into a fixed retail price for each rate schedule. Duquesne will develop on-peak and off-peak rates for each rate schedule. Duquesne will also use each customer's estimated PJM capacity obligation as the billing demand for generation service, which is a change from the Company's existing practice. (DII M.B. at 19-20).

For HPS, most of the pricing elements are a flow through of PJM market charges for hourly energy, ancillary services and losses. Duquesne originally proposed to develop the capacity charge through an auction process. Pursuant to the DII Stipulation, Duquesne has modified that aspect of its proposal and will develop the capacity price based on the PJM capacity market prices. (*Id.* at 20-21).

As initially proposed, Duquesne would collect its reasonable costs for providing the HPS and FPDS by collecting a fixed retail adder of 5 mil/kWh. The purpose of the retail adder was to compensate Duquesne "for: (1) accepting risks associated with providing Large C&I POLR services; (2) conducting auctions; and (3) performing new retail and management functions." (DII M.B. at 21). The DII Stipulation modified that aspect of the Large Customer Plan by proposing two separate adders. The first adder will be a .05 cents/kWh adder applicable to all sales to Large C&I Customers, whether they take service under the POLR III Plan or receive generation from an EGS. The second adder will be recovered only from POLR III customers and is designed to compensate Duquesne at approximately the same revenue level as the adder

Duquesne currently collects under the POLR II Plan. The revenue requirement per rate schedule is based on distribution cost allocators from Duquesne's most recent cost of service study, performed in 1996. These adders range from .035 cents/kWh for Rate Schedule HVPS to .354 cents/kWh for Rate Schedule GL. (R.D. at 23).

The DII Stipulation added several other provisions to the Large Customer Plan. Included in those additional provisions are the following.[5] First, two customers on Rate Schedule HVPS remain on POLR I rates and continue to pay competitive transition charges. Under the DII Stipulation, those customers "will be required to pay the net incremental charges associated with their electric requirements as a result of the Company joining PJM effective January 1, 2005." (DII Stipulation ¶ I.4.c.). Second, similar to the OCA Stipulation, Duquesne has agreed not to seek an increase in distribution rates that would become effective prior to January 1, 2008, unless a governmental entity or an RTO required upgrades to Duquesne's distribution system, the cost of which would prevent Duquesne from earning a fair rate of return. (*Id.* at ¶ I.4.d.). Third, Duquesne agrees that during the term of the distribution rate cap, it will continue to meet or exceed the reliability requirements for distribution service. (*Id.* at ¶ I.4.e.). Fourth, the FPDS price will be "refreshed" on a quarterly basis for HPS or EGS customers that elect to return to the FPDS product for the remainder of the price application period. (DII Stipulation at ¶ I.4.g.(4)). Fifth, Duquesne will assume supplier default risk and will not alter its retail rates for Large C&I customers, but does not waive the provisions of Section 2804(4)(iii)(A)(C) or (D) of the Act, 66 Pa. C.S. § 2804(4)(iii)(A)(C) and (D) (relating to rate cap exceptions). (*Id.* at ¶ I.4.g.(5)). Sixth, Duquesne will endeavor to ensure that Large C&I Customers on POLR service will be able to participate in applicable load management programs offered by PJM. (*Id.* at ¶ I.4.g.(7).

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5 There are additional provisions. We have summarized some of the more significant items here.

Switching restrictions apply to customers taking service under the FPDS. Those customers will commit to remaining on FPDS for the duration of the price application period (i.e., January 1, 2005 through May 31, 2006 for the initial RFP and Enrollment Period) until the next RFP is conducted. A Large C&I Customer could depart FPDS service by paying a GRA. The GRA would be paid to the winning bidders for FPDS supply. If that customer later returned to FPDS, it would pay the refreshed FPDS rate. (Duquesne R.B. at 17-18). There are no switching restrictions on customers taking HPS. (*Id.*)

2. ALJ's Recommendation

The ALJ recommended approval of the Large Customer Plan as modified by the DII Stipulation. The ALJ "stressed" that in his view, "the plan is clearly submitted as an interim or bridge between the POLR II rates that expire on December 30, 2004, and the rates that will be developed following implementation of the Commission's post-transition regulations." (R.D. at 30). As he stated in his ruling on the Small Customer Plan, the ALJ found that the proposed POLR III Plan as modified by the DII stipulation was "the only comprehensible and complete proposal on this record." (*Id.* at 31). The ALJ also found that Duquesne had adequately supported the proposed switching restrictions on the FPDS. For the foregoing reasons, the ALJ recommended approval. (*Id.*).

3. Duquesne's Motion to Strike Reply Exceptions of Reliant

On June 16, 2004, several Parties, including Reliant and Duquesne, filed Replies to the Parties' Exceptions filed June 9, 2004. Reliant's Reply Exceptions request that the Commission modify Duquesne's POLR service for large commercial and industrial (Large C&I) customers by implementing revisions to the POLR Retail Tariff sponsored by Duquesne as Exhibit WVP-1. Specifically, Reliant requests that

Duquesne's Retail Tariff be revised to amend switching restrictions and to implement transition to an hourly only default rate. (Reliant R. Exc. at 2). Duquesne moved to strike Reliant's Reply Exceptions arguing that they are not responsive to any Exceptions filed by the Parties and initiate new arguments to the Recommended Decision. Duquesne avers that pursuant to the Commission's Regulations, the purpose of reply exceptions is to rebut arguments raised by a party in a prior exception. (Duquesne Motion at 3). Duquesne argues that if Reliant's Reply Exceptions are not stricken, Duquesne will be placed at a disadvantage as the Commission's Regulations do not allow parties to file responses to reply exceptions. (*Id.* at 4).

"[I]t is improper for a party to use Reply Exceptions to initiate arguments of error in initial, tentative and recommended decisions. Sections 5.533 and 5.535 clearly contemplate that Exceptions are to focus on initial, tentative or recommended decisions while Reply Exceptions are to focus on the arguments raised by the Excepting party. 52 Pa. Code §§ 5.533(a) and 5.535(a)." *Petition of Core Communications, Inc. for Resolution of Dispute with Verizon Pennsylvania, Inc. Pursuant to the Abbreviated Dispute Resolution Process*, Docket No. A-310922F7000, 2003 Pa. PUC LEXIS 21,*9 (Order entered May 27, 2003).

As stated in the *Core Communications* case, our Regulations clearly provide that the purpose of reply exceptions is to respond to issues raised in exceptions taken to Initial or Recommended Decisions. Reply exceptions are not an avenue by which a party can interject late-filed exceptions into the record. That being said, we do not consider Reliant's Replies to be improper. Reliant's Reply Exceptions address arguments raised by the other Parties in their Exceptions and continues the themes stated in its own Exceptions. Each of the EGSs addressed the issue of switching restrictions and/or the GRA in the following Exceptions: Reliant at 5-6; Constellation at 24-33; Strategic at 6-7; Dominion at 8-9; and, Direct Energy at 5-7. The issue of transitioning to an hourly default rate for Large C&I users was also addressed in these Exceptions:

Reliant at 5, Constellation at 34-38; and, Strategic at 12. Duquesne was on notice that Reliant, as well as other Parties, took exception to the ALJ's decision on the above-discussed issues. As such, Reliant gains no unfair advantage by continuing its arguments related to these issues in its Reply Exceptions. Accordingly, Duquesne's Motion to Strike Reliant's Reply Exceptions is denied.

4. Exceptions and Replies to the Approval of the Large Customer Plan, as Modified by the DII Stipulation

a. Overview

As with the Exceptions to the Small Customer Plan, the Exceptions to the Large Customer Plan can be organized into several distinct categories. The first category to be addressed is the nature of the POLR service to be offered. Several of the Excepting Parties object to the provision of any POLR product other than HPS. Constellation and Reliant raise this issue. Included in this category is an Exception filed by Strategic Energy which asserts that if two POLR products are to be offered, the default service should be HPS, not FPDS.

The next category we will address is the issue of the adders. Constellation, Strategic Energy and Reliant all filed Exceptions on this issue. Included in this category is not only the level of adders to be charged, but whether the administrative cost adder should apply to all customers or POLR customers only. The last category to be addressed is switching restrictions as they relate to the Large Customer Plan.

b. POLR III Plan Products

As noted above, Duquesne proposes to offer two products to Large C&I Customers on POLR service: HPS and FPDS. Constellation argues that only one service

should be provided as POLR service: HPS. Constellation states that the evidence reveals that Duquesne's service territory has strong shopping statistics and a high level of experience and sophistication of Large C&I Customers with retail choice. Given that evidence, Constellation argues that there is no need to offer two POLR products to these customers. (Constellation Exc. at 34-36). Constellation asserts that multiple POLR options only serve to interfere with the market response to customer demand for innovative products and pricing structures. According to Constellation, multiple POLR products will complicate the bidding process and increase administrative costs. (*Id.* at 36).

Constellation argues further that an HPS only product has stimulated large C&I market development in other jurisdictions such as New Jersey and Maryland. Constellation states that an HPS only product balances the needs of Large C&I Customers for a POLR product with the goal of promoting competitive markets. Constellation argues that characterizing an HPS only POLR as a penalty is misleading and ignores the Act's requirement that the Commission balance the requirement to promote competitive markets with customers' POLR needs. (*Id.* at 37). Constellation also argues that an HPS only POLR for Large C&I Customers is appropriate since it provides for market signals to those customers best able to react to price signals. (*Id.* at 38).

Reliant argues that a "POLR service that offers a variety of products becomes a substitute for retail supplier competition, and selects the features of products and services through regulation, not competition." (Reliant Exc. at 4). According to Reliant, the Large Customer Plan as modified by the DII Stipulation would become the Large C&I Customers' first choice, not a true last resort service. Thus, the POLR III Plan as proposed "will interfere with the development of a competitive market." (*Id.*).

Like Constellation, Reliant disputes the ALJ's finding that evidence showing high switching rates under an HPS only POLR demonstrates that customers do not want HPS. According to Reliant, high switching rates under an HPS only POLR service demonstrate that customers have found "even better deals by exploring the benefits of competition, such as competitors' superior prices and products (including both hourly-priced and fixed-priced products)." (Reliant Exc. at 4). Reliant also asserts that if the Commission approves two POLR products, the default service should be HPS and the FPDS should terminate after one year. (*Id.* at 5).

Strategic Energy argues that the ALJ erred by approving the FPDS as the default POLR service. Strategic Energy states that since HPS reflects actual market price changes, that would be the best default service "because it sends accurate price signals to customers so that the benefits from demand response and demand side management can be maximized for both customers and their suppliers." (Strategic Energy Exc. at 12). Strategic Energy also states that hourly pricing most accurately reflects the Act's requirement that POLR prices be based upon prevailing market prices for energy. (*Id.*).

Duquesne responded to the foregoing Exceptions and argues that the FPDS was proposed because no customers want hourly service. According to Duquesne, the fact of Large C&I Customers' preference also supports making FPDS the default option. For these reasons, Duquesne argues that we should reject the arguments which favor an HPS only POLR service. (Duquesne Exc. at 12).

DII argues that the FPDS is entirely consistent with the Act since the pricing will be established through an RFP and customers returning to the FPDS will be charged updated prices based upon the market at that time. The foregoing establishes that the FPDS will be provided at prevailing market prices as required by the Act. (DII R.Exc. at 6-7). DII also argues that an HPS only POLR product will subject Large C&I Customers to hourly and seasonal price fluctuations that will harm their competitive

positions in their industries. (*Id.* at 9-10). DII states that experience indicates that markets evolve over time. Accordingly, the FPDS as proposed is appropriate at this evolutionary stage of Pennsylvania's retail markets. Over time, DII asserts that the Commission should review the FPDS and make such modifications as are appropriate given the state of the market. (*Id.* at 14-15).

In its Reply Exceptions, Reliant again argues that the default service should be HPS, not FPDS. Also, Reliant urges the Commission to limit the provision of FPDS service to the first price application period only, ending that product option on May 31, 2006.

We will grant the Exceptions of Constellation, Reliant and Strategic Energy to the extent that we will modify the structure of the Large Customer Plan to provide that HPS service will be the default service. We will also adopt Reliant's suggestion that the FPDS product should be limited to the first price application period and terminate as a POLR product option on May 31, 2006. In making this determination, we are guided largely by Section 2802(3) of the Act which provides for direct access to the competitive market place. Thus, while we will approve the proposed FPDS for a limited time period, we recognize that the price application period commitment and GRA mechanism restricts the ability of customers on that service to move into the market place.

The HPS service provides the freedom for customers to move into the market at will, subject to administrative switching protocols. Accordingly, in a POLR universe with two product offerings, we find that the product with the most freedom to move into the market must be the default product in order to satisfy the mandates of Section 2802(3). We also find that this construct properly balances the policy considerations which strongly favor competitive markets as set forth in Section 2802(5) of the Act with the considerations requiring service on reasonable terms and conditions as set forth in Section 2802(9).

We disagree with Duquesne's suggestion that the structure of the POLR Plan should be completely aligned with customers' preferences. We also do not agree with DII that an HPS only POLR Plan will necessarily subject customers to seasonal fluctuations that will harm their competitive positions. As set forth in the Act, this Commonwealth has found that a competitive marketplace is better able to address those concerns than a regulatory construct. 66 Pa. C.S. § 2802(5).

We find that there is some merit in DII's argument that the retail market continues to evolve. Thus, we have not adopted Constellation's position that only one POLR product is appropriate at this time. The FPDS option should be made available for the first price application period to provide both Large C&I Customers and EGSs with additional experience in the market and planning time to prepare for an HPS only POLR offering. Duquesne's status as a new member in PJM is an additional factor supporting the FPDS product option for a limited period of time.

c. Retail Adders

As set forth in Section 2807(e)(3) of the Act, Duquesne is entitled to recover all reasonable costs incurred in providing POLR service. After modification by the DII Stipulation, the mechanism Duquesne and DII proposed to accomplish that cost recovery is two retail adders designed to compensate Duquesne for the risk involved in providing Large C&I Customer POLR service and for the costs associated with providing the service. There will be no reconciliation or true up.

The first adder is set at 0.05 cents/kWh and applies to all sales to Large C&I Customers, including POLR sales and sales supplied by an EGS. This adder is designed to recover administrative costs associated with providing the Large C&I POLR services as well as to recover the costs of litigating this proceeding. (DII Supp.B. at 5).

A separate adder applies only to Large C&I Customers taking POLR service and applies to customers on both HPS and FPDS. This second adder is designed to compensate Duquesne for the risks associated with providing POLR service and is set at approximately the same revenue level as the adder it currently collects pursuant to the POLR II Settlement and is based on the distribution cost allocators from Duquesne's most recent cost of service study. (DII Supp.B. at 5-6; DII Stipulation at ¶ I.4.b.).

Reliant excepts to the ALJ's recommendation to approve the proposed adders stating that the adders are too low and do not accurately reflect the costs of service risk and retail activities necessary to provide the POLR service to the Large C&I Customers. Reliant argues that the ALJ merely accepted the adders agreed to by Duquesne and DII without any cost evidence in the record. Reliant argues that this is born out by the experiences in New Jersey and Maryland which indicate that an appropriate total adder would be in the range of 5.0 to 6.5 mils/kWh. Reliant asserts that setting the adders too low will remove any opportunity for an EGS to actively participate in Duquesne's service territory because there will be insufficient headroom for a return. (Reliant Exc. 7-8).

Strategic Energy also excepts to the recommendation to approve the adders as proposed. Strategic Energy argues that the first error is that the administrative cost adder should not be assigned to all Large C&I Customers, including those taking generation service from EGSs. Strategic Energy argues that universal application of this adder would require EGS customers to pay the administrative costs of providing generation service twice: once to their EGS and again to Duquesne. In addition, Strategic Energy argues that such a plan removes any opportunity of an EGS to compete on the basis of administrative efficiency since the EGS customer pays the costs of Duquesne's administration regardless of whether it takes Duquesne's service or not. (Strategic Energy Exc. at 15-16).

Strategic Energy also excepts to the risk adder on the basis that the level of the proposed risk adder does not reflect the evidence of record. According to Strategic Energy, the evidence suggests that the risk adder is more properly in the range of 3.4 mils/kWh on an average basis rather than the 2.2 mils/kWh as proposed. (*Id.* at 17). In addition, Strategic Energy finds fault with using a distribution plant allocator for what is essentially a risk premium for generation service. The more appropriate allocator, according to Strategic Energy, would be a generation plant allocator. (*Id.* at 17-18).

Constellation argues that there is no cost support in the record for either the administrative cost adder or the risk adder. As to the risk adder recovering an equivalent revenue level as that of the POLR II Plan, Constellation argues that the POLR II margin was actually 3.57 mil/kWh rather than the 2.2 mil/kWh proposed. (Constellation Exc. at 21-22). This means that the risk adder "represents a significant reduction from the POLR II settlement...." (*Id.* at 22). Constellation also argues that Duquesne's POLR service is "subsidized extensively through distribution rates." (*Id.* at 23). Constellation argues that there should be an allocation of some distribution costs to the administrative adder in order to more accurately develop that figure. (*Id.* at 23-24). Constellation also argues that it is unlawful to charge the administrative adder to non-POLR customers. (*Id.*).

Duquesne rejoins that the record establishes that Duquesne will incur substantial incremental costs to provide POLR service. In addition, Duquesne asserts that there is no dispute that it will assume significant risks of supplier default on the FPDS service. Duquesne states that although that "risk cannot be quantified precisely, that is not a basis for denying" recovery. (Duquesne R.Exc. at 13).

Duquesne asserts that the risk adder is set at an appropriate amount. Duquesne states that although the Excepting Parties are correct that the actual adder is "slightly lower, on a mills/kWh basis (due to the addition of HVPS loads during POLR III), it should still be sufficient to facilitate retail competition." (*Id.*). On the allocation

issue, Duquesne argues that the allocation method is consistent with that used in POLR II where the size of the adder declines by rate schedule as the size of the customers increase. According to Duquesne, this is consistent with economic development given the sensitivity of large customers to electric costs and their ability to relocate. (*Id.*). Duquesne also argues that universal application of the administrative adder is appropriate because "shopping customers benefit from having the option to return to POLR service...." (Duquesne R.Exc. at 13-14).

DII responds and argues that the record indicates that Duquesne presented substantial evidence that it would incur "approximately $3 million in costs related to conducting the annual request for proposal ('RFP') processes and administering the program." (DII R.Exc. at 17). According to DII, this supports a .5 mil/kWh administrative adder applicable to all sales. Further, DII argues that the costs used to develop this administrative adder were the only administrative costs that have been established and quantified on the record for the Large Customer Plan. (*Id.* at 17-18).

DII also argues that there is no basis in the record to find that any portion of distribution rates will subsidize the POLR Plan. DII points out that Rate HVPS customers currently pay less than 1 mil/kWh for distribution, while other C&I rate schedules pay in the range of 6 to 9 mills/kWh. Given the foregoing, it is "patently illogical to believe" that C&I customers have 5 mills of generation related costs in their distribution rates. (DII R.Exc. at 23).

With regard to the risk adder, DII argues that the proposed design to recover $10 million is consistent with the margin for each rate schedule on POLR II. DII states that while the system average margin may equate to 5 mills for all rate schedules, the actual margins for Large C&I rate schedules are much lower. In addition, DII argues that use of the distribution plant allocator is appropriate. DII states that this allocator was used consistent with DII's expert testimony on appropriate cost allocations; testimony

that was not challenged by the Excepting Parties at hearing. According to DII, absent valid, competing testimony, the risk adder design is based upon the only evidence of record. (DII R.Exc. at 20-22).

We will grant the Exceptions of those Parties objecting to the universal application of the administrative adder. We will deny the Exceptions relating to the level of the two adders and the methodology of determining the risk adder. We agree with DII that the record contains substantial evidence which supports the cost build up of the administrative adder, noting the testimony of DII's Witness Baron on the types of costs involved. Also, as we stated in our discussion of the Small Customer Plan, if there is a question regarding distribution rate subsidies, this record does not support a finding on that issue.

We disagree that simply because POLR service stands ready to serve all customers, all customers must pay the costs of its administration. That type of plan requires shopping customers to pay the administrative costs of generation twice: once to their EGS and then again to Duquesne for generation not used. Universal application of the administrative adder will eliminate, dollar for dollar, any benefits achieved through administrative efficiencies gained by the competitive market.

The foregoing result violates the bedrock principle expressed in Section 2802(5) of the Act relating to the ability of competitive markets to control costs. In addition, there is nothing in this record or in the Act which suggests that it is inappropriate for customers to factor the avoidance of POLR administrative costs in their decision to move into the market. To the contrary, the Act and common sense suggest that is exactly the kind of behavior to be expected in a competitive market construct.

We agree with DII that the risk adder has been appropriately designed and developed. We do have some reservations regarding the use of a distribution plant

allocator for the reasons expressed by Strategic Energy in its Exceptions. However, DII is correct that use of that allocator has been substantially advanced by the record in this case, while no such evidentiary support exists for any competing theory. Accordingly, on the basis of the record in this case, we will deny the Exceptions relating to the risk adder. We wish to emphasize that our decision here is based upon this record and should not be interpreted as precluding other solutions to this issue in future proceedings.

For the foregoing reasons, we will approve the adders set forth in the DII Stipulation except to the extent that the administrative adder may only be applied to POLR III customers. Accordingly, Duquesne will necessarily be required to revise the level of the administrative adder to reflect our determination of this issue.[6]

d. Switching Restrictions

Constellation, Strategic Energy and Reliant all excepted to the ALJ's recommended approval of the switching restrictions for the Large Customer Plan. (Constellation Exc. at 24-34; Strategic Energy Exc. at 6-12; Reliant Exc. at 6-7). We will deny these Exceptions. We have altered the proposed POLR structure so as to provide that Large C&I Customers will be defaulted to HPS, a service for which there are no switching restrictions. Accordingly, to the extent that Large C&I Customers *choose* to participate in the FPDS, they will do so having knowingly subjected themselves to the switching restrictions which include a stay-out provision with a GRA mechanism.

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6 We note that Constellation Cross-Examination Exhibit No. 7 discussed this issue. There is some merit to Duquesne's position that the use of 2003 POLR sales to build the administrative adder will not yield revenues equivalent to those derived from the use of total sales due to switching activity. As set forth below, we will adopt Duquesne's suggestion of a working group approach in the compliance phase. This calculation issue can be properly resolved in that setting.

The fact that Large C&I Customers can only subject themselves to these restrictions by a knowing choice eliminates the concerns which led us to modify the switching restrictions in the Small Customer Plan. Here, Large C&I Customers default to the HPS, where no restrictions exist. Since the Large C&I Customers will default to the HPS, they can only be subject to switching restrictions upon a voluntary and affirmative choice to participate in the FPDS option. Accordingly, we do not find that the restrictions on FPDS erect the same barriers to the market as those proposed for the Small Customer Plan.

As we stated in our resolution of switching restrictions for the Small Customer Plan, there is a lack of evidence, on this record, that supports the implementation of specific seasonal rates or other types of restrictions such as volumetric triggers. Again we stress that this determination is based upon the record before us and it should not be interpreted to foreclose innovative and market-based approaches in future proceedings.

V. PJM West Membership

As part of the POLR II Settlement, Duquesne was required to commence negotiations to join the western region of PJM (PJM West) by January 1, 2005. PJM is the RTO approved by the FERC to: (1) operate the bulk transmission system for the region encompassing all or parts of Delaware, Maryland, New Jersey, Ohio, Pennsylvania, Virginia, West Virginia, and the District of Columbia; and (2) to administer a competitive wholesale power market. (PJM M.B. at 1).

In its Petition to provide POLR service beginning January 1, 2005, Duquesne states that it intends to join PJM West by December 31, 2004, if the Commission permits it to recover the costs associated with joining the RTO. (Duquesne M.B. at 48). Duquesne's Rider No. 1 proposes a surcharge of 0.0708 cents/kWh to be

applied to all customers who purchase their electric generation requirements from the Company. (Duquesne Exh.WVP-1, at revised pg. 82).

ALJ Nemec observed that no Party opposed the PJM West proposal and posited that Commission approval of membership was likely unnecessary. ALJ Nemec, nonetheless, approved Duquesne's request to join the RTO and pass on PJM related costs through the Surcharge. (R.D. at 31, 32). No Party filed Exceptions to the issues of Duquesne joining PJM West or the PJM Surcharge.

This Commission has stated that we support and encourage RTO participation by the electric industries operating in the Commonwealth. *See, Competitive Safeguards for the Pennsylvania Electric Industry*, Docket No: L-00980132, April 28, 2000. PJM West membership will bring Duquesne's customers the benefit of what is arguably the most robustly competitive wholesale market in the country. Joining PJM West will allow Duquesne to maintain high levels of reliability and provide access to PJM's liquid energy markets for both POLR and switching customers. (Petition at 4).

PJM will provide a wide range of services to Duquesne, its customers, and EGSs, including the administration of markets for energy, capacity, and ancillary services, planning, load management, and market monitoring. (Duquesne R. Brief at 37). To recoup the costs of providing these services, PJM charges market participants under its open-access transmission tariff. Duquesne proposes to pass those charges on to its POLR customers via the PJM surcharge.

The OCA and Duquesne agreed that Duquesne's Small Customers would receive service at the fixed POLR III rates for 2005-2007 proposed by Duquesne in Duquesne Exhibit WVP-1, as modified in Revised Exhibit WVP-2 for the addition of the PJM surcharge. (OCA Stipulation at ¶ I.4.(a)). For the period 2008-2010, the OCA agreed that rates should be bounded by a floor and a ceiling sufficient to provide

adequate compensation to Duquesne for the risks incurred to serve small customers. (OCA Stipulation at ¶ I.4.(b)). The OSBA and Duquesne agreed to fix the PJM Surcharge without reconciliation for Small C&I Customer POLR service for the six-year POLR III period at the rate identified in Rider No. 1. (OSBA Stipulation at ¶ I. 4.(b)). For reasons noted earlier in this Opinion and Order, we rejected Duquesne's proposed six-year term in favor of a three-year term. The PJM surcharge will, therefore, be applied to the three-year fixed price. At the conclusion of the approved three-year term, Duquesne may again seek recovery of the PJM Surcharge from Small Customer Plan customers pursuant to Section 2807(e)(3) of the Act.

DII and Duquesne agreed that the PJM Surcharge would apply only to POLR customers. DII and Duquesne further agreed that similar costs incurred by EGSs would be the responsibility of EGSs and their customers. (DII Stipulation at ¶ I.4.(g)(9)). Two of the industrial customers on Rate HVPS remain POLR I customers and will continue to pay stranded costs after January 1, 2005. Their stranded cost recovery is expected to continue through June 2005. (DII M.B. at 42). The Act at Section 2804(4)(ii), 66 Pa. C.S. § 2804(4)(ii), provides that a generation rate cap applies to customers paying a CTC.

Prior to reaching the agreed upon DII Stipulation, DII argued that the PJM surcharge could not be applied to those Large C&I Customers which continue paying CTCs pursuant to Section 2804(4)(ii). However, as a member of PJM West, Duquesne will serve HVPS and special contract customers as a LSE under the PJM transmission tariff. The PJM Surcharge directed here is not for the purpose of collecting generation charges. On that basis, we find that the PJM surcharge does not disturb the POLR I generation rate cap. In addition to the fact that the PJM Surcharge does not represent generation charges, we find that the charges incurred by Duquesne by virtue of its new membership in PJM West constitute charges for services purchased from markets previously not available to Duquesne customers. Thus, the charges are for the recovery

of the costs of new services. The Act's rate cap provisions do not apply to new services offered after its effective date. 66 Pa. C.S. § 2804(4)(vi).

Because the PJM costs are not for generation supply, and because the Surcharge covers costs related to new services, the PJM Surcharge does not violate the rate cap provisions of Section 2804(4)(ii). PJM membership will benefit all customers receiving POLR service. As such, Duquesne is entitled to recover the prudently incurred, incremental costs associated with joining PJM, as expressed in the proposed PJM Surcharge, from all POLR customers.

VI. Miscellaneous Matters

A. Marketing of POLR III Service

Constellation excepts to the failure of the ALJ to provide a specific prohibition against Duquesne's marketing of its POLR III service. Constellation argues that such a prohibition would ensure that Duquesne does not use its customer service centers that provide distribution functions to actively market its POLR III services. Constellation points out that this type of express prohibition was contained in the POLR II settlement. However, Constellation does acknowledge that Duquesne will necessarily have to provide objective POLR and rate information to customers, Commission personnel and EGSs. Constellation suggests that Duquesne voluntarily provide that type of information with EGSs in advance of distribution to customers to avoid problems and misunderstandings. (Constellation Exc. at 39-40).

Duquesne responds that this is an issue best left to state-wide POLR Regulations. Duquesne states that it has no intent to act in an anticompetitive manner. Duquesne states that it "intends only to ensure that customers understand their options." (Duquesne R.Exc. at 21-22).

We will grant this Exception and direct that the marketing condition set forth in POLR II Settlement remain in force for the POLR III Plan. Even though we agree with Duquesne that this is an issue that should be discussed in the context of state-wide POLR Regulations, that does not preclude consideration of that issue here. As a general concept, we agree with Constellation that a POLR provider should not "market" its services as if it were a competitive product in the marketplace. On the other hand, Duquesne is correct (and Constellation recognizes) that objective consumer information regarding POLR services is essential. From these arguments, it appears that Duquesne intends to conduct itself consistent with the current condition in place. Accordingly, continuation of that condition is appropriate until state-wide POLR Regulations address the issue.

B. Waiver of POLR Regulations

Direct Energy filed an Exception stating that the ALJ erred by ignoring Direct Energy's proposal that Duquesne's Small Customer Plan be superseded by the Commission's post-transition POLR Regulations. (Direct Energy Exc. at 7). Duquesne responds to this Exception and flatly states that "Duquesne cannot accept this condition." (Duquesne R.Exc. at 22). Duquesne argues that it cannot make commitments for its supply portfolio as proposed "if it does not have assurance that the long-term, fixed rates set forth in the POLR III Plan will remain in effect, and will not be revised or terminated by generic PUC rulemakings." (*Id.*).

We will not grant this Exception as presented. However, in ruling on this Exception, we decline to give Duquesne an advanced, blanket waiver from regulations that have yet to be developed or even proposed. At this juncture, any such pronouncement would be far too premature. Simply put, we have absolutely no basis upon which to determine whether such a waiver would be in the public interest, or not.

In response to Duquesne's argument relating to commitments in support of its supply portfolio, we again emphasize our intent to adhere to the requirements of Section 2807(e)(3) of the Act that a POLR supplier must recover all reasonable costs and acquire energy at prevailing market rates. Duquesne has gone to great lengths in this proceeding to prove that its proposed rates for the Small Customer Plan satisfy these statutory requirements. We have determined that they are consistent with the Act for the initial three-year period. Nothing in this determination suggests that Duquesne will be unable to obtain the same determination for a subsequent term, depending on the evidence presented at that time.. Also, nothing in our determination of this Exception will impact any request for waiver which may be presented by Duquesne, if Duquesne believes that such a waiver is required. Simply put, there is no way to know, at this juncture, whether a waiver would even be required.

C. Strategic Energy's Exception on Consolidated Billing

In this Exception, Strategic Energy argues that the ALJ erred in denying Strategic Energy's proposal to make consolidated billing available. Strategic Energy asserts that its proposal is justified because it benefits the competitive market and consolidated billing will mitigate the anti-competitive effects of Duquesne's POLR Plan. (Strategic Energy Exc. at 22). Duquesne responds and asserts that Strategic Energy fails to explain why this issue should be decided in this proceeding. Duquesne suggests that this is an issue that may be considered in post-transition POLR Regulations. (Duquesne R.Exc. at 22).

We agree with Duquesne that this is not the appropriate proceeding in which to decide this issue. Accordingly, this Exception is denied.

D. OSBA, OCA and DII Stipulations: Conditions on Distribution Rates and Renewable Energy

The OCA Stipulation, the OSBA Stipulation and the DII Stipulation all contain a provision which restricts the opportunity of Duquesne to seek a distribution rate increase until some specific time in the future. While we will in large part approve the proposed POLR III Plan as modified by these Stipulations, the record before us contains no evidence which would support such a stay-out provision. Indeed, we question whether it is appropriate in the first instance to direct a distribution rate condition in the context of a POLR proceeding. Accordingly, we will not adopt that provision here.

The OCA Stipulation also contains a provision which mandates that Duquesne will utilize renewable and environmentally beneficial resources for at least 2% of its small customer supply portfolio during the years 2005-2007, even in the absence of legislation mandating such a commitment. Duquesne is free to voluntarily adopt this provision and we encourage it to do so. Also, we would expect that Duquesne would comply with any statutory direction in this area. However, we will not direct such a condition in this proceeding on the basis of the litigated record before us. This is an appropriate issue to be developed in state-wide POLR Regulations if no statutory direction is forthcoming.

E. Regulatory Approvals

Duquesne addresses three specific regulatory approvals in the context of its POLR III Plan. First, Duquesne asks that we issue the findings required under Section 32(k) of the Public Utility Holding Company Act of 1935 (PUHCA), 15 U.S.C. § 79z-5(k), in order to permit it to enter into a contract to purchase energy from Duquesne Power, an affiliated exempt wholesale generator. Next, Duquesne requests that we issue our approval, to the extent necessary, for Duquesne Power to acquire the Sunbury

generating station. Finally, Duquesne requests approval under Section 2102(b) of the Code, 66 Pa. C.S. § 2102(b), to enter into an affiliated interest agreement with Duquesne Power to procure power to serve customers taking POLR III service under the Small Customer Plan. (Petition at 22-24).

With regard to approval of the acquisition of the Sunbury generating station by Duquesne Power, an unregulated affiliate of Duquesne, it does not appear that Commission approval of that transaction is required.

Duquesne has also requested approval of the Duquesne – Duquesne Power supply arrangements as an affiliated interest agreement pursuant to Section 2102(b) of the Code. Duquesne asserts that the supply arrangements are reasonable and consistent with the public interest. (Duquesne M.B. at 57). We agree that the affiliated interest agreement for supply arrangements is in the public interest and we will approve that agreement as required by Section 2102(b) of the Code. In doing so, we acknowledge that the term of the power supply agreement extends beyond the term of the Small Customer Plan as approved herein. As we have discussed at length, nothing in this Opinion and Order prevents Duquesne from seeking to recover market based prices for energy acquired for POLR supply subsequent to the term mandated herein. Thus, we do not perceive our approval of the power supply agreement for purposes of Section 2102(b) to be at odds with our decision regarding the Small Customer Plan term.

As noted above, Duquesne also seeks approval of the power arrangement pursuant to Section 32(k) of PUHCA. In order to grant approval under that Section, we must find that the power arrangement: (i) will benefit consumers; (ii) does not violate any state law (including where applicable, least cost planning; (iii) would not provide the affiliate with any unfair competitive advantage by virtue of its affiliation or association with Duquesne; and (iv) is in the public interest. 15 U.S.C. § 79z-5(k)(2)(A)(ii). Based upon the record before us, we determine that the arrangement here under review will

benefit consumers and does not violate state law. The record before us contains no evidence that the arrangement will provide Duquesne Power with any unfair advantage by virtue of its affiliation or association with Duquesne. Finally, the record establishes that the arrangement is in the public interest. For these reasons, we will approve of the arrangement to the extent necessary pursuant to Section 32(k) of PUHCA. As we stated in our approval under Section 2102(b) of the Code, we do not perceive our approval here to be inconsistent with our determination of the Small Customer Plan term.

G. Compliance Filing Procedure

Duquesne requests that we provide for a compliance filing procedure. (Duquesne R.Exc. at 24-25). Duquesne anticipates filing a revised Retail Tariff, a revised Electric Generation Supplier Coordination Tariff and "procedures to implement the wholesale purchases by RFP required for" the Large Customer Plan. (*Id.*). Duquesne states that it will serve those materials on the Parties for comment. However, Duquesne also suggests that it may be necessary to schedule technical conferences with interested Parties to review the compliance documents and procedures. For these reasons, Duquesne requests that we direct that Duquesne propose a compliance filing schedule and procedure within thirty days after the entry date of this Opinion and Order. The schedule and procedure should be designed to permit the Parties to participate in the compliance procedures while ensuring that compliance is completed in sufficient time to enable Duquesne to begin offering POLR III service on January 1, 2005.

We agree with this proposal. While we have approved a majority of the POLR III Plan as proposed and as modified by the OCA, OSBA and DII Stipulations, we have directed certain modifications that will require attention in the compliance phase of this proceeding. Also, as Duquesne states, some of its proposed procedures require additional development. Because of time concerns, we will reduce the time period for response to fifteen days following entry of this Opinion and Order. Comments, if any, to

the proposed schedule and procedure must be filed within twenty-five days of the date of entry of this Opinion and Order. The schedule and procedure must provide for at least one technical conference with interested parties. The schedule must also be designed to ensure participation by the Parties and the completion of actions necessary to come into compliance with this Opinion and Order such that Duquesne can begin offering POLR III service on January 1, 2005.

Conclusion

For the reasons discussed above, we will grant, in part, and deny, in part, the Exceptions of the Parties in this proceeding. We will adopt the Recommended Decision of Administrative Law Judge Michael A. Nemec as modified by, and consistent with the foregoing Opinion and Order, and grant the Petition of Duquesne as modified by the Stipulations of the OCA, the OSBA and the DII, and as further modified consistent with this Opinion and Order; **THEREFORE,**

IT IS ORDERED:

1. That the Motion of Duquesne Light Company to Strike the Reply Exceptions of Reliant Energy, Inc. is denied.

2. That the Exceptions of the Office of Trial Staff, Reliant Energy, Inc., Direct Energy, Dominion Retail, Inc., Citizens Power, Inc., Constellation Power Source, Inc. and Constellation Newenergy, Inc., and Strategic Energy, L.L.C. are granted in part, and denied in part, consistent with this Opinion and Order..

3. That the Recommended Decision of Administrative Law Judge Michael A. Nemec is adopted as further modified by this Opinion and Order.

4. That the Petition of Duquesne Light Company for approval of its Plan for Provider of Last Resort service, as modified by the Revised Partial Stipulations between Duquesne Light Company and the Office of Consumer Advocate and the Office of Small Business Advocate, and as modified by the Stipulation between Duquesne Light Company and the Duquesne Industrial Intervenors is approved to the extent consistent with this Opinion and Order.

5. That the proposed sale of electric energy to Duquesne Light Company by Duquesne Power will benefit consumers; does not violate any state law; has not been shown to provide any unfair competitive advantage to Duquesne Power; and, is in the public interest under Section 32 of the Public Utility Holding Company Act of 1935, 15 U.S.C. § 79z-5(k), consistent with this Opinion and Order.

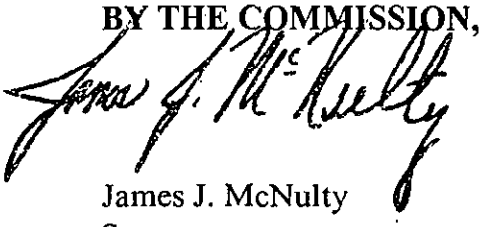
6. That the proposed contract for power supply between Duquesne Light Company and Duquesne Power is approved pursuant to Section 2102(b) of the Public Utility Code, 66 Pa. C.S. § 2102(b), relating to affiliated interest agreements, consistent with this Opinion and Order.

7. That Duquesne Light Company's request to join the western region of PJM Interconnection is approved.

8. That within fifteen (15) days of the entry of this Opinion and Order, or such additional time as may be granted, Duquesne Light Company shall file for our consideration, a proposed schedule and procedure for the management of its compliance filings designed to implement the Provider of Last Resort Plan approved herein. The proposed schedule and procedure will provide for at least one technical working group and will be designed to permit Duquesne Light Company to begin offering service under the approved Provider of Last Resort Plan on January 1, 2005.

9. That within twenty-five (25) days of the date of entry of this Opinion and Order, or such additional time as may be granted, the Parties to this proceeding may file Comments to the proposed compliance schedule and procedure.

BY THE COMMISSION,



James J. McNulty
Secretary

(SEAL)

ORDER ADOPTED: August 19, 2004

ORDER ENTERED: AUG 2 3 2004

CERTIFICATE OF SERVICE

I hereby certify that I am this day serving a true copy of the foregoing document upon the participants listed below in accordance with the requirements of 52 Pa. Code Section 1.54 (relating to service by a participant).

VIA E-MAIL AND FIRST CLASS MAIL

Steven C. Gray, Esq.
Office of Small Business Advocate
Suite 1102, Commerce Building
300 North Second Street
Harrisburg, PA 17101

David A. McCormick, Esq.
The Department of Defense and Federal Executive Agencies
Regulatory Law Office
U.S. Army Legal Services Agency
Department of the Army (DAJA-RL 4120)
901 North Stuart Street, Room 713
Arlington, VA 22203-1837

Tanya J. McCloskey, Esq.
James A. Mullins, Esq.
Lori A. Herman, Esq.
Aron J. Beatty, Esq.
Office of Consumer Advocate
555 Walnut Street
Forum Place, 5th Floor
Harrisburg, PA 17101-1923

David B. MacGregor, Esq.
Morgan, Lewis & Bockius LLP
1701 Market Street
Philadelphia, PA 19103-2921

Joseph L. Vullo, Esq.
1460 Wyoming Avenue
Forty Fort, PA 18704-4224

Michael W. Gang, Esq.
John H. Isom, Esq.
Morgan, Lewis & Bockius LLP
One Commerce Square
417 Walnut Street
Harrisburg, PA 17101-1904

Richard A. Kanaskie, Esq.
Office of Trial Staff
Pennsylvania Public Utility Commission
400 North Street, 2nd Floor West
P.O. Box 3265
Harrisburg, PA 17105-3265

Eric Joseph Epstein
4100 Hillside Road
Harrisburg, PA 17112

Scott J. Rubin, Esq.
3 Lost Creek Drive
Selinsgrove, PA 17870-9357

Mark C. Morrow, Esq.
UGI Utilities, Inc.
460 North Gulph Road
King of Prussia, PA 19406

Charles McPhedran, Esq.
Citizens for Pennsylvania's Future
117 S. 17th St., Suite 1801
Philadelphia, PA 19103

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SECRETARY'S BUREAU

Mr. Eugene M. Brady
Commission on Economic Opportunity
165 Amber Lane
P.O. Box 1127
Wilkes-Barre, PA 18703-1127

Patricia Armstrong, Esq.
Thomas T. Niesen, Esq.
Thomas, Thomas, Armstrong & Niesen
212 Locust Street, Suite 500
P.O. Box 9500
Harrisburg, PA 17108-9500

Kent D. Murphy, Esq.
Exelon Business Services Co.
2301 Market Street, S23-1
P.O. Box 8699
Philadelphia, PA 19101-8699

John L. Munsch, Esq.
Allegheny Energy
800 Cabin Hill Drive
Greensburg, PA 15601-1689

Michael Fiorentino, Esq.
Joseph Otis Minott, Esq.
Clean Air Council
135 S. 19th Street, Suite 300
Philadelphia, PA 19103

Louise A. Knight, Esq.
Joseph J. Malatesta, Esq.
Saul Ewing LLP
2 North Second Street, 7th Floor
Harrisburg, PA 17101

Paul E. Russell, Assoc. General Counsel
PPL Electric Utilities Corporation
Two North Ninth Street
Allentown, PA 18101-1179

Roger E. Clark, Esq.
Sustainable Development Fund
718 Arch Street, Suite 300 North
Philadelphia, PA 19106-1591

Daniel Clearfield, Esq.
Kevin J. Moody, Esq.
Wolf Block Schorr & Solis-Cohen LLP
212 Locust Street, Suite 300
Harrisburg, PA 17036

Richard S. Herskovitz, Esq.
Vice President, Rates
Duquesne Light Company
411 Seventh Avenue, 8-2
Pittsburgh, PA 15219

Honorable Ember S. Jandebeur
Pennsylvania Public Utility Commission
Scranton State Office Bldg., Room 318
100 Lackawanna Avenue
Scranton, PA 18503

Honorable Susan Colwell
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street, 2nd Floor
Harrisburg, PA 17120

Michael G. Wolfe, Esq.
FirstEnergy Corp.
2800 Pottsville Pike
P.O. Box 16001
Reading, PA 19612-6001

James P. Melia, Esq.
Kirkpatrick & Lockhart LLP
240 North Third Street
Harrisburg, PA 17101-1507

Pamela C. Polacek

Counsel to the PP&L Industrial
Customer Alliance

Dated this 13th day of September, 2004, at Harrisburg, Pennsylvania.