OPINION AND ORDER

BY THE COMMISSION:

Before the Commission for consideration and disposition is the Recommended Decision of Administrative Law Judges (ALJs) Wayne L. Weismandel and David A. Salapa, issued November 2, 2006, in the above captioned consolidated proceedings involving the Merger Savings Remand of GPU, Inc. (GPU) and FirstEnergy Corp. (FirstEnergy), as well as the General Rate Increase and the Rate Transition Plan proposals of Metropolitan Edison Company (ME) and Pennsylvania Electric Company (PE) (collectively, the Companies or MEPN). Also before the Commission are the Exceptions and Reply Exceptions filed thereto.

Exceptions to the Recommended Decision were filed by the Office of Trial Staff (OTS) on November 21, 2006. The following Parties filed Exceptions on November 22, 2006: the Companies, Citizen Power, the Office of Small Business Advocate (OSBA), the Office of Consumer Advocate (OCA), Constellation New Energy, Inc. and Constellation Energy Commodities Group (collectively, Constellation), Met-Ed Industrial User Group (MEIUG) and Penelec Industrial Customer Alliance (PICA), PennFuture, and the Berks County Community Foundation and the Community Foundation for the Alleghenies (collectively, the SEFs).

The following Parties filed Reply Exceptions on December 4, 2006: the Companies, Citizen Power, OSBA, OCA, OTS, Constellation, the Commercial Group, MEIUG and PICA, PPL Electric Utilities Corporation (PPL) and R.H. Sheppard Co. Inc. (Sheppard).

I. HISTORY OF THE PROCEEDINGS

In *ARIPPA v. Pa. PUC*, 792 A.2d 636 (Pa. Cmwlth. 2002) *alloc. denied*, 572 Pa. 736, 815 A.2d 634 (2003) (*ARIPPA*), the Pennsylvania Commonwealth Court, among other things, remanded to the Commission the issues of determining the amount of and the allocation of merger savings arising from the merger of GPU and FirstEnergy. MEPN were, prior to the merger, regulated public utility subsidiaries of GPU and are now regulated public utility subsidiaries of FirstEnergy. The remanded issues remained docketed at Commission Docket Nos. A-110300F0095 and A-110400F0040, and were subsequently referred to as the Merger Savings Remand Proceeding.

By way of a Secretarial Letter dated April 2, 2003, the Commission thereafter acknowledged that '[o]n January 16, 2003, the Pennsylvania Supreme Court denied or quashed all pending applications for appeal from' *ARIPPA*. Additionally, the Commission therein directed, among other things:

> 1. The matter of the economic savings resulting from the merger of GPU Corp. and FirstEnergy Corp. at Docket Nos. A-110300F0095 and A-110400F0040 is remanded to the Office of Administrative Law Judge for hearings on the amount and allocation of the merger savings.

By Implementation Order adopted and entered October 2, 2003, at Docket Nos. A-110300F0095, A-110400F0040, P-00001860, and P-00001861, the Commission reaffirmed this portion of the Secretarial Letter dated April 2, 2003.[1]

During the balance of calendar year 2003, and continuing through 2005, the Parties to the Merger Savings Remand Proceeding engaged in negotiations to attempt to

[1] A complete history of the post-ARIPPA 1 proceedings is contained in the Implementation Order adopted and entered October 2, 2003.

reach a settlement and provided periodic reports to the presiding officer, Administrative Law Judge (ALJ), Larry Gesoff.

On April 10, 2006, ME filed with the Commission Tariff - Electric Pa. P.U.C. No. 49, Docket No. R-00061366. On that same date, PN filed Tariff – Electric Pa. P.U.C. No. 78, Docket No. R-00061367 Each company also filed Petitions for Approval of a Rate Transition Plan; ME at Docket No. P-00062213 and PN at Docket No. P-00062214. The proposed Tariffs were to be effective June 10, 2006. ME's proposed Tariff contained changes calculated to produce additional revenues of 19 to 24 percent for 2007 and changes in its generation rates for 2008, 2009 and 2010, which could increase rates by up to $165 million each year. PN's proposed Tariff contained changes calculated to produce additional revenues of 15 to 19 percent for 2007 and changes in its generation rates for 2008, 2009 and 2010, which could increase rates by up to $135 million each year. The Petitions for Approval of a Rate Transition Plan for each company proposed new generation rates that would exceed the rate caps established pursuant to the Companies' restructuring proceedings required under the Electricity Generation Customer Choice and Competition Act, 66 Pa. C.S. § 2801 *et seq.* (Competition Act), and the Joint Petition for Full Settlement of the Restructuring Plans of MEPN and Related Dockets and Related Proceedings (Restructuring Settlement) approved by Commission Final Opinion and Order, entered October 20, 1998, at Docket Nos. R-00974008, R-00974009, P-00971215, P-00971216, P-00971217, P-00971223, P-00971278, P-00981324, P-00981325 and P-00900450. The Companies also filed a Motion to Consolidate the Merger Savings Remand Proceeding, Docket Nos. A-110300F0095 and A-110400F0040, with the rate cases and transition plan cases.

On May 4, 2006, the Commission adopted and entered an Order which consolidated the Merger Savings Remand Proceeding with the two rate cases and the two transition plan cases, suspended the filings until January 10, 2007 and ordered an investigation and hearings by the Office of Administrative Law Judge (OALJ). The consolidated case was assigned to the presiding ALJs.

The following entities and individuals filed Formal Complaints against the Companies' proposed rate increase: MEIUG and the Industrial Energy Consumers of Pennsylvania (IECPA); PICA and IECPA; OSBA; OCA; Pennsylvania Rural Electric Association and Allegheny Electric Cooperative, Inc. (PREA/AEC); Central Bradford Progress Authority; Robert H. Tansor; L.C. Rhodes; Stan Alekna; G. Thomas Smeltzer; Pierre Fortis; Michael R. Wright; Benjamin Moyer; Carmine Lisante; Berks County Center for Independent Living d/b/a Abilities In Motion (Abilities In Motion); and Sheppard. All of the Complaints filed against the proposed rate increase were satisfied or withdrawn except for those filed by the following Parties: MEIUG and IECPA; OSBA; OCA; Sheppard; PICA and IECPA; Pierre Fortis; and L.C. Rhodes. OSBA also filed formal Complaints against the transition plan filings of MEPN, and the OTS entered its Notice of Appearance on April 18, 2006.

The following entities filed Petitions to Intervene in the consolidated cases which were granted: the Utility Workers Union of America Local 180 and the International Brotherhood of Electrical Workers Local 459 (collectively, the Unions); ARIPPA[2]; the SEFs; Constellation; York County Solid Waste and Refuse Authority (YCSWA); Retail Energy Supply Association (RESA); PPL Electric Utilities Corporation (PPL); Citizen Power; the Commercial Group; the Community Action Association of Pennsylvania (CAAP); PREA/AEC; and the National Energy Marketers Association (NEMA). The Companies objected to the Petitions to Intervene filed by Citizen Power, PREA/AEC, PPL, and NEMA.

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[2] ARIPPA is a trade association composed of 14 non-utility generation power plants operating across Pennsylvania, all of which use waste coal as a source of fuel. Seven of the members of ARIPPA have long-term contracts to sell power to the Companies.

The following entities withdrew[3] from participating in the consolidated proceeding: the Unions; NEMA; PREA/AEC; and Morgan Stanley Capital Group, Inc. (MSCG).

By Accounting Order in *Petition of Metropolitan Edison Company and Pennsylvania Electric Company for Authority to Modify Certain Accounting Procedures*, Docket No. P-00052143, adopted May 4, 2006, entered May 5, 2006, the Commission granted Petitions to Intervene filed in that case by MEIUG, PICA, and PREA/AEC, authorized the Companies to defer for accounting and financial reporting purposes certain incremental FERC-approved transmission charges, and preserved the ability of any party to a rate case to seek or oppose rate recovery of any of the deferred costs. In the Accounting Order, the Commission expressly stated that the Companies would be allowed an opportunity to 'seek rate recovery of these incremental transmission expenses in the pending rate cases.

On May 16, 2006, OCA, OTS, MEIUG/PICA and IECPA, and PennFuture filed a Joint Petition For Clarification, Or Reconsideration Of Consolidation Order And For Establishment Of A Public Meeting Date, contending that the schedule established at the Initial Prehearing Conference in the consolidated case, while designed to accommodate the statutory time requirement for completion of a general rate increase case as well as the Commission's published schedule for Public Meetings prior to the suspension date of January 10, 2007, was not sufficient for the litigation of the consolidated case. Additionally, the ALJs issued a Protective Order, as submitted by the Parties, to apply to litigation of the consolidated case.

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[3] Eighteen Parties remained involved in the consolidated case: the Companies, OTS, OCA, OSBA, MEIUG/PICA and IECPA, PPL, the SEFs, RESA, PennFuture, Constellation, Citizen Power, Sheppard, CAAP, ARIPPA, YCSWA, and the Commercial Group.

By Order adopted and entered May 19, 2006, the Commission granted in part the Joint Petition For Clarification, Or Reconsideration Of Consolidation Order And For Establishment Of A Public Meeting Date, ordering the Companies to inform the Commission's Secretary, no later than May 22, 2006, if they would voluntarily extend the effective dates of their proposed tariffs in these proceedings to January 12, 2007 and, if so, a Public Meeting would be scheduled for January 11, 2007 for the purpose of deciding these consolidated proceedings. Further, the Order directed the ALJs to establish a new litigation schedule for the consolidated case if the Companies agreed to the voluntary extension. On May 22, 2006, the Companies advised the Commission's Secretary that they agreed to extend the effective date of their proposed tariffs to January 12, 2007.

During the period June 20, 2006, through July 13, 2006, nine Public Input Hearings were held in Erie, Warren, Johnstown, Altoona, York, Reading, Mansfield, Towanda, and Bushkill. A total of twenty-four witnesses appeared and offered testimony at these sessions.[4] Separate transcripts of the proceedings at each session were produced containing a total of 268 pages. On July 20, 2006, a tenth Public Input Hearing was held in Easton. One witness appeared and offered testimony at this session. A transcript of the proceedings was produced containing 25 pages.

By letter dated July 27, 2006, the Companies requested that the Commission make a determination to include the issue of their NUG[5] purchased power

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[4] Five witnesses testified at Erie, two witnesses testified at Warren, five witnesses testified at Johnstown, one witness testified at Altoona, two witnesses testified at York, five witnesses testified at Reading, no witnesses testified at Mansfield, three witnesses testified at Towanda, and one witness testified at Bushkill.

[5] A NUG is a non-utility generator, i.e. a generation facility owned and operated by an entity who is not defined as a utility in that jurisdictional area.

accounting methodology in the consolidated case.[6] By letter dated August 4, 2006, addressed to the presiding ALJs at the Docket Nos. of the consolidated case, the Companies requested approval of the inclusion of their revised NUG purchased power accounting methodology in the consolidated case. On August 11, 2006, the Companies filed correct copies of the Bureau of Audits Reports, correcting attachments to their August 4, 2006 letter request.

By Commission Order adopted August 17, 2006, entered August 18, 2006, in *Metropolitan Edison Company and Pennsylvania Electric Company – Approval of the Reports on the Audit of Non-Utility Generation Related Cost Recovery Through the Competitive Transition Charge for the Year Ended December 31, 2005*, Docket Nos. D-05NUG009 and D-05NUG010, the Commission, among other things, provided:

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6 The Commission's Bureau of Audits issued A Report On the Audit of Non-Utility Generation Related Stranded Cost Recovery Through The Competitive Transition Charge For The Year Ended December 31, 2005, for ME at Docket No. D-05NUG009 and for PN at Docket No. D-05NUG010 on August 8, 2006. In each Report, the Bureau of Audits found that the Companies had revised the previously applied NUG accounting methodology effective January 23, 2006, retroactive to January 1999. The revised methodology increased ME's cumulative undercollection balance by approximately $19,000,000 and for PN, increased the balance due from the NUG Trust Fund by approximately $6,000,000. In each Report, the Bureau of Audits recommended that 'the Company be directed to revert back to the original NUG cost accounting methodology until such time as the Commission approves an alternative to that methodology. By Secretarial Letter dated June 30, 2006, the Commission invited comments on the Reports. OSBA and OTS submitted comments supporting the Bureau of Audits' recommendations. The Companies submitted reply comments requesting that the issue of the revised accounting methodology be addressed in the consolidated case. All comments were filed at Docket Nos. D-05NUG009 and D-05NUG010. By Secretarial Letter dated August 2, 2006, the Commission's Secretary advised the Companies that its July 27, 2006, letter 'is not accepted for filing' at Docket Nos. D-05NUG009 and D-05NUG010. The Companies were further advised that if a similar letter was filed at the dockets of the consolidated case, 'any party can file responses to [such a] letter with copies to the presiding ALJs. The Secretarial letter went on to state that '[a]t that time, the ALJs can address, if appropriate, the issues raised in your letter.

2. That the Companies revert back to the original NUG cost accounting methodology until such time as the Commission approves a change to that methodology. This Order is not intended to limit the Companies' ability to petition for a change from the accounting methodology utilized by the Companies between January 1999 and January 2006.

3. That the Companies are to adjust the appropriate accounts so as to reflect the balances they would have had absent the Companies' unilateral change in methodology.

4. That consistent with our Secretarial letter dated August 2, 2006, the Companies' proposal to change the NUG cost accounting may be examined in the pending Rate Transition Plan at Docket Nos. R-00061366 and R-00061367 if deemed appropriate by the presiding ALJs. In the event that the ALJs decide that it is not appropriate to examine the change in NUG cost accounting in the pending rate transition plan dockets, the Companies may file a petition as set forth in Ordering Paragraph 2.

Consistent with Ordering Paragraph No. 4 of the Commission's August 18, 2006 Order, it was determined that inclusion of the issue of the Companies' unilateral change in NUG accounting methodology in the consolidated case was not appropriate. It was also ordered that the Companies take all appropriate actions to comply with the Commission's Order so that the information presented in the consolidated case would be in compliance with the Commission Order.

An Initial and further Hearings were held as scheduled on August 24, 25, 28, 29, and 30, 2006. During the course of the Hearing, a total of twenty witnesses appeared and were available for cross-examination. Additionally, the written testimony of another twenty-eight witnesses was received into evidence by stipulation of the Parties. YCSWA, ARIPPA, PPL, RESA, Citizen Power, Sheppard, Pierre Fortis, and L. C. Rhodes presented no witnesses. Numerous statements (many with attached exhibits and/or appendices), exhibits, and cross-examination exhibits sponsored by the Parties were received into evidence, as were two ALJ exhibits (ALJ Exhibit 1 and 2). A transcript of the proceeding containing 798 pages (numbered 404 through 1201) was produced. The following Parties filed Main Briefs on September 22, 2006: the Companies, OTS, OCA, OSBA, MEIUG and PICA and IECPA, PPL, the SEFs, RESA, PennFuture, Constellation, Citizen Power, Sheppard, CAAP. ARIPPA, and YCSWA. On September 26, 2006, in accordance with the extension of time granted to it, the Commercial Group filed its Main Brief.

The following Parties submitted Reply Briefs on October 6, 2006: the Companies, OTS, OCA, OSBA, MEIUG and PICA and IECPA, PPL, the SEFs, RESA, PennFuture, Constellation, Citizen Power, the Commercial Group, and Sheppard. YCSWA, ARIPPA, and CAAP did not file Reply Briefs.

On October 11, 2006, OCA filed Revised Tables I and II for the PN Transmission Income Summary and Summary of Adjustments, along with an errata sheet changing the text of the OCA Main and Reply Briefs to reflect the revised Tables I and II for PN Transmission Service. On October 16, 2006, OTS filed separate Corrected Tables I and II, Income Summary and Summary of OTS Adjustments, for MEPN.

The Recommended Decision of ALJs Salapa and Weismandel, which was served on the Parties on November 2, 2006, rejected the proposed annual increases of $225,784,000 and $165,547,000 for MEPN, respectively, and recommended that the Commission issue an Opinion and Order directing MEPN to file a tariff allowing recovery of no more than $41,470,000 and $34,288,000,[7] respectively, in additional base rate revenue. The ALJs also rejected the Companies' proposed rate transition plans. In

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[7] The Recommended Decision, served November 2, 2006, included Tables which did not reflect all of the ALJs' recommended adjustments. In their Reply Exceptions, the Companies provided, in concurrence with the Parties of the proceeding, the necessary adjusted Tables.

the matter of merger savings, it was determined that the Companies would calculate the savings from 2001 to 2006 and allocate 50% of the $140.4 million to ratepayers. The savings would then be allocated to rate classes on the basis of present distribution revenues and be credited to ratepayers over a four year period, 2007 to 2010.

Exceptions and Reply Exceptions were filed as noted above.

II. MERGER SAVINGS

A. Allocation of Merger Savings

1. Positions of the Parties

The Companies argued that there should be no sharing of merger savings. They asserted that since the merger, FirstEnergy has provided millions of dollars of benefits to customers above and beyond merger savings. If merger savings are directed to customers, that would constitute a windfall to customers. (R.D. at 30).

OSBA and OCA proposed a 50/50 sharing of merger savings. OCA proposed that merger savings be returned to customers over a period of four years. OSBA recommended that merger savings be allocated to rate classes on the basis of present distribution revenues. (R.D. at 30).

Citizen Power and OTS argued that all of the merger savings should be passed on to customers. Citizen Power asserted that any suggestion that FirstEnergy provided financial support which benefited customers is without merit since the customers were insulated from increased power costs due to rate caps. OTS argued that the alleged financial support by FirstEnergy was actually lost opportunity costs, not actual financial support. OTS argued that no money changed hands; accordingly, there can be no basis for asserting that a subsidy occurred. In addition, OTS asserted that to the extent FirstEnergy experienced lost opportunity costs, that was the result of management decisions of FirstEnergy and the Companies. (R.D. at 30-31).

2. ALJs' Recommendation

The ALJs adopted the OCA and OSBA position which provided for a 50/50 sharing of merger savings between the Companies and ratepayers. The ALJs agreed with Citizen Power that ratepayers have been insulated from increased power prices by rate caps which substantially nullified any suggested financial benefits flowing from FirstEnergy. (R.D. at 31). The ALJs rejected the position of Citizen Power and OTS that all of the merger savings should flow to ratepayers. The ALJs noted that the merger was approved as being in the public interest which extends to providing benefits to the Companies' shareholders and those of FirstEnergy. The ALJs observed that allowing shareholders to share in merger savings would provide an incentive to the shareholders to invest in new facilities and technology. (*Id.* at 32).

With regard to the calculation of the merger savings, the ALJs recommended that shareholders and customers each receive 50% of the merger savings, as calculated by the Companies for the years 2001-2004, and as calculated by OSBA for the years 2005 and 2006. According to the ALJs, that would return $36.8 million to ME ratepayers and $33.4 million to PN ratepayers. The ALJs recommended that the savings be allocated to rate classes on the basis of present distribution revenues and shall be a credit to each ratepayer within the rate class. The ALJs also recommended that the merger savings be returned over a four year period. (R.D. at 32).

3. Exceptions

The Companies filed two Exceptions to the ALJs' recommendation on allocation of merger savings. In the Companies' Exception No. 2, they argue that the

ALJs erroneously rejected consideration of the generation support provided by FirstEnergy on the basis that rate caps insulated customers from market prices. However, the Companies assert that this approach ignores this Commission's Opinion and Order in *Joint Application for Approval of Merger of GPU, Inc. with FirstEnergy Corp.* Docket Nos. A-110300F0095 and A-110400F0040 (May 24, 2001). The Companies state that our Opinion and Order in that proceeding specifically stated that this Commission needed to evaluate 'evidence regarding issues such as the specific role FirstEnergy will play in assisting [ME] and [PN], both monetarily and in terms of generation, in meeting their [POLR] responsibilities. (MEPN Exc. at 2-3, citing, *Joint Application for Approval of Merger* at 38).

The Companies argue that the ALJs failed to consider 'the over $700 million in generation-related support FirstEnergy has provided MEPN since the merger. (MEPN Exc. at 3). In addition, the Companies assert that they have absorbed $143 million of PJM transmission costs in 2005. The Companies argue that allocation of merger savings over and above the support already provided constitutes a windfall to ratepayers. *Id.*

In the Companies' third Exception, they argue that if a sharing of merger savings is directed, a four year period for the credit is arbitrary. The Companies assert that if merger savings are to be allocated to customers, they should be credited over the same time period in which the savings were deemed to have accrued, six years. This is consistent with the ALJs' recommendation for a five year recovery period for deferred universal service costs. (MEPN Exc. at 3).

Citizen Power cites error in the ALJs' recommendation to allocate 50% of the merger savings to shareholders. In its Exception No. 1, Citizen Power argues that the recommended allocation is not supported by substantial evidence and 'is not the product of reasoned decisionmaking [sic]. (Citizen Power Exc. at 3). Citizen Power argues that the standard set forth in *City of York v. Pa. PUC*, 295 A.2d 825 (Pa. 1972), requires that the merger must provide substantial benefits. Accordingly, Citizen Power asserts that the merger savings to be passed through to customers must be substantial to satisfy that standard. Citizen Power states that in order to be considered substantial, the merger savings allocation must be 100% to customers. (*Id.* at 4).

Citizen Power also argues that as originally proposed, FirstEnergy and GPU projected annual company-wide savings of $150 million as one of the benefits of the merger. However, that amount was reduced by almost half when reduced by severance costs, costs the Companies should have been aware of at the time they stated merger savings as $150 million. Citizen Power asserts that since the Companies originally supported the merger based on a figure without off-setting severance costs, now that the set-off has occurred, the entire savings should be passed through to ratepayers. (Citizen Power Exc. at 5).

Citizen Power cites error in the ALJs' finding that the 'public interest' includes the Companies' shareholders. Citizen Power claims that the ALJs provided no support for this proposition. According to Citizen Power, this analysis means that any merger which simply benefits shareholders would pass the *City of York* standard which is an absurd result. (Citizen Power at 6). Citizen Power also argues that the ALJs' statement that shareholders would have an incentive to invest due to sharing in the merger savings has no support in the record. Citizen Power states that there is no evidence at all which suggests that merger savings have anything to do with whether shareholders will invest in facilities or new technologies. Although increased shareholder investment was stated as a potential merger benefit, Citizen Power asserts that was separate and distinct from merger savings. (*Id.* at 7).

Reply Exceptions to the Companies Exceptions were filed by Citizen Power, OCA, OTS and OSBA. Citizen Power responds to the Companies' Exception

No. 2 and states that the ALJs properly determined that ratepayers were insulated from market prices and any benefit received through the merger in the form of lower power prices was illusory. Citizen Power asserts that the same analysis applies to any claims that the merger permitted an absorption of increased transmission costs since there was a transmission rate cap in place until December 31, 2004. (Citizen Power R.Exc. at 4-8). OSBA replies to the Companies' Exception No. 2 and also asserts that rate cap protections render any suggested company provided benefits inconsequential. OSBA also states that by allocating the savings 50%-50%, the ALJs properly balanced the interests of the ratepayers and shareholders. (OSBA R.Exc. at 2-3). The OCA makes similar arguments in its response and observes that any 'benefits' provided by FirstEnergy or the Companies were merely lost opportunity costs, not actual benefits passed through to customers. (OCA R.Exc. at 2-3). OTS makes similar arguments in its response. (OTS R.Exc. at 3).

The Companies respond to Citizen Power's Exception No. 1 and argue that the Commission has never stated that merger savings must be given to customers to pass the *City of York* public interest test. Rather, the Commission indicated that each case must be evaluated on its own. Commitments such as distribution rate reductions to pass through merger savings, improved reliability and environmental issues have all served to indicate that a particular merger was in the public interest. (Companies R.Exc. at 1-3).

Reply Exceptions to the Companies' Exception No. 3 were filed by OCA, OTS, OSBA and Citizen Power. OCA argues that since the ALJs did not include a time value of money adjustment, it was appropriate to return the savings as quickly as possible. The OCA states that a four year period minimizes the impact on the Companies, but is reasonable for customers. (OCA R.Exc. at 3). In its Reply, OTS argued that the four year recovery period will be easier to administer and will return the merger savings to ratepayers faster than the time frame proposed by the Companies. (OTS R.Exc. at 4). OSBA asserts that the Companies have had the use of the merger savings for six years without paying interest. In addition, OSBA argues that there is no testimony in support of six years. (OSBA R.Exc. at 3-4). Citizen Power argues that the four year period was supported by evidence advanced by OCA, while there is no record support for the Companies' six year proposal. Citizen Power also asserts that the four year period minimizes the impact on the Companies while providing a reasonable time frame for recovery by ratepayers. (Citizen Power R.Exc. at 8-9).

4. Disposition

We will grant the Companies' Exception No. 2. As noted in the Companies' Exception, in the *Joint Application for Approval of Merger*, we stated that we intended to evaluate the record developed on issues such as the role FirstEnergy would play in assisting ME and PN with their POLR responsibilities. (MEPN Exc. at 2-3). In this proceeding, the record reveals that FirstEnergy has provided over $700 million in generation-related support since the merger. This has been crucial in enabling the Companies to meet their POLR responsibilities post-merger. The Companies also point out that they have absorbed $143 million in PJM transmission costs in 2005. These benefits substantially exceed the amount of merger savings at issue. (*Id.*) We agree with the Companies that the ALJs failed to accord the appropriate weight to this support.

Various Parties argue that some or all of the generation support provided by FirstEnergy should be discounted as lost opportunity costs or because of existing rate cap protection. As a practical matter, however, the generation support provided by FirstEnergy enabled the rate caps to be maintained. To illustrate this point, the existence of rate caps did not help customers in California when their utilities went bankrupt and electricity had to be procured by the state at market prices. In addition, these arguments ignore the fact that regardless of rate caps or the form of support, FirstEnergy has provided substantial ongoing support of hundreds of millions of dollars to the Companies and the Companies' ratepayers since the merger. In these circumstances, we agree that an allocation of merger savings over and above the support already provided is not warranted.

In the *City of York*, the standard for review of mergers is whether the merger will produce some substantial public benefit in order to support a finding that the merger is in the public interest. In the *City of York*, the Supreme Court upheld the Commission's finding that a merger of three telephone companies would result in affirmative benefits to customers due to improved operations and financial strength. No distribution of merger savings to customers was required in that case. *City of York*, 295 A.2d at 829. Citizen Power argued that in order to meet the *City of York* test, there must be an allocation of a substantial amount of merger savings. (Citizen Power Exc. at 4). However, the standard does not mandate any particular form of benefit, such as an allocation of merger savings. In prior merger proceedings, we have found that commitments relating to reliability and customer service, universal service, staffing and environmental issues were appropriate matters in the examination of whether a merger would benefit the public. *Joint Application of PECO Energy Company, et. al.* Docket No. A-110550F0160 (February 1, 2006).

Here, we find that the ongoing generation support of over $700 million as well as absorption of PJM transmission costs for 2005 are substantial benefits fully satisfying the *City of York* standard. There is no need to increase those benefits by allocating a portion of merger savings to ratepayers in order to find that there has been a substantial benefit from the merger. Accordingly, we will grant the Companies' Exception No. 2 and deny Citizen Power's Exception No. 3. The Companies' Exception No. 3 is denied as moot.

B. Amount of Merger Savings

The ALJs found that the amount of merger savings through the end of 2006 is $140.4 million. The total merger savings attributable to ME for the period 2001-2006 is $73.6 million and the amount for PN is $66.8 million. (R.D. at 25). The ALJs also recommended that a four year credit period be established for the flow through of merger savings to customers. The Companies filed Exception No. 1 to the ALJs conclusion that merger savings should have been tracked through 2005 and 2006. Citizen Power filed its

Exception No. 2 arguing that the ALJs erred by failing to include an adjustment for the time value of money and an escalation factor. In view of our disposition of the issue of allocation of merger savings, the issues regarding the amount of merger savings and the credit period are moot. Accordingly, the Companies' Exception No. 1 and Citizen Power's Exception No. 2 are denied.

III. NON-NUG STRANDED COST RECOVERY/NUG COST RECOVERY

A. Non-NUG Stranded Cost Recovery

The ALJs set forth the background of this issue at Pages 32 through 34 of the Recommended Decision. The Restructuring Settlement entered into by the Companies addressed the recovery of stranded costs together with a myriad of other issues.[8] The Companies agreed in the Restructuring Settlement that their non-NUG stranded costs would be recovered by means of a Competitive Transition Charge (CTC) which would last from January 1, 1999 through December 31, 2010 for ME and through December 31, 2009 for PN. There is no provision for an extension of the time for recovery of non-NUG stranded costs. NUG stranded costs are permitted to be recovered for a longer period of time, provided that recovery is terminated no later than December 31, 2020. (ALJ Exh. 1, at B.1, B.2).

It is important to note that the Companies were required to account for non-NUG stranded cost recovery and NUG stranded cost recovery separately. However, the Companies had the opportunity to recover both types of stranded costs through the CTC and could decide how much of the CTC revenue would be allocated to which type of stranded cost. Also, the Companies were permitted to recover carrying charges on the non-NUG stranded costs, but none on the NUG stranded costs. At the time of the

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[8] The Restructuring Settlement has been placed in the record in this proceeding as ALJ Exhibit 1.

hearings in this proceeding, ME has non-NUG stranded costs yet to be recovered. PN has no non-NUG stranded costs, but proposes to utilize the CTC to recover certain claimed nuclear decommissioning costs. (R.D. at 32-35).

1. Positions of the Parties

Before the ALJs, ME asserted that it would not be able to recover its full non-NUG stranded costs prior to December 31, 2010. Accordingly, ME proposed to add carrying charges to the NUG CTC balance to match the carrying charges of 10.4% now in place for the non-NUG balance. ME argued that this would be economically indifferent to customers, since the overall CTC would not change because more CTC revenue could be allocated to the non-NUG stranded costs and recovery of the NUG balance would be delayed. ME also stated that although the overall CTC would not be changed, the unchanged CTC revenue requirement would have to be reallocated by rate group in order to permit full collection of the non-NUG stranded costs by rate class within the required time frame. As an alternative, ME suggested that the Commission could increase its CTC by 0.004¢ per kWh in order for ME to fully recover its non-NUG stranded costs within the required timeframe. (R.D. at 35).

OSBA, OCA, OTS, the Commercial Group and MEIUG/PICA all oppose ME's initial proposal relating to the addition of carrying charges to the NUG stranded cost balance and the increase in the non-NUG CTC. These Parties noted that the Restructuring Settlement permitted ME to apply CTC revenues to either type of stranded cost. These Parties then argued that ME chose to apply CTC revenues towards its NUG stranded cost balance because the NUG balance did not earn a carrying charge. By failing to assign an appropriate amount of CTC revenue to the non-NUG stranded cost balance, these Parties argue that ME must bear the responsibility of failing to collect its full non-NUG stranded costs within the time frame dictated by the Restructuring Settlement. These Parties assert that either option proposed by ME is an increase in the amount of ME's CTC recovery which is solely the result of ME's decision to allocate more CTC revenues to NUG stranded cost than non-NUG stranded cost due to the fact that NUG stranded costs did not earn a carrying charge. (R.D. at 35-36).

2. ALJs' Recommendation

The ALJs recommended rejection of the ME proposals. The ALJs agreed with the opposing Parties that ME made a business decision to allocate CTC revenues to its NUG stranded cost balance because that balance did not earn a carrying charge. The ALJs stated '[i]t chose to pay off the NUG balance first so that it could earn a return on the unpaid non-NUG balance. [ME] did this knowing that the Restructuring Settlement provided a deadline for recovering its non-NUG stranded costs of December 31, 2010. (R.D. at 37). The ALJs further concluded that given the shorter timeframe for recovery of non-NUG stranded costs, 'logic' dictated that ME would have assigned more CTC revenue to the stranded cost balance with the shortest collection period. However, ME did the opposite with predictable results. *Id.*

The ALJs determined that if there is a shortfall in ME's non-NUG stranded cost recovery, it is the predictable result of ME's decision to allocate more CTC revenues to NUG stranded cost recovery. The ALJs noted that ME still has the option to shift CTC revenues to the non-NUG stranded cost balance and may do so at any time. However, since the asserted short-fall in non-NUG stranded cost recovery is the result of ME's voluntary decision on CTC revenue allocation, the ALJs recommend rejection of ME's proposed adjustments. (R.D. at 37).

3. Exceptions

ME excepted to the ALJs' recommendation arguing that the recommendation erroneously 'concludes that Dec. 31, 2010 is an absolute 'deadline' for recovery of all non-NUG stranded costs, and that the non-NUG CTC can neither be adjusted to meet that deadline, nor extended so as to provide full cost recovery. (Companies Exc. at 4). In their Exception No. 4, the Companies argue that the Restructuring Settlement provided ME with the 'absolute right' to allocate CTC revenues between non-NUG and NUG stranded costs. Yet, the thrust of the recommendation is that ME must in some manner be faulted for that allocation. *Id.*

According to ME, the recommendation ignores the fact that the Commission can adjust CTC levels to ensure full stranded cost recovery. In addition, the deadline for non-NUG stranded cost recovery was stated as an 'initial' target. (Companies Exc. at 4). In order for ME to fully recover the amount of stranded costs set forth in the Restructuring Settlement, the Companies assert that one of their proposals must be adopted. In addition, ME argues that in order for it to more fully collect its non-NUG stranded costs by rate class by the December 31, 2010 deadline, the CTC revenue requirement must be reallocated by rate group consistent with ME's proposed Cost of Service allocations. ME states that it appears that the ALJs allowed that reallocation. (*Id.* at 4-5).

OCA, OTS, OSBA and MEIUG/PICA filed replies to the Companies' Exception No. 4. OCA states that the effect of the Companies' proposal is to increase the NUG stranded cost award though the application of interest. However, the need for the Companies' proposal is the result of the Companies' voluntary decisions on how to recover their various stranded costs. The Companies' proposal contradicts the agreed upon terms of the Restructuring Settlement and must be rejected. (OCA R.Exc. at 4). Similarly, OTS asserts that the Companies' situation is one of their own making, that the Restructuring Settlement does not provide for the Companies' proposal and that the Companies should be left with the consequences of their decisions. (OTS R.Exc. at 5). OSBA and MEIUG/PICA make similar responses. (OSBA R.Exc. at 4; MIEUG/PICA R.Exc. at 12-13).

4. Disposition

We will deny the Companies' Exception No. 4. The Companies are correct that their Restructuring Settlement provided ME with some discretion as to the method for recovering non-NUG and NUG stranded costs. However, the record amply supports the ALJs' determination that the Restructuring Settlement also provided a deadline for the collection of non-NUG stranded costs. In addition, the Restructuring Settlement does not provide for any extension of that deadline. (R.D. at 37; ALJ Exh. 1 at 13-14, ¶¶ B1 and B2). Accordingly, the date for achieving full collection of non-NUG stranded costs was not an 'initial' target as suggested by the Companies. Given that deadline, it was incumbent upon ME to exercise its discretion in such a fashion that the non-NUG stranded cost deadline would be met.

We agree with the ALJs that ME decided to structure its stranded cost collection in a manner that would permit it to earn as large a return on the unpaid non-NUG balance as possible. The result of that decision is that absent a change in the collection structure, ME will not meet the deadline for its non-NUG stranded cost collection. This is a result readily apparent to ME and should have been considered when structuring its stranded cost collection. It is simply giving full effect to *all* of the Restructuring Settlement's terms, including the deadline for collection of non-NUG stranded costs. We also agree with the OCA's position that adoption of ME's proposal to add carrying charges to the NUG balance in order to make up for the shortfall is an attempt to increase the stranded cost award set forth in the Restructuring Settlement. Similarly, we do not find that the ALJs recommended adoption of the Companies' proposed reallocation. We agree with the ALJs and also deny the proposed reallocation of the CTC revenue requirement.

B. Non-stranded NUG Costs

1. Positions of the Parties

The Companies proposed to defer for future recovery certain NUG related costs that are not deemed stranded costs recoverable through the CTC. The Companies took the position that NUG market value was comprised of NUG LMP (locational marginal pricing) and capacity cost, or NLACC. The Companies asserted that going forward, the NLACC will be substantially greater than the generation revenue (based upon the shopping credit) they will recover from POLR customers. The Companies request an accounting order from the Commission to defer as a regulatory asset, for future recovery, the amount by which the NLACC exceeds the POLR generation rates. ME's projected deferral is $87.3 million and PN's projected deferral is $108.2 million. (R.D. at 34).

The Companies proposed to defer collection of the deferred costs to a time when the existing CTC could be reduced. Collection would occur through a new reconcilable non-CTC rider which could be assessed in an amount equal to the reduction in the CTC amount thus having no impact on the over-all CTC charge to customers. A carrying charge would be included on the balance to be collected. The non-CTC rider (termed the NUG Service Charge rider by the Companies, or NSC) would be assessed on all distribution customers. (R.D. at 38).

Alternatively, the Companies proposed that the Commission could approve an NSC rate in addition to base rates which would be implemented in 2007 That NSC rate would be set initially to recover the difference between the NLACC and generation charges projected for 2007 Thereafter, the NSC would be reconciled with actual data. The NSC would continue as long as POLR was supplied by NUGs. A third alternative was proposed which provided for an NSC rate in addition to base rates that would recover the difference between the test year generation rate and the NLACC. The

Companies stated that any of the three proposals could be adjusted to account for any period in which the generation revenues actually exceeded the NLACC to prevent over-recovery. (R.D. at 39).

The Companies argued that failure to recommend adoption of any of the NSC alternatives would violate State and Federal law by refusing to permit the Companies to fully collect NUG costs. They cite to *Freehold Cogeneration Associates, LP v. Board of Regulatory Commissioners*, 44 F.3d 1178 (3rd Cir. 1995), *cert. denied*, 516 U.S. 815 (1995) and *Petition of Pennsylvania Electric Company, Re: Agreement with Scrubgrass Power Corp.* Docket No. P-870248 (Order entered January 21, 1988). According to the Companies, these decisions stand for the proposition that the Companies are entitled to recover their full NUG costs. (R.D. at 42).

OSBA, OCA, OTS, the Commercial Group and MEIUG/PICA opposed all three of the Companies' proposals. OSBA, OCA, the Commercial Group and MEIUG/PICA argued that the Restructuring Settlement established the methodology for calculating NUG stranded costs, provided for recovery of those costs and provided for full recovery of those costs. According to these Parties in opposition, the Companies are simply trying to recalculate NUG stranded costs in a manner more favorable than the Restructuring Settlement, label them as something other than stranded costs and pursue collection outside of the CTC. These Parties also argue that any 'losses' stated by the Companies are illusory since they could sell NUG power on the open market at the NLACC price and avoid those losses. To the extent that replacement power must be procured for POLR, that replacement power would be governed by the rate cap provisions of the Restructuring Settlement. (R.D. at 40).

OTS proposed that NUG costs which are to be collected under the NSC should be collected beginning in 2007 The NUG expense shortfall should be collected through the maximum generation rate proposed by OTS. OTS argues that this is better than the Companies' proposal since the OTS maximum generation rate is lower than that proposed by the Companies, except for PN's 2007 rate if a generation rate increase is granted here. In addition, OTS argues that its alternative avoids the carrying charges proposed by the Companies since no deferral is provided. Also, by providing for immediate collection, the customers who incur the costs will be paying the costs. (R.D. at 41).

2. ALJs' Recommendation

The ALJs recommended rejection of the Companies' NSC proposal. They agreed with OCA, OSBA, the Commercial Group and MEIUG/PICA that the Companies were simply attempting to package a change in NUG stranded cost methodology as something other than stranded costs to the Companies' advantage. The Companies' proposals were deemed to be inconsistent with the Restructuring Settlement, which was deemed to be in accordance with both case authorities cited by the Companies. The ALJs also agreed that any 'losses' as described by the Companies could be eliminated if the Companies sold the NUG power on the market at market prices. Finally, the ALJs agreed with the OCA that the only tenable argument available to the Companies would be if they had new NUG projects which post-dated the Restructuring Settlement. Since that is not the case, the ALJs recommend rejecting the Companies' proposals. (R.D. at 41-42).

3. Exceptions

The Companies argue that the ALJs and the opposing Parties confuse the issue involving ongoing NUG costs. In their Exception No. 5, the Companies argue that nothing in their proposals seeks to modify the Restructuring Settlement. According to the Companies, the ALJs erred by ignoring the distinction between NUG stranded costs and the recovery of non-stranded NUG costs. The Companies assert that the difference between the NUG contract price and the NLACC are recoverable under the Restructuring Settlement as stranded costs. However, the difference between the generation charge (or shopping credit) and the NLACC does not fall under the stranded cost definition. (Companies Exc. at 5-6).

The Companies further argue that because the costs they seek to recover through the NSC are not stranded costs, they are ongoing NUG costs which are covered by the *Freehold* and *Scrubgrass* decisions which mandate full recovery of ongoing NUG costs. In addition, the Companies cite to Section 527 of the Public Utility Code (Code), 66 Pa. C.S. § 527 which mandates recovery of all NUG-related costs. Accordingly, since the costs which the NSC is designed to recover are not included in the CTC, they must be recovered through a combination of the generation rate and a mechanism designed to operate when the generation rate is less than the NLACC. (Companies Exc. at 8-9). The Companies further argue that the suggestion that they could avoid losses by selling NUG power into the market would deny the benefits to the Companies' customers of the NUG power for which they are paying stranded costs. (*Id.* at 9).

OCA, Constellation, OSBA and MEIUG/PICA responded to this Exception. OSBA asserts that the Companies' proposal 'is simply a back-door attempt to change the calculation of NUG stranded costs, a fact which the ALJs recognized and a position which they rejected. (OSBA R.Exc. at 5). OCA argues that the Companies' proposal is 'an attempt to either increase future NUG stranded cost recovery or to break the generation rate caps while couching the recoveries in NUG-related terms. (OCA R.Exc. at 5). The OCA asserts that the effect of the proposal is to value NUG stranded cost based on the POLR rate rather than market price. That increases the amount of NUG stranded costs in violation of the Restructuring Settlement. (*Id.* at 6). MEIUG/PICA advances arguments similar to those made by OSBA and OCA. (MEIUG/PICA R.Exc. at 14-15). Constellation argues that the Companies' proposal is actually an effort to collect increased generation costs. As such, any collection methodology must be properly reflected as generation costs and be by-passable by customers served by an EGS. (Constellation R.Exc. at 1-4).

4. Disposition

Our review of the Companies' Exception No. 5 begins with the Restructuring Settlement and its treatment of NUG costs. With regard to NUG costs, the Restructuring Settlement provides:

> The Joint Petitioners agree that this Settlement and the NUG cost recovery mechanism provided for in Parts B and C herein, initially through the CTC and subsequently through a separate recovery mechanism for each Company, shall be deemed to constitute and provide for full and actual cost recovery of all costs and charges incurred by the Companies for (1) energy and capacity under and in compliance with existing NUG agreements identified in Appendix F ("NUG Agreements"), and (2) voluntary buyout, buydown or restructuring of the NUG Agreements.

(ALJ Exh. 1 at 61).

According to the foregoing language, agreed to by the Companies, the NUG cost recovery set forth in the Settlement Agreement provides for 'full and actual cost recovery' of *all* of the Companies' NUG costs. There is no need to change that methodology in this proceeding as the Companies have already agreed that the Settlement Agreement methodology is appropriate and adequate.

Moreover, the Companies further agreed that:

> So long as GPUE [the Companies] receives full recovery of its NUG-related stranded costs consistent with the terms of this Settlement, the Companies further agree not to make any argument or claim before any state or federal court of administrative body, including but not limited to the

> Commission and the FERC, based on a contention that the Settlement or the Commission's orders in the GPUE restructuring proceedings provide for inadequate recovery of GPUE's NUG-related costs, and shall assert that any such claim or argument raised by another party should be dismissed with prejudice.

(ALJ Exh. 1 at 61-62).

The Companies' arguments in this proceeding are efforts to change the balance struck by the foregoing provisions of the Restructuring Settlement. The Companies argued before the ALJs that failure to approve this claim and one of the three proposed collection alternatives would be a violation of Section 527 of the Code, 66 Pa. C.S. § 527, and the decisions in *Freehold* and *Scrubgrass*. However, that argument is put to rest by the Companies' own agreement in the Restructuring Settlement that all of their NUG costs will be fully recovered through the methodology provided in the Restructuring Settlement. Should any doubt arise about the Companies' intent in that agreement, the Companies agreed to move to dismiss, in any forum, any assertion that the Restructuring Settlement fails to provide for an adequate recovery. In the face of such explicit terms, we are not persuaded by the Companies' arguments here.

Alternatively, the Companies argue that the ALJs confused stranded costs with ongoing NUG costs in rejecting this claim. This argument is unpersuasive as well. MEIUG/PICA effectively argued that the very costs described by the Companies are encompassed by Section 2803 of the Electricity Generation Customer Choice and Competition Act (the Competition Act), 66 Pa. C.S. §§ 2801, *et seq.* § 2803. (MEIUG/PICA M.B. at 41). However, even if the Companies' argument is considered, then these costs would constitute generation costs subject to the generation rate caps. As noted by the ALJs, the Companies could sell the NUG power on the open market and avoid any losses so that Section 527 *Freehold* and *Scrubgrass* are followed. Any replacement power purchased would be subject to the generation rate caps. Regardless, we agree with the analysis which finds that these costs are covered by the Restructuring Settlement in which the Companies agreed that the collection methodology provided for full recovery of those costs. The Companies' Exception No. 5 is denied.

IV GENERATION RATE CAP

The ALJs discussed the Companies' proposal to establish generation rates above current rate cap levels at Pages 42 through 69 of their Recommended Decision. Included in that discussion is a thorough examination of the background of the rate caps, the Restructuring Settlement and the Competition Act. We will summarize some of that discussion here before moving to a discussion of the various arguments on this issue.

One of the concerns expressed in the Act was the desire to ensure that the transition to an open retail market for electricity would be as smooth as possible. *See*, 66 Pa. C.S. §§ 2802(8), (9), (10), (11) and (12). One way to accomplish that type of transition was that rate caps were placed on generation, transmission and distribution rates for the same amount of time that an electric distribution company (EDC) was to collect stranded costs from customers and that EDC's customers had full access to a competitive market, whichever was shorter. 66 Pa. C.S. § 2804(4)(i) and (ii). For the Companies, their Restructuring Settlement provided for a cap on transmission and distribution charges until December 31, 2004. For generation, the Companies' rate cap was extended to December 31, 2010. However, given the extension of the rate cap to December 31, 2010, the Companies were permitted to put an increase in the generation rate cap in effect on January 1, 2006 by 5% over the generation rates initially set in the Restructuring Settlement. (R.D. at 46).

Although the Restructuring Settlement provided for a generation rate cap through 2010 for both Companies, the Restructuring Settlement expressly provided that the Companies could seek an exception to the rate cap pursuant to Section 2804(4)(iii) of the Act, 66 Pa. C.S. § 2804(4)(iii). That Section reads in pertinent part:

> An electric distribution utility may seek, and the commission may approve, an exception to the limitations set forth in paragraphs (i) and (ii) [relating to rate caps] only in any of the following circumstances:
>
> (A) The electric distribution utility meets the requirements for extraordinary rate relief under section 1308(e) (relating to voluntary changes in rates).
>
> * * * *
>
> (D) The electric distribution utility is subject to significant increases in the unit rate of fuel for utility generation or the price of purchased power that are outside of the control of the utility and that would not allow the utility to earn a fair rate of return.
>
> * * * *
>
> (F) The electric distribution utility seeks to increase its allowance for nuclear decommissioning costs to reflect new information not available at the time the utility's existing rates were determined, and such costs are not recoverable in the competitive generation market and are not covered in the competitive transition charge or intangible transition charge, and such costs would not allow the utility to earn a fair rate of return.
>
> * * * *

66 Pa. C.S. § 2804(4)(iii).

The ALJs also discussed the merger of GPU (the Companies' former parent) and FirstEnergy. As stated by the ALJs, FirstEnergy and GPU averred that 'the combination of their resources, years of utility experience, and expertise of the two companies would enhance the capabilities of Met-Ed and Penelec so that those subsidiaries could fulfill their obligations to provide safe, adequate, and reliable service to their retail customers in Pennsylvania. (R.D. at 48, quoting *ARIPPA*, 792 A.2d at 645). In that vein, the ALJs observed that FirstEnergy had a corporate supply portfolio that included a generation affiliate, FirstEnergy Solutions (FES), as well as the indication that FirstEnergy 'would be in a position to provide additional assistance to GPU Energy in meeting its [POLR] obligations. (*Id.* quoting *ARIPPA*, 792 A.2d at 646). The ALJs stated: 'FirstEnergy's acknowledgment of this obligation, combined with the offering of FES's generation services, suggested that the Companies, under the helm of FirstEnergy, were ready, willing, and able to ensure POLR supply for Met-Ed and Penelec's customers through 2010. (R.D. at 48).

The ALJs then described the relationship between FES and MEPN post-merger. The ALJs noted that FES entered into a Partial Requirements Agreement (FES Agreement) under which FES agreed to provide the additional power the Companies needed to meet their POLR obligations.[9] The FES Agreement had a term of one year after which it could be terminated on short notice. For several years, the FES Agreement worked well, particularly in those years when the market cost of power was less than the rate cap. However, in 2004, it became 'reasonably certain' that the market cost of power would remain above the rate cap. (R.D. at 49). At that point, FES explored other options and, in November of 2005, FES gave notice that it would terminate the FES Agreement in accordance with its terms. After several extensions, FES notified the Companies that the FES Agreement would be terminated effective December 31, 2006. 'In light of this termination, Met-Ed and Penelec now seek relief from the Commission by requesting that the generation rate cap be lifted so that ratepayers can be held liable for the costs of the Companies procuring POLR supply from third-party suppliers at higher market prices. (R.D. at 50). (Footnote omitted).

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9 The ALJs noted that the FES Agreement was to supply approximately 32% of the Companies' POLR needs at rate cap levels. (R.D. at 48, n. 29).

We will examine the Companies' request for an exception to their generation rate caps against the foregoing backdrop.

A. Positions of the Parties

The Companies' first argument in support of a rate cap exception asserted that the request is consistent with the Restructuring Settlement. The Companies argued that Section D.4 of the Restructuring Settlement provides for the possibility of an exception. Section D.4 of the Restructuring Settlement provides, in part:

> The Joint Petitioners agree that the rate cap exceptions set forth in Section 2804(4) of the [Act] shall apply to the rates set forth in this Settlement, except as otherwise specifically set forth herein.

(ALJ Exh. 1, § D.4).

The Companies then argued that Section F.9 of the Restructuring Settlement provides an independent, specific exception to the rate cap other than Section 2804(4) of the Act. According to the Companies, they endeavored to provide for a competitive POLR offering consistent with the Restructuring Settlement in which independent bidders were to assume some or all of the Companies' POLR obligation. When that competitive POLR program (called 'CDS' in the Restructuring Settlement) failed to materialize, the Companies argued that Section F.9 of the Restructuring Settlement provides that a new rate cap will be established upon petition to the Commission. (R.D. at 51).

Alternatively, the Companies argued that they met the statutory standard for rate cap relief under Section 2804(4) of the Act. They argued that the market cost of power exceeded the rate cap to such an extent that the Companies could not earn a fair rate of return. In addition, the Companies asserted that the increase in cost was beyond their control. Noting that the *ARIPPA* decision had resulted in the denial of the Companies' prior request for a rate cap exception, they argued that the circumstances have substantially changed since that decision. Accordingly, while *ARIPPA* is the current state of the law regarding Section 2804(4) standards for rate cap exceptions, the situation now facing the Companies no longer compares to the facts analyzed in that case. (R.D. at 58-65).

Finally, the Companies argued that the Restructuring Settlement should be modified because it is no longer in the public interest. They pointed to Section 703(g) of the Code, 66 Pa. C.S. § 703(g), and observed that the Commission has the authority to amend or rescind any of its orders. The Companies argued that the financial circumstances they face are of such a nature as to warrant an exception to the rate cap under the Commission's general authority to reconsider and modify the Restructuring Settlement.

OCA, OSBA, OTS, MEIUG/PICA, the Commercial Group and Citizen Power all opposed the Companies' request. These Parties disagreed with the Companies' argument that the Restructuring Settlement provided any alternative to the rate cap exception found in Section 2804(4) of the Act. (*See, e.g.* OCA M.B. at 15-23; OSBA M.B. at 61-66; MEIUG/PICA M.B. at 16-22). The Parties in opposition agreed that the Restructuring Settlement provided an opportunity for the Companies to seek an exception to the rate cap. However, they asserted that any such request must be processed under the statutory exception found in the Act, as that was interpreted by the Commonwealth Court in *ARIPPA*.

The opposing Parties argued that the Companies failed to meet either standard in Section 2804(4)(iii)(D) to justify an exemption. First, these Parties argued that the Companies failed to show that their financial circumstances were beyond their control. For example, MEIUG/PICA argued that the Companies engaged in supply acquisition strategies that were similar to those that the *ARIPPA* decision found to be within the Companies' control and failed to protect against the risks of a volatile supply market. (MEIUG/PICA M.B. at 23-24). In this regard, MEIUG/PICA noted the FES Agreement and its termination provisions which wholly favored FES and utterly failed to protect the Companies. According to the MEIUG/PICA, the Companies could hardly have been surprised that the FES Agreement would be terminated when prices rose, yet they failed to take any action to either alter the terms of the FES Agreement or hedge the risks of termination. *Id.*

MEIUG/PICA asserted that the foregoing situation was a calculated business risk taken by the Companies under the FirstEnergy umbrella which served the interests of FirstEnergy shareholders while failing to provide for the Companies' known POLR obligation. MEIUG/PICA argued that this is the identical situation confronted in *ARIPPA*, where the Commonwealth Court found that kind of strategy did not meet the test of Section 2804(4)(iii)(D) of the Act. (MEIUG/PICA M.B. at 24-28).

These Parties also argued that the Companies failed to show that they would be unable to earn a reasonable rate of return as a result of increased power supply costs. OCA argued that to the extent the Companies asserted that they could not earn a reasonable rate of return, the Companies' calculations were 'wholly inconsistent with traditional ratemaking and result solely from the threatened actions of their affiliate. (OCA M.B. at 33). OCA also argued that the Companies calculated their rates of return by assuming that FES will not supply power at the rate cap price. Then, they assumed all other expenses were as proposed by the Companies, but assumed revenues as proposed by OCA without making any of the expense adjustments proposed by OCA. According to OCA this methodology completely skewed the rates of return calculation. Had proper ratemaking techniques been employed, OCA testified that the Companies would have the opportunity to earn the return on equity allowed by the Commission and the Federal Energy Regulatory Commission 'on the applicable jurisdictional investments. (OCA

M.B. at 33, quoting OCA St. 3S at 23). The Parties opposing the Companies' request also disagreed that Section 703(g) of the Code helped the Companies in any way. (*See, e.g.* OCA M.B. at 35-40).

B. ALJs' Recommendation

The ALJs recommended rejection of the Companies' request for an exception to the rate cap. First, the ALJs found that the Restructuring Settlement did not provide for any standard for an exception independent of Section 2804(4)(iii) of the Act. (R.D. at 52-57). Once that determination was made, the ALJs reviewed the record in light of Section 2804(4)(iii)(D) and *ARIPPA*. According to the ALJs, nothing has changed in the Companies' approach since *ARIPPA* that would warrant a different result. (*Id.* at 59).

The ALJs determined that the Companies' divestiture of generation assets continued to be a factor that affected their affairs at this point in time. *ARIPPA* had already determined that divestiture and the Companies' subsequent actions were within their control and failed to satisfy one of the two prongs of Section 2804(4)(iii)(D). Then, according to the ALJs, the issue became whether circumstances have changed sufficiently since the decision in *ARIPPA* to warrant a different result. They found that no such change had occurred. (R.D. at 61-67). The ALJs found that cancellation of the FES Agreement 'was a strategic business decision designed to maximize the profit of an unregulated affiliate over the POLR needs of the Companies. (*Id.* at 64). On that basis, the ALJs determined that this was almost identical to the Companies' previous strategy which was found to be within the Companies' control in *ARIPPA*. The ALJs stated: 'As the Court has already decided, it is illegal to shift the risk of the Companies' business decisions to ratepayers. (R.D. at 64, citing *ARIPPA*, 792 A.2d at 665).

The ALJs next addressed the Companies' argument that it was in the public interest to modify the Restructuring Settlement which the ALJs determined to be a request for reconsideration pursuant to Section 703(g) of the Code. In that regard, the ALJs found that the Companies had failed to demonstrate 'the type of financial harm that could warrant such an extreme outcome. (R.D. at 66). The ALJs pointed to testimony which established that other Pennsylvania EDCs face the same or similar circumstances now faced by the Companies. Those EDCs also have unregulated supply affiliates that are foregoing higher profits while providing POLR supply at rate cap prices. The ALJs noted testimony indicating that FirstEnergy's shareholders own all of FirstEnergy and its regulated and unregulated companies, including MEPN. The ALJs also noted that FirstEnergy and its shareholders have experienced financial gains in the post-merger period, noting that FirstEnergy's 2006 earnings are 'at an all time high. (R.D. at 67). Accordingly, the ALJs found that there is 'absolutely no basis to modify the Restructuring Settlement. (*Id.* at 68).

C. Exceptions

The Companies filed five separate Exceptions to the Recommended Decision regarding their request for an exception to the rate cap. In Exception No. 6, the Companies assert that the Commission should grant relief based upon the Restructuring Settlement or amend the Restructuring Settlement in order to do so. The Companies argue that the ALJs ignored portions of the Restructuring Settlement relating to the CDS. According to the Companies, the failure of the CDS program left the full POLR load with the Companies. The Companies argue that this clearly supports their view that failure of that program justified an exception to the rate cap. In this context, the Companies argue that the ALJs erred by viewing Section F.9 of the Restructuring Settlement as a 'process' section for managing a Section 2804(4)(iii)(D) request rather than as an independent exception to the rate cap. (Companies Exc. at 9-10). The Companies also assert error in the ALJs' denial of relief under Section 703(g) of the Code. They assert that the 'evidence clearly compels amending the 1998 plan to restore the intended balance. (Companies Exc. at 12).

Next, the Companies argue that the ALJs misconstrued *ARIPPA* and expanded the holding of that case to issues not before the Commonwealth Court at that time. The Companies assert that the focus of *ARIPPA* was the Companies' power procurement decisions pre and post-divestiture. The Companies argue that the ALJs interpreted *ARIPPA* as finding that the Companies divestiture was a poor business decision, within their control and thus failed the control standard under Section 2804(4)(iii)(D). However, that issue was not before the Court. In order to reach their conclusion, the Companies also argue that the ALJs failed to recognize 'the corporate separateness' of the various FirstEnergy subsidiaries. (Companies Exc. at 12-13). To the extent the ALJs expanded their view to encompass FirstEnergy at the holding company level, the Companies argue they have erred and gone beyond what is required under Section 2804(4)(iii)(D) of the Act which specifically limits the focus to the involved utility. (*Id.* at 13). Thus, according to the Act, it was only the Companies, not any affiliates or the holding company, that were subject to examination under the statutory test. (*Id.* at 14-15). On that basis, the power supply pricing issues faced by the Companies at this time are beyond their control. *Id.*

In Exception No. 7 the Companies argue that the ALJs appear to find that FirstEnergy agreed to take on the POLR obligation of the Companies as part of the Merger proceeding. The Companies argue that the ALJs blurred the distinction between the Companies and FirstEnergy's unregulated affiliates. Also, the Companies argue that there is no record evidence to support any suggestion that FirstEnergy agreed to support the Companies POLR supply. (Companies Exc. at 16).

The Companies argue that since there is no legal obligation of FirstEnergy to provide POLR power at below-market prices, there is no legal significance to the financial performance of FirstEnergy, FES's costs to supply power or FirstEnergy's Ohio utilities' commitment to POLR supply in Ohio. (Companies Exc. at 16). Similarly, the Companies argue that just as the Commission would not expect the Companies to support inadequate financial performance by FirstEnergy's Ohio utilities and unregulated affiliates, the Commission cannot expect those entities to support inadequate financial performance by the Companies. (*Id.* at 17). Finally, the Companies assert that the Commission has no authority to direct FES to provide POLR power supply to the Companies at below market rates. Wholesale power transactions are under the jurisdiction of the Federal Energy Regulatory Commission. (*Id.* at 18).

In Exception No. 8, the Companies argue that the record is devoid of any support for the proposition that the Companies failed to act to protect themselves and chose to rely on short term agreements. The Companies assert that the record contains substantial evidence that they pursued accepted risk management strategies and pursued all reasonable avenues to procure long-term, fixed price contracts. To a large extent, the Companies were successful; however, there were not enough of such contracts to provide all of the Companies' POLR needs. Accordingly, there was simply nothing more the Companies could have done. (Companies Exc. at 18-19).

The Companies assert in Exception No. 9 that the ALJs erred to the extent they state that the Companies and their officers 'violated unspecified fiduciary obligations, were motivated only by a desire to increase profits at the expense of customers and that, as a result, the current problems are 'of their own making. (Companies Exc. at 19, quoting the R.D. at 61-65). The Companies acknowledge that many of their officers are also officers of FirstEnergy, 'as is typical for a holding company system. *Id.* However, that does not equate to some failure on the part of those offices by failing to ensure that the FES Agreement provided for a term coextensive with the Companies' POLR obligation. Had the FES Agreement contained terms suggested by the ALJs, it would not have been 'commercially and economically supportable. (*Id.*

at 20). Unaffiliated suppliers were not willing to offer long-term, fixed price contracts without termination rights. The fact that the FES Agreement lasted as long as it did attests to the willingness of FES to continue the uneconomic arrangement because of its affiliation with the Companies. *Id.*

Contrary to some assertions, the Companies argue that FirstEnergy made it clear in the merger proceeding that it could not assume the Companies' 'full POLR obligations regardless of commercial practicability. (Companies Exc. at 21). The Companies assert that FirstEnergy is now being criticized for taking steps that it was never obligated to take in the first instance. *Id.*

In Exception No. 10, the Companies argue that the record establishes that they are not in the same position as other Pennsylvania EDCs. Accordingly, the ALJs are in error to the extent that they find that the Companies must pursue the same or similar power acquisition measures. First, the Companies argue that no other EDC had a provision for at least an 80% bid-out of POLR load (the CDS program). Next, with regard to PPL, the Companies argue that PPL divested its plants at book value to an affiliate, did not reduce its stranded costs as a result of the sale, the affiliate provides a full requirements power supply and PPL and its affiliate have sufficient capacity to service all of PPL's POLR load. By contrast, the Companies divested their generation to third parties, they reduced their stranded costs as a result of the sale, they and their affiliates do not have sufficient supply to serve all of their POLR load and the Companies' affiliate provides more costly, residual, peaking supply. The Companies assert that these factors clearly distinguish them from other Pennsylvania EDCs and indicate that a different supply situation exists. (Companies Exc. at 21-22).

Constellation also filed its Exception No. 1 to the ALJs' comment, that Constellation's argument did not present a cogent legal basis that rates should be more closely aligned with market prices. (Constellation Exc. at 4-7). Constellation argues that the proposed adjusted rates would remain below market prices during the transition period. Accordingly, Constellation asserts that the proposed rates will serve as barriers to competition since competitors will be unable to compete with the Companies' POLR rates. Constellation observes that the record indicates there are no competitive offerings in the Companies' territory at this point and the proposed rates will do nothing to alter that. On that basis, Constellation argues that if any adjustment to rates is made, the adjustment should be to align the rates 'to more closely approximate the Companies' projected market prices during the remainder of the transition period. (Constellation Exc. at 7).

OCA, OTS, OSBA, MEIUG/PICA, the Commercial Group, Citizen Power, PPL and Sheppard filed replies to the Companies' Exceptions concerning the exception to the rate cap. With regard to the Companies' argument that their Restructuring Settlement provided for an exception to the rate cap upon the failure of the CDS program, the OCA asserts that any exception provided by the Restructuring Settlement must be governed by the standards set forth in Section 2804(4)(iii) of the Act. (OCA R.Exc. at 7-9). The OCA argues that the Companies' reliance on Section F.9 of the Restructuring Settlement was misplaced. According to the OCA, the ALJs were correct when they determined that Section F.9 merely provided for an expedited process for the review of any requested exception, but that the standard to be met was as set forth in Section 2804(4)(iii). Most of the other Parties filing Replies made similar arguments. (*See, e.g.* MEIUG/PICA R.Exc. at 4-5; OSBA R.Exc. at 6; Sheppard R.Exc. at 2, PPL R.Exc. at 2-5).

In response to the Companies' argument in support of reconsideration and modification of the Restructuring Agreement, the opposing Parties argue that there is no record support for reconsideration. The OCA states:

> The OCA submits that there is no sound basis for altering the Restructuring Settlement. Indeed, Met-Ed and Penelec are in no different situation than any other Pennsylvania utility that is buying power from its generation affiliate to meet the obligations of its Restructuring Settlement. Those other utilities' generation affiliates are foregoing potential, additional profits which is what the Companies complain of here. The Companies have not provided a reasonable basis to rescind or modify the Commission's Order that approved the Restructuring Settlement.

(OCA R.Exc. at 10).

MEIUG/PICA state:

> The Companies have an obligation to meet their POLR rate caps, as agreed to in the Settlement, and this obligation was confirmed in *ARIPPA*. The Companies entered into a Restructuring Settlement that brought rate stability to their customers during the transition from regulated rates to a competitive market; however, this rate stabilization came at a high price to consumers through the payment of billions of dollars of stranded costs. Not surprisingly, the Companies now seek to revise the portions of the Restructuring Settlement with which Met-Ed and Penelec are no longer satisfied; however, the Companies do not offer to provide any corresponding relief to customers. In fact, the Companies seek to increase the stranded costs to be collected, thereby compounding the detrimental effects that such a proposal would have on ratepayers, in addition to completely defying the intent of the signatories to the Settlement. Modifying the Settlement merely because the Companies are no longer satisfied with the 'benefit' of their 'bargain' would be contrary to the public interest, and the ALJs reasonably rejected this request.

(MEIUG/PICA R.Exc. at 8). (Citations omitted).

PPL makes an argument similar to that advanced by MEIUG/PICA. (PPL R.Exc. at 12). Citizen Power responds that the fact that the Companies were unable to justify an exception to the rate cap under terms they agreed to is not a reason to modify the Settlement Agreement. 'Doing so would allow Met-Ed and Penelec to perform an end-run around the terms they agreed to, and would endorse just the type of 'heads I win, tails you lose' construct' which was disallowed in *ARIPPA*. (Citizen Power R.Exc. at 12).

The Companies' third argument in Exception No. 6 is that the ALJs expanded *ARIPPA* and improperly reached issues not encompassed in that decision. PPL responds that the essential point of the *ARIPPA* decision was the Court's discussion of the meaning of Section 2804(4)(iii)(D)'s standard of price increases beyond the control of the utility. PPL asserts that the ALJs were correct that the Companies' divestiture of generation assets together with their 'subsequent decision to enter into a short-term, terminable, partial requirements contract with their affiliate thereafter, were wholly within their control. It is that decision which resulted in the Companies' current situation regardless of whether or not *ARIPPA* determined that divestiture was a bad business decision. (PPL R.Exc. at 14).

The OSBA asserts that the Companies' assertion here is a mis-statement of the Recommended Decision. According to the OSBA, the ALJs did not conclude that *ARIPPA* found that divestiture was a bad business decision. The ALJs properly found that *ARIPPA* stands for the proposition that divestiture followed by a failure to secure supply contracts to protect the Companies' POLR obligation does not constitute a circumstance beyond the Companies' control. (OSBA R.Exc. at 6). OCA makes a similar argument. (OCA R.Exc. at 10-12).

In response to the Companies' Exception No. 7 (relating to FirstEnergy's acknowledgement of the Companies' POLR obligations and the separate corporate identities of the Companies and FirstEnergy), MEIUG/PICA states:

> Interestingly. FE has been more than willing to utilize the Companies in order to maximize profit and only now seeks to 'separate' these affiliates when more profitable alternatives are available. R.D. at 49. For example, the FES Agreement was favorable for FE shareholders when the average market cost of power fell below rate cap levels in 2003, as compared to if FES sold this generation into the wholesale market. Once market prices rose above the rate cap, providing POLR supply was not as profitable for FES (and FE), and FES cancelled the Agreement. Considering the benefits FE has reaped from this Agreement, the ALJs' finding that the Companies (including any affiliates and parent) must shoulder the outcome of these decisions, rather than to foist these burdens on to ratepayers, is not unreasonable.

(MEIUG/PICA R.Exc. at 10-11).

OCA responds that FirstEnergy merged with the Companies with full awareness of the Companies' POLR obligation. In addition, OCA argues that the ALJs have placed no obligation on FES, the generation affiliate. However, the Commission does have the authority to disallow claims that it finds 'unreasonable in light of the alternatives and actions that were available to the Companies. (OCA R.Exc. at 13). OCA also points out that the financial condition of FirstEnergy was directly placed in issue by the Companies in their argument that the FES Agreement constituted a 'subsidy' which could not be sustained and actually harmed FirstEnergy and its shareholders. Having made the argument, the Companies cannot now claim that the ALJs erred by examining the evidence on that issue; an issue raised by the Companies. *Id.* OCA also asserts that the ALJs were correct in noting that FirstEnergy extended its Ohio POLR commitment *after* the merger and with full knowledge of the Companies' Pennsylvania POLR commitment. According to OSA, this means that FirstEnergy is treating its Ohio affiliates differently than its Pennsylvania affiliates. Accordingly, the Companies' position that FirstEnergy generation was not sufficient to provide the Companies' POLR supply 'rings particularly hollow. (OCA R.Exc. at 13-14).

PPL also responds to the Companies' Exception No. 7. PPL asserts that whether or not FirstEnergy agreed to support the Companies' POLR obligation in the merger proceeding is irrelevant to the issue presented here. PPL states: 'Simply put, the basis of the ALJs' recommended decision is that the increases in the price of purchased power facing Met-Ed and Penelec were not beyond their control. What First Energy promised to do (or did not promise to do) does not alter the answer to this question. (PPL R.Exc. at 14).

The Companies' Exception No. 8 argues that the record supports a finding that the Companies did take steps to protect customers and 'pursued all reasonable and prudent actions to procure POLR supply. (Companies Exc. at 18). The Companies assert that their efforts resulted in several long term contracts which will provide benefits to their customers through the POLR obligation. However, 'additional such contracts were *simply not available* in the market. *Id.* The Companies conclude that 'the evidence demonstrates that there was essentially nothing more MEPN could have done to 'protect' customers. (*Id.* at 19).

PPL responds to this Exception and argues that the Companies made a business decision to split their load into base load and peaking components. Once that decision was made, the Companies secured long-term contracts for the base load portion of their POLR responsibility. However, they 'chose to rely on a short-term, terminable supply contract with their unregulated affiliate [FES] for the peaking portion of their POLR supply requirements. (PPL R.Exc. at 6). The termination of the FES peaking contract is the 'undisputed cause of the increase in energy costs facing the Companies and the undisputed cause of the generation rate increases requested in this proceeding. (Tr. 598-599). *Id.*

PPL argues further that while a full requirements contract may have been more expensive than the split base load and peaking arrangement, it would have eliminated the need to seek a generation rate increase now. In addition, PPL asserts that any 'savings' which the Companies assign to their business strategy is a myth because the customers were paying rates set in the Restructuring Settlement. Any difference between the base load contract and rates was retained by the Companies. Again, the Companies pursued a procurement strategy in their interest, the strategy was less than optimum from their perspective and they now ask the customers to support their failed strategy. (PPL R.Exc. at 7). Additionally, while a peaking supply contract may have been more difficult to procure at the time the FES Agreement was terminated, a full requirements contract would have been more readily available as that transaction is far more attractive to suppliers. (*Id.* 7-8).

OCA replies to the Companies' Exception No. 8 and asserts that the ALJs properly found that the Companies pursued a strategy of relying on customers as a backstop for their costs. 'The ALJs properly identified the self-inflicted problems that the Companies have created through their POLR procurement policies and the Recommended Decision should be adopted on these issues. (OCA R.Exc. at 15). MEIUG/PICA make a similar argument noting that the FES Agreement protected the Companies' unregulated affiliate rather than customers since FES was free to terminate the agreement when market prices rose above the rate cap. MEIUG/PICA argues that arrangement was hardly outside of the control of the Companies. MEIUG/PICA notes that such a termination provision was not found in any of the Companies' other POLR supply arrangements. (MEIUG/PICA R.Exc. at 11).

Citizen Power responds that the test under *ARIPPA* is 'whether the increased purchase power costs were 'the results of business decisions, regardless of whether the decisions were prudent. (Citizen Power R.Exc. at 15). According to Citizen Power, '[t]he power purchasing strategies of the Companies were exclusively within their control, and it was these strategies, whether deemed prudent or not, that have left them exposed to POLR supply costs without adequate hedges. *Id.*

In their Exception No. 9, the Companies assert that the ALJs incorrectly determined that their corporate officers acted in a fashion that benefited shareholders to the detriment of ratepayers. The Companies also argue that their corporate officers acted at all times in a fashion consistent with their fiduciary duties. The Companies argue that all corporate officers owe a fiduciary duty to shareholders. However, the Companies gave due consideration customer interests. (Companies Exc. at 19-21).

OTS responds that the Companies' corporate officers failed to 'operate in the best interests of Met-Ed and Penelec. (OTS R.Exc. at 7). OTS argues that 'corporate decisions were apparently made exclusively to increase FirstEnergy shareholder value and not made based upon what is in the best interest of the operating utility. *Id.* Similarly, OCA argues that FirstEnergy's corporate leaders were entering into short-term cancellable contracts on behalf of the Companies with their affiliate. OCA then asserts that FirstEnergy made 'a calculated decision to terminate the supply arrangement (FES Agreement) to gain additional profits for its unregulated affiliate. (OCA R.Exc. at 15-16). OCA concludes that the Companies' claim of price spikes due to the cancellation of the FES Agreement 'is a self-inflicted wound that is designed to increase the profits of FirstEnergy's unregulated affiliates at the expense of Met-Ed and Penelec's customers. (*Id.* at 16). MEIUG/PICA makes a similar argument. (MEIUG/PICA R.Exc. at 10).

PPL responds to this Exception and states:

> Analysis of the fiduciary obligations of officers of the various companies does not change the fact that Met-Ed and Penelec choose [sic] to enter into a short-term, terminable partial requirements contract with its affiliate, and the affiliate is now terminating the agreement, an act which exposes Met-Ed and Penelec to increases in the price of purchased power, and which was completely within their control.

(PPL R.Exc. at 16).

The Companies argue in Exception No. 10 that the ALJs erred when they determined that the Companies were in the same position as other EDCs in the Commonwealth which are operating under rate caps with POLR obligations. The Companies argue that no other EDC had a provision like their CDS plan; that their divestiture of generation was unique since they sold their plants to third parties; and, that to the extent they now have affiliate-owned generation, that is insufficient to supply their entire POLR needs. (Companies Exc. at 21-22).

OCA responds that the Companies are 'in essentially the same position as the other Pennsylvania restructured utilities who have honored their rate caps. As the ALJs stated in the Recommended Decision, 'Other Pennsylvania EDCs have met their obligations under their Restructuring Settlements, despite the likelihood that greater profits could be realized if they did not continue to meet their obligation. (OCA R.Exc. at 16, quoting the R.D. at 67). PPL responds that 'the Companies explain, in some detail, the differences between PPL Electric and their own Restructuring Settlements (Met-Ed Penelec Exceptions, at 21-22), but they do not and cannot explain why they needlessly exposed their customers to substantial price risk by failing to obtain a long-term full requirements contract. (PPL R.Exc. at 8).

MEIUG/PICA argue that whatever differences the Companies purport to show. those differences are immaterial to the issue of whether they should receive an exception to the rate cap. MEIUG/PICA assert that 'nothing in the profile of the Companies prohibited Met-Ed and Penelec from meeting their POLR obligations, as has been done by all other EDCs, except for the Companies' business decisions, which sought to maximize profits. (MEIUG/PICA R.Exc. at 12).

OSBA responded to Constellation's Exception No. 1 and recommended rejection of that argument. OSBA posits that Constellation's position would result in an increase in rates over and above what the Companies have requested. In addition, OSBA argues that Constellation has failed to present evidence necessary to support a finding on what the 'market prices' would be in order to establish a basis upon which to align the proposed rates. (OSBA R.Exc. at 16). OSBA also comments that Constellation is actually seeking to 'turn this proceeding into a post-cap POLR case, not the rate-cap exception case that it is. *Id.*

D. Disposition

The Companies Exception No. 6 is a two-pronged argument which first claims that the Restructuring Settlement provides for an exception to the rate cap in addition to that found in Section 2804(4)(iii)(D) of the Code. Second, even if there is no explicit additional exception in the Restructuring Settlement, the Companies argue that the circumstances are such that we should reconsider our Order approving the Settlement and create one under Section 703 of the Code, 66 Pa. C.S. § 703). Neither of these arguments is persuasive.

We have reviewed the Restructuring Settlement in the context of the Companies' arguments that the failure of the CDS provisions provides them with an alternative exception to the rate cap. Two particular provisions are of interest. First, ¶ F.3 of the Restructuring Settlement provides that '[r]egardless of whether PLR service is provided by GPUE or a competitive PLR supplier, all retail PLR service shall be subject to the applicable generation rate caps. Second, ¶ F.9 provides that if there are no qualified bids for CDS service, the Companies will provide PLR service at the rate cap levels unless the Companies file a petition with the Commission and receive approval to exceed the rate caps. ¶ F.9 provides no standard under which such a petition would be adjudicated, but it does provide a time limit (90 days). However, Section 2804(4)(iii)(D) does provide such a standard. We agree with the ALJs that ¶ F.9 provides the process by which the Companies could have petitioned for an exception to the rate caps, but that Section 2804(4)(iii)(D) of the Code provides the standard.

We also agree with the ALJs that there is nothing in the record that would persuade us to exercise our discretion to reconsider the Restructuring Settlement and provide for a rate cap exception independent of the Code. As stated by Citizen Power, to provide such an alternative exception at this point 'would allow Met-Ed and Penelec to perform an end-run around the terms they agreed to, and would endorse just the type of 'heads I win, tails you lose' construct' which was disallowed in *ARIPPA*. (Citizen Power Exc. at 12). MEIUG/PICA also note that the rate caps were part of the over-all agreement struck in the Restructuring Settlement which included 'the payment of billions of dollars of stranded costs. (MEIUG/PICA Exc. at 8). We find nothing in the record before us which would persuade us to adjust that negotiated balance independent of the standards set forth in Section 2804(4)(iii)(D) of the Code. The Companies' Exception No. 6 is denied.

In Exception No. 7 the Companies' argue that the ALJs erred when they appeared to find that FirstEnergy agreed to take on the POLR obligation of the Companies. The Companies also argue that the ALJs ignored the distinction between the Companies and FirstEnergy's unregulated affiliates. There is simply no merit to this Exception and we will deny it. In addition, the Companies argue in Exception No. 8 that they took all prudent steps to properly manage their supply portfolio. We will deny that Exception as well.

The ALJs' entire discussion of the Companies' relationship with FirstEnergy and FirstEnergy's unregulated affiliates centered around the Companies' contractual relationships with FES and FirstEnergy's knowledge of the Companies' POLR obligations at the time of the merger. This discussion was in the context of Section 2804(4)(iii)(D)'s standards for an exception to the rate cap and whether the

Companies' POLR supply acquisitions were properly structured so that the rise in the current prices for supply could be found to be outside of the control of the Companies. The ALJs did find that the Companies entered into an agreement with one of FirstEnergy's unregulated affiliates (FES) that provided for early termination and left the Companies exposed to a rising market. That procurement strategy is remarkably similar to the strategy that the *ARIPPA* court found to be in the Companies' control.

The Companies argue that no long term contracts were available at attractive rates similar to the FES Agreement. However, PPL points out that the FES Agreement was for peaking energy and was not a full requirements contract such as would have been attractive to an alternative supplier. (PPL R.Exc. at 7-8). The termination of the FES Agreement is the reason the Companies are facing increased energy costs now. The strategy of the Companies to split their POLR supply acquisition into base load and peaking components was within their discretion as was the decision to enter into the FES Agreement with its termination provisions.

Whether or not FirstEnergy agreed to support the Companies' POLR obligations, the fact is that the Companies' POLR supply portfolio was managed in such a fashion that left them exposed to a rising market. The Companies' arguments regarding the availability of long-term contracts are unconvincing given the manner in which they structured their portfolio. We are also mindful of the fact that the FES Agreement provided FES with above market prices for a period of time. It is not surprising that FES terminated the Agreement in accordance with its terms when the market price rose. That circumstance was within the Companies' control and a direct result of their business strategy. Thus, in accordance with Section 2804(4)(iii)(D) of the Code, and consistent with *ARIPPA*, we will deny Exception Nos. 7 and 8.

In Exception No. 9, the Companies argue that the ALJs erred in their discussion of the role of certain corporate officials in the FES contract. In Exception No.

10, the Companies argue that the ALJs erred when they found that the Companies are similarly situated as other Pennsylvania EDCs who are required to provide POLR service under rate caps. We find that both of these issues have little relevance to the standards for a rate cap exception under Section 2804(4)(iii)(D) of the Code and *ARIPPA*. Regardless of the ALJs' discussion on these points, the fact is that the decision to enter into a short-term, terminable partial requirements contract with an affiliate was within the Companies' control. It is the termination of that contract which exposes the Companies to the current market prices. Accordingly, we will deny Exception Nos. 9 and 10.

V TRANSMISSION SERVICE CHARGE RIDER

The Companies' transmission rate caps have expired and the Companies' proposed removing transmission costs from base rates and establishing a reconcilable Transmission Service Charge (TSC) Rider. The proposed TSC Rider was designed to include all transmission service-related costs incurred to meet the Companies' POLR obligations. (R.D. at 69). The specific costs to be included in the TSC Rider as proposed by the Companies are:

> (i) network integration transmission service (NITS) costs and FERC-approved PJM transmission congestion charges; (ii) FERC-approved transmission-related ancillary and administrative costs incurred and administered by PJM; (iii) 'Other' costs similar to those in (i) and (ii) that may arise in the future, as approved by FERC and charged under the PJM Open Access Transmission Tariff (OATT); and (iv) transmission risk management costs incurred to mitigate risks associated with transmission-related costs.

(R.D. at 71).

The ALJs stated that there was no dispute regarding the level of any of the costs as proposed by the Companies. In addition, there was no dispute regarding inclusion of any of the costs proposed in the Companies' Exhibit MRH-1, except for congestion and related risk management costs. (R.D. at 71).

The Companies also proposed to include previously deferred 2006 transmission costs in the TSC rider. (R.D. at 74). This was opposed by several Parties. We will first review the issue surrounding the inclusion of congestion costs in the TSC Rider. Then we will move to consideration of the inclusion of the deferred 2006 transmission costs.

A. Inclusion of Congestion Costs in the TSC Rider

1. Positions of the Parties

The Companies must obtain transmission services from PJM Interconnection, LLC (PJM), in order to deliver generation to their POLR customers. In the Companies' view, those transmission services generate the costs as set forth in our quote of the ALJs above. For the most part, the costs are imposed by PJM in accordance with the FERC approved OATT The Companies propose to collect those costs through the TSC Rider. (R.D. at 71).

Those costs that are challenged in this proceeding come under the category of 'congestion costs' and related risk management costs. These costs come into play when there is congestion on the transmission system which affects delivery of power to the Companies' POLR customers. 'Transmission congestion occurs when the amount of electricity flowing over certain portions of the transmission grid nears the capacity of those same points on the grid. (R.D. at 71).

The Companies asserted that congestion costs and related risk management costs are tied to transmission congestion and are properly included in the TSC Rider. The Companies pointed out that FERC has adopted a final rule which will offer transmission rate incentives to reduce transmission congestion in *Promoting Transmission Investment Through Pricing Reform*, Docket No. RM06-4-000 (Order No. 679 issued July 20, 2006), 116 FERC ¶ 61,057 (July 20, 2006). This rule was adopted pursuant to Section 219 of the Federal Power Act, 16 U.S.C. § 824s, a new provision added by the Energy Policy Act of 2005. In addition, it was noted that PJM recently authorized construction of $1.3 billion in electric transmission upgrades in order to ensure continued grid reliability and reduce congestion costs. (R.D. at 72).

The Companies asserted that the foregoing demonstrates 'the direct correlation between the state of the transmission system and the level of congestion costs. (R.D. at 72). The Companies also asserted that the Energy Policy Act of 2005 and FERC's action in *Promoting Transmission Investment* both reveal that Congress and the FERC intend that transmission congestion should be dealt with through new transmission facilities, not generation facilities. Also according to the Companies, no Party challenges inclusion of NITS-type capital expenditures in the TSC Rider. Given that circumstance, the Companies argue that proper matching of the costs associated with improving the transmission system with the benefit of reducing congestion costs indicates that both types of costs should be included in the same cost category – transmission. *Id.*

OCA, MEIUG/PICA, Constellation and the Commercial Group all argued that congestion costs and related risk management costs are more properly categorized as generation costs, not transmission costs. These Parties asserted that congestion charges reflect the differences in the cost of generation that result when the least cost available energy cannot be delivered to a constrained area and higher cost generation units in that area must be dispatched to serve load. (MEIKUG/PICA R.B. at 25-27). Accordingly, while the amount of congestion on the system never affects the price of transmission, it has a direct and immediate impact on the price of generation. *Id.* Constellation stated that 'Congestion costs are not determined based on the transmission rate structure but are a function of energy prices (i.e. LMP) and that is why classifying them as transmission costs is inappropriate. (CNE St. 1S at 6). Constellation also noted that Financial Transaction Rights (FTR) and Auction Revenue Rights (ARR) revenues and FTR costs are a function of the amount of energy delivered and are more properly reflected as generation costs. (CNE St. 1S at 6).

OTS argued that the TSC should be rejected altogether. According to the OTS, there is insufficient Commission authority to properly review the annual reconciliation process. (R.D. at 70).

2. ALJs' Recommendation

The ALJs recommended adoption of the TSC Rider. They found that the Companies had met their burden of proof and that the TSC mechanism is a just and reasonable method to recover those costs. They found that contrary to OTS' position, Section 1307(e) of the Code, 66 Pa. C.S. § 1307(e), provided sufficient authority for the Commission to oversee the reconciliation process. The ALJs noted that the proposed TSC Rider is similar to that recently approved by the Commission in *Pa. PUC v. PPL Electric Utilities Corp*. Docket No. R-00049255 (Order entered December 2, 2004). (R.D. at 70).

The ALJs also recommended that congestion costs, including transmission risk management costs, be treated as transmission costs and should be reflected in the TSC Rider. The ALJs found that the opposing Parties confused the measurement of congestion costs (based upon generation prices) with the existence of congestion on the transmission system. According to the ALJs, if there were no congestion on the transmission system, there would be no congestion costs and no need to acquire risk management tools such as FTRs and ARRs. Similarly, the ALJs found that Contracts for Differences (CFD) costs are like ARRs and FTRs and should be contained in the TSC Rider. (R.D. at 72-73).

The ALJs stated that the Companies modified their initial proposal so as to allocate costs on a demand and energy basis and they recommended adoption of this methodology. (R.D. at 70). The transmission and related ancillary service costs were estimated to be $156.6 million for ME and $81.7 million for PN in 2006. The TSC Rider would commence in January. 2007

3. Exceptions

In OTS' Exception No. 4, OTS recommends rejection of the TSC Rider. OTS argues that the TSC proposal does not provide for a prudence review and should be rejected. OTS asserts that the review available under Section 1307(e) of the Code, 66 Pa. C.S. § 1307(e), does not provide for the proper scope of review for a reconcilable charge. Accordingly, OTS recommends that the TSC should be rejected. (OTS Exc. at 8).

MEIUG/PICA filed Exception No. 1 to the ALJs' recommendation. MEIUG/PICA argue that the nature and purpose of congestion and congestion related expenses reveal a clear connection to generation. MEIUG/PICA assert that the ALJs' recommendation is 'counterintuitive' to the extent they find that MEIUG/PICA confuse measurement of congestion costs with the existence of congestion on the transmission system. They argue that congestion on the transmission system results in higher generation costs via LMP. There is never an impact on transmission costs. (MEIUG/PICA Exc. at 3). In addition, MIEUG/PICA argue that the connection of these costs to generation should prevent their inclusion in the TSC Rider because that would permit the Companies to sidestep the generation rate caps.

MEIUG/PICA argue further that inclusion of congestion costs in the TSC Rider could have the result of double collection. Recalling that congestion will result in a higher LMP. any ratepayer electing real-time or day-ahead LMP service from the

Companies as the POLR provider will pay for the cost of congestion twice, once under the TSC Rider and once in the LMP. (MEIUG/PICA Exc. at 5).

MEIUG/PICA also assert that congestion risk management tools are generation related. They point out that FTRs operate as a hedge against paying the higher price of generation during congestion periods. FTRs are not held as guarantees that power will be delivered, they are held to hedge against the risk of higher generation charges. 'Because FTRs entitle the Companies to recover the difference in the price of *generation* due to congestion, it is clearly a generation-related expense. (MEIUG/PICA Exc. at 5). MEIUG/PICA argue further that ARRs follow load in order to maximize the benefits of retail competition. But if ARRs are attached to the transmission system, that could potentially require two separate TSC Riders; one for shopping customers and one for POLR customers in order to accommodate shifts of ARRs with load. 'This result would be both confusing to customers and administratively burdensome. (*Id.* at 6).

Constellation asserted error in its Exception No. 2. According to Constellation, the ALJs erred in two ways. Constellation asserts that the ALJs erred when they found that the Parties in opposition confused the measurement of congestion with the existence of congestion on the transmission system. This error was said to be caused by the manner in which the ALJs defined congestion. According to Constellation, the ALJs characterized congestion as the result of constraints on the transmission system. However, Constellation argues that the FERC defines congestion differently:

> Congestion is defined as the inability to inject and withdraw additional energy at particular locations in the network due to the fact that the injections and withdrawals would cause power flows over a specific transmission facility to violate the reliability limits for that facility. The market operator manages congestion by scheduling and dispatching generators that can meet load in the presence of congestion. Financially, in LMP markets the price of congestion is measured as the

> difference in the cost of energy at two different locations in the network.

(Constellation Exc. at 8-9, quoting *Long Term Firm Transmission Rights in Organized Electricity Markets*, FERC Docket no. RM06-8-001, Order No. 681-A (Issued November 16, 2006), at ¶ 7).

Constellation argues that the foregoing indicates that FERC has 'confirmed that the existence of congestion is tied to the injection and withdrawal of the energy commodity, (Constellation Exc. at 9). Accordingly, Constellation concludes that congestion is a cost of supplying and using energy and is generation-related. *Id.* Constellation also asserts that recognition of these costs as generation related is necessary for the development of the competitive market. EGSs incur these costs as a cost of supplying generation and must pass them on to shopping customers. Constellation argues that unless these costs are deemed part of generation, POLR customers will pay the costs twice, once to the Companies and again to their EGS. *Id.*

OCA filed its Exception No. 12 to the inclusion of congestion costs, FTRs and ARRs in the TSC Rider. OCA asserts that because congestion costs are determined by generation prices and are unrelated to the transmission rate structure, they are generation related. (OCA Exc. at 32). With regard to costs that are not billed by PJM, those costs are said to be in the Companies' direct control and 'have no place in the TSC. *Id.*

The Companies respond to each of the Exceptions noted above. With regard to OTS' argument regarding oversight, the Companies assert that Section 1307(e) of the Code mandates a public hearing on the annual reconciliation and any matters pertaining to the TSC Rider. In addition, the Companies assert that OTS ignores the FERC role in reviewing and approving transmission costs. (Companies R.Exc. at 5).

The Companies respond to those Parties opposed to including congestion costs and congestion risk management in the TSC Rider and argue that the ALJs correctly determined that they are transmission costs, not generation. The Companies reiterate that the issue is not whether the costs are measured by generation or transmission, but that the costs arise because of the state of the transmission system. (Companies R.Exc. at 9). The Companies also respond to Constellation's argument regarding double payments and the impact on competition. According to the Companies, both generation and transmission rates are by-passable by shopping customers. That includes the TSC Rider. (*Id.* at 7).

4. Disposition

Most of the Parties have agreed that a TSC is an appropriate mechanism for the Companies to recover transmission costs. OTS objected to the TSC on the basis that there is no prudency oversight under Section 1307(e) of the Code which is necessary for a reconcilable charge such as the TSC. We will deny OTS' Exception No. 4. We agree with the ALJs and the Companies that Section 1307(e) provides more than sufficient oversight. Specifically, Section 1307(e)(2) provides that the Commission will hold an annual hearing on the TSC 'and any matters pertaining to the use of such automatic adjustment clause in the preceding period and may include the present and subsequent periods. We find that Section 1307(e) provides this Commission with sufficient oversight authority.

Several Parties filed Exceptions to the ALJs' inclusion of congestion charges in the TSC. We will deny these Exceptions (MEIUG/PICA Exc. No. 1, Constellation Exc. No. 2; OCA Exc. No. 12). On this issue, we agree with the ALJs that the congestion charges are the result of transmission constraints and are properly included in the TSC. Constellation argues that the FERC definition is at odds with this finding because it speaks in terms of injection and withdrawal of generation. However, that definition centers on the fact that withdrawals and injections of generation become a problem when they 'would cause *power flows over a specific transmission facility to violate the reliability limits for that facility. Long Term Firm Transmission Rights in Organized Electricity Markets.* (Emphasis added). Thus, it is the transmission system which creates the potential for congestion and triggers the need for risk management tools that result in congestion charges. As the ALJs stated, 'if there is no constraint on the transmission system, there are no congestion costs, regardless of the generating stations' location or dispatch order. We agree.

In addition to the foregoing, we note the definition of transmission and distribution costs contained in Section 2803 of the Code, 66 Pa. C.S. § 2803: 'All costs directly or indirectly incurred to provide transmission and distribution services to retail customers. This includes the return of and return on capital investments necessary to provide transmission and distribution services and associated operating expenses, including applicable taxes. Clearly, the congestion costs at issue here are costs incurred to provide transmission services to retail customers. The FERC has approved inclusion of almost all of these charges in PJM's Open Access Transmission Tariff as transmission related charges. The Code's broad definition quoted here and FERC's treatment of their recovery as transmission related charges support our finding that the charges are properly recovered as transmission charges in the TSC.

B. Deferred 2006 Transmission Charges

In *Petition of Metropolitan Edison Company and Pennsylvania Electric Company for Authority to Modify Certain Accounting Procedures*, Docket No. P-00052143 (Order entered May 5, 2006) (Deferral Order), the Commission granted the Companies' request to defer for accounting and financial reporting purposes certain incremental FERC-approved transmission charges. When the Commission granted the Companies' request, it specifically stated that authorization for the deferral was not an assurance of future rate recovery, that the Companies were to claim the deferred costs at the first available opportunity, and that any party to a rate case was entitled to oppose the claim. (R.D. at 74).

1. Parties' Positions

The Companies propose to recover their deferred 2006 transmission costs over a ten year period with interest. The carrying charges will be calculated at the Companies' cost of long term debt as approved in the Deferral Order. The deferral period commenced January 1, 2006. Accordingly, the future test year (calendar 2006) encompasses twelve months of the deferral period. The Companies' original deferral request was for both 2005 and 2006 costs. That was modified in this proceeding to encompass only the 2006 costs. (R.D. at 75).

The Companies argued that the deferred costs were new costs created by the expansion of PJM and could not have been projected in the Companies' previous rate proceedings. In addition, the Companies asserted that the costs were extraordinary and, since the rates proposed in this proceeding will not go into effect until 2007 these costs will not be recovered absent approval in this proceeding. Finally the Companies asserted that they acted promptly to recover the costs when they became known, first through the request for deferral and then by inclusion in their first rate proceeding through the TSC Rider. The foregoing is said to meet the test of *Popowsky v. Pa. PUC*, 868 A.2d 606 (Pa. Cmwlth. 2004) (*Popowsky*). (R.D. at 75-76).

OSBA argued that the failure of the Companies to recover their 2006 transmission costs is entirely of their own making. OSBA points out that the Companies' transmission rate caps expired on December 31, 2004. The Companies had every opportunity to seek a transmission rate adjustment effective for 2005. Had they done so, there would not have been unrecovered transmission expenses. Instead, the Companies sought deferred accounting treatment. As such, the problem of recovery is one brought on the Companies by their own actions. OSBA asserted that denial of the requested recovery would reduce the Companies' combined TSC revenue requirement from $230 million to $203.3 million. (OSBA M.B. at 25).

OCA argued that approval of the deferred costs would constitute improper single-issue ratemaking because the Companies are seeking recovery of one element of their total operations without considering other elements 'for example, the Companies' excess distribution revenues. (OCA M.B. at 84, quoting OCA St. 3 at 23). The OCA further argued that the only exception to the prohibition against single item ratemaking requires a finding that the item is extraordinary, non-recurring and volatile, citing *Pennsylvania Electric Company v. Pa. PUC*, 502 A.2d 722 (Pa. Cmwlth. 1983). OCA asserted that none of the three requirements have been met. OCA asserted that the costs involved are normal costs of providing service, the costs have been relatively consistent from year to year and they occur every year, and the Companies failed to pursue the costs through a rate proceeding at their earliest opportunity. OCA argued that the only costs which could be deemed volatile were the congestion costs, which OCA asserted were generation costs, not transmission costs. (*Id.* at 85). OCA also argued that if recovery is permitted, congestion costs should be removed and there should be no carrying charges on the amortized amount. OCA asserted that rejection of carrying charges is consistent with the Commission's policy of not allowing a return on a cost at the same time it is being amortized and recovered in rates. (OCA M.B. at 85-86).

MEIUG/PICA also opposed recovery of the deferred 2006 transmission costs. Like OCA, MEIUG/PICA argued that the costs failed to meet the test that they be extraordinary, unanticipated and non-recurring, citing *Popowsky*. (MEIUG/PICA M.B. at 50). MEIUG/PICA advanced arguments similar to those made by OCA described above. (*Id.* at 50-51).

2. ALJs' Recommendation

The ALJs recommended approval of the request to recover the deferred 2006 transmission expenses. The ALJs found that the costs met the test set forth in *Popowsky*. The ALJs described that test as follows:

> The analysis includes: (1) 'whether the costs arise from an inaccurate projection in a prior proceeding' which includes a consideration of 'whether the costs were anticipated and whether they were imposed on the utility from the outside' (2) 'the extraordinary nature of the costs' including 'whether the expenses themselves are extraordinary and nonrecurring' 'whether the triggering event was an unanticipated, extraordinary, one-time event' and 'whether the expenses are legitimate operating expenses which, if recovery is denied on the grounds that rate recognition would be retroactive, will never be recovered' and (3) 'whether the utility claimed the expenses at the first reasonable opportunity' which includes a consideration of 'whether the utility acts as thought the expenses are something it can absorb with its current revenue under its existing tariff.'

(R.D. at 75, quoting *Popowsky*, 868 A.2d at 611).

The ALJs determined that each of the three tests had been met. They found that none of the costs could have been anticipated in the Companies' prior proceedings and, except for the CFD which have been deemed transmission, the costs have been imposed on the Companies by the FERC approved PJM OATT That was said to satisfy the first test. Second, the ALJs found that the costs were extraordinary as they were substantial. The ALJs noted that net congestion costs alone escalated by 450% from 2004 to 2006. Also, given the Deferral Order and the fact that the proposed rates are to be effective in 2007 these costs will not be recovered absent approval in this case. This was found to satisfy the second test. Finally, the ALJs found that the Companies acted quickly noting that they immediately filed for deferral when the costs became clear and they are only seeking recovery of the costs for 2006. As such, they acted at the first opportunity and did not act as though the deferred costs were something that could be absorbed. Accordingly, the ALJs recommended a finding that the deferred 2006 transmission costs met the test in *Popowsky* for an exception to the prohibition against single issue ratemaking. (R.D. at 75-76). The ALJs also recommended approval of carrying charges 'due to the magnitude of the charges to be recovered (exceeding $200 million) and the length of time over which the charges will be amortized (ten years, beginning in 2007), (R.D. at 77).

3. Exceptions

In OSBA's Exception No. 1, OSBA argues that the ALJs erred by finding that the deferred 2006 transmission costs met the *Popowsky* test. OSBA argues that the ALJs failed to consider whether the costs were anticipated by the Companies. OSBA asserts that the Companies acted to request deferral treatment ten days after the end of their transmission rate caps. Accordingly, they clearly anticipated the imposition of these costs. Because the Companies anticipated imposition of the costs, it was error for the ALJs to find that the first prong of *Popowsky* was satisfied. OSBA also argues that 'the expansion of PJM (with an associated increase in transmission costs due to an increase in congestion) was not an unanticipated, extraordinary, one-time event. These transmission costs are, in fact, usual and ordinary costs of doing business. (OSBA Exc. at 7). Also, OSBA argues that the Companies did not act at their first reasonable opportunity. Rather than seek rate relief, the Companies pursued a deferral. They did not seek recovery of the costs when they were incurred. OSBA argues that 'for all of 2005, the Companies behaved as if they could absorb these costs under the existing tariff. (OSBA Exc. at 9). Accordingly, OSBA argues that the *Popowsky* test has not been met and the claim must be rejected.

In its Exception No. 2, OSBA also asserts error in the ALJs' recommendation to approve carrying charges on the deferred costs. First, the Companies could have avoided the deferral by seeking timely recovery in a rate proceeding. Thus, the problem is of the Companies own making and ratepayers should not be made to pay carrying charges resulting from the Companies' decision to defer recovery. Second, OSBA asserts that over the ten year period, it is likely that ratepayers who were not customers when the charges were incurred will be forced to pay them. Finally. the Commission should not encourage delayed recovery of transmission expenses by approving carrying charges, particularly when the Companies could have acted much earlier. (OSBA Exc. at 9-11).

OSBA also filed its Exception No. 3 which claims error in the ALJs' failure to clarify whether the amortization of 2006 transmission costs would be by-passable by shopping customers. OSBA argues that these costs should not be by-passable since customers who received transmission services from the Companies in 2006 bear cost-causation responsibility for the charges. If any of those customers move to an EGS during the amortization period, they will avoid payment of costs incurred on their behalf. This, in turn, will result in fewer customers paying the costs. (OSBA Exc. at 12).

OCA's Exception No. 11 (OCA Exc. at 28-31) and MEIUG/PICA's Exception No. 2 (MEIUG/PICA Exc. at 7-9) make the same arguments stated in OSBA's Exception No. 1. OCA also claims error in the ALJs' recommended approval of carrying charges. OCA argues that approval violates 'the Commission's established policy of not allowing a return on a cost at the same time it is being amortized and recovered in rates. (OCA Exc. at 30).

The Companies respond to OSBA, OCA and MEIUG/PICA and assert that the ALJs' analysis of *Popowsky* and the application of *Popowsky* to the facts here are correct. (Companies R.Exc. at 10-11). The Companies also respond to OCA and OSBA's opposition to carrying charges. The Companies argue that they are not seeking to include the 2006 costs in rate base. In addition, the magnitude of the costs and the length of the amortization period support the request for carrying charges.

4. Disposition

We agree with the ALJs' recommendation to approve the Companies' request to recover the deferred 2006 transmission expenses. The ALJs properly analyzed the request under the standards set forth in *Popowsky* and found that the record supported approval of the recovery. For the reasons set forth at Pages 74 through 77 of the Recommended Decision, we will adopt the ALJs' recommendation. Accordingly, OSBA Exception No. 1, OCA Exception No. 11 and MEIUG/PICA's Exception No. 2 are denied.

We also agree with the ALJs' recommendation to approve carrying charges at the rate set forth in the Deferral Order. OCA and OSBA both excepted to this recommendation. We will deny these Exceptions. We agree with the Companies that the magnitude of the costs and the length of the amortization period provide adequate support for carrying charges. The ALJs' analysis of the *Popowsky* standards also rebuts most of the OSBA's arguments in OSBA's Exception No. 2.

In OSBA's Exception No. 3, it argues that the ALJs erred by failing to address the issue of whether the deferred transmission charge is by-passable by shopping customers. OSBA argues that customers who were transmission customers of the Companies in 2006 should not be able to by-pass the deferred charges. We find that it is by-passable. As noted by the Companies, the OSBA position is impractical and poor policy. For the reasons expressed in the Companies' Reply Exceptions at Pages 11-12, Note 8, we will deny OSBA's Exception No. 3.

VI. GENERAL PRINCIPLES FOR A 1308 GENERAL RATE INCREASE CASE

In deciding this, or any other, general rate increase case brought under Section 1308(d) of the Code, 66 Pa. C.S. § 101 *et seq.* certain general principles always apply.

A public utility is entitled to an opportunity to earn a fair rate of return on the value of the property dedicated to public service. *Pennsylvania Gas and Water Co. v. Pa. PUC*, 341 A.2d 239 (Pa. Cmwlth. 1975). In determining a fair rate of return the Commission is guided by the criteria provided by the United States Supreme Court in the landmark cases of *Bluefield Water Works and Improvement Co. v. Public Service Comm'n of West Virginia*, 262 U.S. 679 (1923) and *Federal Power Comm'n v. Hope Natural Gas Co.* 320 U.S. 591 (1944). In *Bluefield*, the Court stated:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure 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. A rate of return may be too high or too low by changes affecting opportunities for investment, the money market and business conditions generally.

The burden of proof to establish the justness and reasonableness of every element of a public utility's rate increase request rests solely upon the public utility in all proceedings filed under Section 1308(d) of the Code. The standard to be met by the public utility is set forth at Section 315(a) of the Code, 66 Pa. C.S. § 315(a):

> **Reasonableness of rates.** –In any proceeding upon the motion of the Commission, involving any proposed or existing rate of any public utility, or in any proceeding upon complaint involving any proposed increase in rates, the burden of proof to show that the rate involved is just and reasonable shall be upon the public utility.

The Pennsylvania Commonwealth Court, in reviewing Section 315(a) of the Code, interpreted the utility's burden of proof in a rate proceeding as follows:

> Section 315(a) of the Public Utility Code, 66 Pa. C.S. § 315(a), places the burden of proving the justness and reasonableness of a proposed rate hike squarely on the public utility. *It is well-established that the evidence adduced by a utility to meet this burden must be substantial.*

Lower Frederick Twp. Water Co. v. Pa. PUC, 48 Pa. Cmwlth. 222, 226-227, 409 A.2d 505, 507 (1980) (emphasis added). See also, *Brockway Glass Co. v. Pa. PUC*, 63 Pa. Cmwlth. 238, 437 A.2d 1067 (1981).

In general rate increase proceedings, it is well established that the burden of proof does not shift to parties challenging a requested rate increase. Rather, the utility's burden of establishing the justness and reasonableness of every component of its rate request is an affirmative one and that burden remains with the public utility throughout the course of the rate proceeding. It has been held that there is no similar burden placed on other parties to justify a proposed adjustment to the Company's filing. The Pennsylvania Supreme Court has held:

> [T]he appellants did not have the burden of proving that the plant additions were improper, unnecessary or too costly: on the contrary, that burden is, by statute, on the utility to demonstrate the reasonable necessity and cost of the installations, and that is the burden which the utility patently failed to carry.

Berner v. Pa. PUC, 382 Pa. 622, 631, 116 A.2d 738, 744 (1955).

This does not mean, however, that in proving that its proposed rates are just and reasonable a public utility must affirmatively defend every claim it has made in its filing, even those which no other party has questioned. As the Pennsylvania Commonwealth Court has held:

> While it is axiomatic that a utility has the burden of proving the justness and reasonableness of its proposed rates, it cannot be called upon to account for every action absent prior notice that such action is to be challenged.

Allegheny Center Assocs. v. Pa. PUC, 570 A.2d 149, 153 (Pa. Cmwlth. 1990) (citation omitted). See also, *Pa. PUC v. Equitable Gas Co.* 73 Pa. P.U.C. 310, 359 – 360 (1990).

Additionally, the provisions of 66 Pa. C.S. § 315(a) cannot reasonably be read to place the burden of proof on the utility with respect to an issue the utility did not include in its general rate case filing and which, frequently, the utility would oppose. Inasmuch as the Legislature is not presumed to intend an absurd result in interpretation of its enactments[10] the burden of proof must be on a party to a general rate increase case who proposes a rate increase beyond that sought by the utility.

The mere rejection of evidence contrary to that adduced by the public utility is not an impermissible shifting of the evidentiary burden. *United States Steel Corp. v. Pa. PUC*, 72 Pa. Cmwlth. 171, 456 A.2d 686 (1983).

In analyzing a proposed general rate increase, the Commission determines a rate of return to be applied to a rate base measured by the aggregate value of all the utility's property used and useful in the public service. The Commission determines a proper rate of

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[10] 1 Pa. C.S. § 1922(1), *PA Financial Responsibility Assigned Claims Plan v. English*, 541 Pa. 424, 64 A.2d 84 (1995).

return by calculating the utility's capital structure and the cost of the different types of capital during the period in issue. The Commission is granted wide discretion, because of its administrative expertise, in determining the cost of capital. *Equitable Gas Co. v. Pa. PUC*, 45 Pa. Cmwlth. 610, 405 A.2d 1055 (1979) (determination of cost of capital is basically a matter of judgment which should be left to the regulatory agency and not disturbed absent an abuse of discretion).

Any issue or Exception that we do not specifically address has been duly considered and will be denied without further discussion. It is well settled 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); *see also, University of Pennsylvania v. Pennsylvania Public Utility Commission*, 485 A.2d 1217 (Pa. Cmwlth. 1984). A voluminous record does not create, by its bulk alone, a multitude of real issues demanding individual attention *Application of Midwestern Fidelity Corp.* 26 Pa. Cmwlth. 211, 230 fn.6, 363 A.2d 892, 902, n. 6 (1976). With the foregoing principles in mind, we turn to the rate issues before us.

VII. RATE BASE/CASH WORKING CAPITAL

A. Distribution

Based on their lead/lag studies of revenues and expenses, ME claimed cash working capital of $85,580,000 and PN claimed cash working capital of $76,625,000. (R.D. at 81). There is disagreement among the Parties over the following issues: 1) Payment lag associated with Pennsylvania Corporate Net Income Tax (CNI) and Pennsylvania Capital Stock Tax (CS); 2) Treatment of certain so-called 'non-cash' items; 3) Treatment of transmission costs; 4) Treatment of return on equity: 5) Payment lag associated with interest on long-term debt; and 6) Payment lag associated with certain 'Other O&M' items.

1. Pennsylvania Corporate Net Income Tax and Pennsylvania Capital Stock Tax

a. Positions of the Parties

ME's and PN's lead/lag studies calculate the payment lag associated with these taxes based on their use of the statutory 'safe harbor' method for payment of these taxes, which entails four payments each of 25% of the second prior year's tax liability. Because they have used the 'safe harbor' method, MEPN argue that their calculations are reasonable. By utilizing the safe harbor method for paying estimated taxes, MEPN arrived at a lag calculation of 30.8 days. (MEPN Sts. 11-R, Exh. MJS 1 and 2 at 12 and 13; R.D. at 81).

The OTS disagreed and recommended increasing the payment lag associated with these taxes from 30.8 to 55.8 days. The OTS stated that its adjustment is based on the statutory payment requirements pursuant to the Pennsylvania Tax Code, which establishes a prepayment system requiring four estimated payments of 22.5% on the 15th day of the third, sixth, ninth, and twelfth month of the calendar or fiscal year. According to the OTS, prepayment requirements are satisfied if 90% of the final tax liability is paid in the quarterly installments. The final payment of 10% is due when the corporate tax return is filed. Using this method, the OTS calculated the lag associated with these taxes to be 55.8 days. (R.D. at 81–82).

The OTS asserted that the safe harbor method used by MEPN requires four estimated payments equal to 100% of the second prior year's tax liability in order to avoid underpayment penalties. The OTS argued that MEPN's lag calculations under the safe harbor method are flawed because their calculations do not account for all payments and treat the four estimated prepayments as if they equal 100% of their final tax liability. The OTS contended that the four prepayments allow MEPN to escape underpayment penalties but do not necessarily satisfy the entire tax obligation. The OTS opined that MEPN may have to remit a final payment to satisfy its tax obligation in full. According to the OTS, MEPN's lag calculation accounts for the four prepayments, but it does not reflect any final payment that may be necessary to satisfy the total tax liability. (R.D. at 82).

The OTS contended that MEPN's failure to account for a final payment resulted in a miscalculation of the weighted percentage for each payment. By failing to include the final payment, the OTS asserted that MEPN calculated the lag by weighing the four prepayments as if they equal 100% of the tax liability. Accordingly, the OTS asserted that doing so is erroneous if the prepayments are less than the total tax liability and MEPN may have to make a final payment to satisfy their entire tax obligation. The OTS believes that by incorrectly weighting the estimated prepayments against the final tax liability, the MEPN lag calculations are flawed and artificially low. Therefore, the OTS recommended an adjustment of $1,506,000 for ME and $1,772,000 for PN because its adjustment is based on an accurate calculation of the lag associated with these taxes of 55.8 days. (R.D. at 82).

b. ALJs' Recommendation

The ALJs agreed with MEPN. The ALJs found that the OTS argument assumes that these taxes will escalate every year, but that the OTS provided no evidence in support of this proposition. The ALJs noted that there is no evidence in the record that the Commonwealth either has already increased the rates of these taxes or intends to in the near future. The ALJs stated that while it is possible that the amount of taxes will increase due to MEPN producing additional taxable income, there is no evidence in the record that either ME's or PN's liability for these taxes have increased in years where the tax rates have remained constant. Furthermore, according to the ALJs, it is possible that the Commonwealth may reduce the rate of one or both of these taxes with the result that

ME's and PN's liability for these taxes could remain the same or decrease from that of previous years, causing a reduction in the payment lag. Therefore, the ALJs rejected the OTS' adjustments and concluded that the Companies' recommendation is reasonable and should be adopted. (R.D. at 82 – 83).

c. Exceptions

In its Exceptions, the OTS avers that the ALJs incorrectly adopted the artificially low 30.8 Pa CNI and Pa CS lag calculation posited by the Companies. The OTS rejoins that the Companies' lag calculations under the safe harbor method are flawed because the calculation does not account for all payments and treats the four estimated prepayments as if they equal 100% of the Companies' final tax liability. The OTS notes that the ALJs' reasoning that the OTS argument assumes that these taxes will escalate every year, is in error given that the safe harbor method, as an alternative to the estimated statutory method, should only be used when a Company has escalating tax liability. The OTS opines that it is imprudent cash management to use the safe harbor method when tax liabilities are decreasing because the Companies will pay more than necessary to satisfy its total tax liability. Furthermore, the OTS asserts that based on the Companies' decision to use the safe harbor method, it is logical to assume that the tax liabilities have been increasing. The OTS states that the Companies have not expressly denied making a final payment in testimony or briefs. Therefore, the OTS asserts that its analysis properly exposed this flaw in MEPN's lag calculation and its adjustments should be adopted. (OTS Exc. at 8-12).

In reply, MEPN rejoin that the OTS' principal argument is based on a 'hypothetical' company and is dependent on assuming that there is an incremental final tax liability on top of the four 'safe harbor' payments. As the ALJs concluded, the Companies aver this assumption is not supported in the record as these taxes could just as well remain the same or decrease, rather than increase, in any given year. MEPN also criticize the OTS for the introduction of a new rationale that prudent cash management mandates use of the safe harbor method only when an increase in these taxes is assured. The Companies aver that there is no foundation in the record for this position as it assumes a prescience about ultimate tax liabilities. The Companies maintain that the use of the safe harbor methodology to avoid penalties is prudent even without the perfect foresight suggested by the OTS. (MEPN R.Exc. at 12-13).

d. Disposition

Based upon the evidence of record, we deny the Exceptions of the OTS and adopt the recommendation of the ALJs. We find that the Company's position, that the OTS' adjustment is based on a faulty assumption that there will be an incremental final tax liability above and beyond the four 'safe harbor' payments, is reasonable and convincing. We are in agreement with the ALJs that there is no evidence in the record to support the OTS' assumption as there is no assurance that the final tax liability will not be satisfied by the quarterly installments.

2. Treatment of "Non-Cash" Items

a. Positions of the Parties

MEPN have included in their analysis items such as depreciation, amortization, deferred income taxes, and uncollectibles, claiming that they create a need for cash and, therefore, should be reflected in cash working capital. MEPN argued that the term 'non-cash' expense is misleading because it suggests that there is or was no cash outlay, which is untrue. According to MEPN, each of these items reflects an outlay of cash. They explained that depreciation represents the return of capital that was actually invested on a cash basis in plant. Then, as soon as the depreciation expense is booked upon the delivery of service, the amount of the expense is credited to the depreciation reserve and net plant is reduced, thus ending the investor's right to earn a return on that portion of the cash investment. However, the associated revenues representing the return of the cash capital investment are not received until the customer pays for the service, creating a cash working capital requirement to the extent of the lag between the booking of the depreciation expense and the receipt of the associated revenues. (R.D. at 83).

Similarly, according to MEPN, deferred taxes relate to timing differences between book and tax depreciation associated with actual cash invested in plant and are deducted from rate base, preventing the investor from earning a return on that portion of the cash investment. Even though the timing differences eventually turn around, at which time deferred taxes are booked as a current tax expense offset, with a reversal of the related rate base deduction, there is still a cash working capital requirement that must be recognized to the extent of the lag between the initial rate base deduction and the receipt of the associated revenues. MEPN argued that other so-called 'non-cash' items also represent actual cash outlays that must be reflected in a cash working capital analysis. (R.D. at 84).

The OCA argued that including depreciation, amortization, deferred income taxes, and uncollectibles in the cash working capital claim is improper. According to the OCA, cash working capital is a measure of the Companies' day-to-day cash needs which arise due to differences between the time when payment for the expenses incurred to render service must be made and the time when revenues resulting from the provision of that service are received. The OCA argued that depreciation, amortization and deferred income taxes are not cash expenses for which a payment must be made at a specified date. Therefore, according to the OCA, these expenses do not create a need for cash and are not properly included in the lead-lag study analysis to determine cash working capital. Additionally, the OCA averred that depreciation and deferred income taxes represent sources of internally generated funds. (R.D. at 84).

The OCA contended that the Commission has held that no consideration should be given to non-cash items in the cash working capital computation citing *Pa. PUC. v. Phila. Suburban Water Co.* 58 Pa. PUC 668, 674 (1984) ("we consider uncollectible accounts expense to be a non-cash expense and, as such, no return allowance will be granted"); *Pa. PUC v. Mechanicsburg Water Co.* 80 Pa. PUC 212, 226 (1993) (elimination of non-cash items, such as amortization and written-off uncollectibles, from the cash working capital calculation); *Pa. PUC v. Roaring Creek Water Co.* 81 Pa. PUC 285, 292 (1994); and *Pa. PUC v. Columbia Gas of Pa, Inc.* 74 Pa. PUC 282, 300 (1990) ("any expense which does not require the utility to utilize cash funds does not require a CWC allowance"). The OCA concluded that the Commission should reject the Companies' inclusion of non-cash items in its claim for cash working capital.

b. ALJs' Recommendation

The ALJs agreed with the OCA's position. The ALJs found that the prior Commission decisions cited by the OCA consistently reject including non-cash items in cash working capital. The ALJs state that, while MEPN point out some state utility commissions have adopted their position that non-cash items should be included in cash working capital, the decisions of other state utility commissions are not controlling in this proceeding. The ALJs maintain that prior Commission decisions are controlling. They concluded that MEPN have cited no Commission decisions in support of their position that non-cash items should be included within the calculation of cash working capital nor have they proven that the Commission should deviate from its prior decisions. Therefore, the ALJs adopted the position of the OCA and excluded the non-cash items from cash working capital. (R.D. at 85).

c. Exceptions

In their Exceptions, MEPN rejoin that the Commission should reconsider outdated precedent and reflect so-called non-cash items in cash working capital lead-lag studies with an appropriate revenue lag because these items at one time entail an outlay of cash. The Companies opine that although the ALJs might feel constrained to follow Commission precedent, it is entirely appropriate for the Commission to reconsider its prior decisions so as to adopt the more appropriate and theoretically sound position of those other state commissions. MEPN cite a Connecticut decision at *The United Illuminating Company*, Docket No. 01-10-1- 2002 Conn. PUC LEXIS 183, at *103-04 (Ct. DPUC, Sept.26, 2002), as well as two New Jersey cases[11] as support for their position.

In reply, the OCA submits that the Commission precedent referred to by the Companies is not 'outdated' and there is absolutely no basis for including non-cash items in cash working capital. The OCA reiterated that cash working capital is a measure of the Company's day-to-day cash needs which arise due to differences between the time when payment for the expenses incurred to render service must be made and the time when revenues resulting from the provision of that service are received. It avers that depreciation, amortization and deferred income taxes are not cash expenses for which a payment must be made at a specified date and are, therefore, not properly included in the lead-lag study analysis to determine cash working capital. The OCA maintains that the ALJs correctly rejected the Companies' proposal to include non-cash items in the cash working capital calculation based on Commission precedent. (OCA R.Exc. at 16-17).

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[11] *Middlesex Water Company,* Docket No. WR 00060362, at 17 (BPU, June 6, 2001); *Public Service Electric and Gas Company,* Docket No. ER85121163 (BPU, April 6, 1987).

d. Disposition

Our review of the record evidence leads us to conclude that the ALJs recommendation relative to the treatment of 'non-cash' items within the cash working capital analysis is reasonable and consistent with Commission precedent. We find that the OCA's position that depreciation, amortization, deferred income taxes and uncollectibles are not cash expenses for which a payment must be made at a specified date is correct. Therefore, these expenses are not properly included in the lead-lag study analysis to determine cash working capital. We are not persuaded by the Companies' arguments to deviate from our prior decisions on this issue and will continue to follow Commission precedent. Accordingly, the Exceptions of MEPN on this matter are denied.

3. Treatment of Transmission Costs

a. Positions of the Parties

MEPN contended that their distribution-related cash working capital request is distinct from the Federal Energy Regulatory Commission (FERC) allowance. Their position is that the Pennsylvania jurisdictional lag covered here is the time between MEPN's load serving entity payment to PJM for transmission service, compared to receipt of customer revenues for transmission service. According to the Companies, the FERC jurisdictional cash working capital allowance relates to transmission owner revenue requirements associated with provision of network integrated transmission service. The Companies claim that the OCA is under the mistaken impression that the cash working capital allowance included in FERC-approved transmission rates is duplicative of the transmission-related cash working capital request included by MEPN in these proceedings. (R.D. at 85).

MEPN argued that just as certain transmission-related operations and maintenance costs must be recovered through retail rates, there are also transmission-related cash working capital requirements that must be reflected in retail rates. According to MEPN, there are two distinct transmission-related cash working capital requirements. (R.D. at 85).

The OCA asserted that the Commission should reject inclusion of transmission costs in cash working capital. According to the OCA, the Companies are fully compensated for their share of the overall cost of service from the revenues which PJM collects for that service. The OCA maintained that such compensation is based on the fact that the Companies' transmission revenue requirements established by FERC include a cash working capital component approved by FERC in its rate setting process. The OCA claimed that including transmission costs yet again in the lead-lag study in setting distribution rates is improper because the Companies are already compensated for transmission related working capital requirements by their FERC approved revenue requirement. The OCA concluded that to the extent that MEPN believe that FERC has not properly measured the cash working capital requirement associated with transmission service, that is an issue to be pursued at FERC, not with this Commission. (R.D. at 86).

b. ALJs' Recommendation

The ALJs agreed with the Companies, noting that MEPN have two different roles. As an owner of transmission facilities, they provide transmission services to others by transmitting others' electricity and then receive payment for that service at a later date. The ALJs found that FERC includes a cash working capital component that includes a lag period in setting rates for others using MEPN transmission facilities. Furthermore, according to the ALJs, as load serving entities, MEPN pay PJM for transmission services and are later paid for the electricity they transmitted to others. The ALJs adopted MEPN's position that the FERC cash working capital calculation does not include this service. The ALJs found that these are two separate items and concluded that there is no double counting. (R.D. at 86).

c. Exceptions

The OCA excepts, stating that the Commission should reject inclusion of transmission costs within the Companies retail cash working capital claim because the Companies are already fully compensated for their share of the overall cost of transmission service from the revenues which PJM collects for that service. The OCA avers that the Companies' argument that the cash working capital transmission request is 'totally distinct from the FERC allowance, as it relates to the Companies obligations, is without merit and should be rejected. According to the OCA, FERC allows cash working capital to reflect the time between when the Companies render service and the Companies receive payment for that service. The OCA contends that if the Companies now wish to contend that the FERC method does not include the lag between the time the Companies pay PJM and when they are paid for the electricity they have sent to others, then the remedy is at FERC, not through Pennsylvania distribution rates. According to the OCA, adding a transmission service cash working capital claim to distribution rates results in a double-counting of what is already provided for by FERC. (OCA Exc. at 5-6).

In reply, MEPN note that the ALJs properly accepted their position that there are two separate transmission related roles, one associated with the Companies role as transmission owners which is reflected in FERC rates and the other role associated with the Companies as LSEs, which is not reflected in FERC rates. As a result, ME's and PN's transmission related cash working capital claim is not duplicative of the cash working capital of their FERC rates and the argument of the OCA is fallacious and should be rejected. (MEPN R.Exc. at 13-14).

d. Disposition

Based upon the evidence of record, we will deny the Exceptions of the OCA and adopt the recommendation of the ALJs. We disagree with the OCA's position that the cash working capital allowance included in FERC-approved transmission rates is duplicative of the transmission-related cash working capital request included by MEPN. We find that MEPN are correct that there are two distinct transmission-related cash working capital requirements and that their request does not result in a double counting as alleged by the OCA.

4. Treatment of Return on Equity and Payment Lag Associated with Interest on Long-Term Debt

a. Positions of the Parties

MEPN urged the Commission to adopt their position that return on equity and interest are paid from operating income that is the property of the investor immediately upon the rendition of service. MEPN admitted that there is precedent to the contrary, but contended that these proceedings provide an opportunity for the Commission to adopt a proper approach to these related cash working capital issues. MEPN asserted that these items should be included in the lead/lag study with a zero payment lag. MEPN contended that their position has long been accepted by the New Jersey Board of Public Utilities. (R.D. at 87).

The OCA argued that interest should be treated as an expense and should be included in the study with a payment lag reflecting the terms of the debt, while return on equity should be excluded from the study. The OCA contended that including the return on equity in the lead-lag study also overstated the cash working capital needed and allows the Companies to earn an improper overall return on equity. According to the OCA, this treatment of the return on equity in the cash working capital provides daily compounding of the allowed rate of return. The OCA concluded that the Commission should reduce each of the Companies' claims for cash working capital to reflect accepted ratemaking procedure. (R.D. at 87).

b. ALJs' Recommendation

The ALJs agreed with the OCA's position noting that while MEPN cite decisions from the New Jersey Board of Public Utilities as support for their position, the decisions of other state utility commissions are not controlling in this proceeding. The ALJs found that prior Commission decisions must be followed. They state that MEPN have cited no Commission decisions in support of their position nor have they proven that the Commission should deviate from its prior decisions. Therefore, the ALJs adopted the OCA position. (R.D. at 87).

c. Exceptions

In their Exceptions, MEPN reiterate their position that the Commission should reconsider outdated precedent and include return on equity and interest on long-term debt in cash working capital lead-lag studies with a zero payment lag, for the reasons already articulated. The Companies opine that while the ALJs may be bound by prior Commission precedent, the Commission should reconsider this issue and adopt the more appropriate and theoretically sound approaches of other state commissions. (MEPN Exc. at 24-25).

In reply, the OCA rejoins that the Commission should not stray from well-established Pennsylvania precedent that excludes interest expense and return on equity in the cash working capital calculation. The OCA maintains that the Companies have provided no support for departing from long-standing Commission precedent. (OCA R.Exc. at 17-18).

d. Disposition

Our review of the record evidence leads us to conclude that the ALJs recommendation relative to the treatment of return on equity and interest on long-term debt within the cash working capital analysis is reasonable and consistent with Commission precedent. We are in agreement with the OCA's position that interest should be treated as an expense and should be included in the lead-lag study with a payment lag reflecting the terms of the debt and that return on equity should be excluded from the study. We are not inclined to adopt ME's and PN's requests that we vary from well-established Commission precedent, as their request is unsupported in the record. The decisions cited by the Companies are not controlling in this proceeding. Accordingly, the Exceptions of MEPN on this matter are denied.

5. Payment Lag Associated with Certain "Other O&M" Items

a. Positions of the Parties

MEPN contended that Other O&M constitutes less than 10% of Total O&M, and consists of some items with payment terms less than 30 days and some greater than 30 days. Therefore, according to the Companies, use of the 'standard' 30-day O&M payment lag is reasonable. MEPN stated that while it is theoretically possible to analyze the payment lag associated with each Other O&M item separately, any additional precision would be outweighed by the additional time and resources required for such an assessment. (R.D. at 88).

The OCA contended that interest on customer deposits that are paid annually should be separately accounted for, and that specific payment lags on pole rentals should be reflected in the lead/lag study, rather than including both items under 'Other O&M. The OCA argued that interest on customer deposits is not an O&M

expense, rather it is an interest expense included in the cost of service. According to the OCA, there is no reason to assign a lag of thirty days to interest on customer deposits. The interest is paid on customer deposits annually and the Commission should use an average payment lag of 182.5 days. (R.D. at 88).

The OCA asserted that the Companies both receive pole rentals from telecommunications companies and pay pole rentals to those same companies. Both categories of payments are based on annual contracts billed after the end of the year. As a result, OCA stated there are significant lags in both receipt of payments from the Telecommunications companies and payment to those companies. According to the OCA, the Companies only recognized a long lag in the receipt of revenue but used thirty days as the lag for payment of expenses. For the sake of consistency. the OCA concluded that the Companies should recognize that the lag for payment of pole rentals to the telecommunications companies is as long as the lag in the receipt of revenues. (R.D. at 88).

b. ALJs' Recommendation

The ALJs agreed with the OCA's positions noting that interest on customer deposits is not an O&M expense, but is included in the cost of service. Therefore, the ALJs concluded that the actual average payment lag of 182.5 days should be used. The ALJs also agreed with the OCA that both payments to and from telecommunications companies should use lags that are consistent since the actual amounts are billed after the end of the year. Therefore, according to the ALJs, the lag time for payment to the telecommunications companies shall be the same as the lag period for the receipt of revenue from the telecommunications companies or 467.4 days for ME and 324.3 days for PN. (R.D. at 88 – 89).

c. Disposition

No Party excepts to the ALJs' recommendation in regard to this issue. Finding the ALJs' recommendation to be reasonable, appropriate and in accordance with the record evidence, it is adopted.

VIII. REVENUES AND EXPENSES

A. Universal Service Charge Deferral Recovery Period and Imposition of Carrying Charges

1. Positions of the Parties

a. Deferral Recovery Period

Pursuant to Section I.2 of their Restructuring Settlement, MEPN was permitted to implement and seek recovery of Universal Service and Energy Conservation costs if the programs' expenses exceeded the amounts established in the Commission's Order. Accordingly, ME deferred $182,000 and PN deferred $3.929 million of such costs for consideration in this proceeding. (ME Exh. RAD-2 and PN Exh. RAD-4, at 23; MEPN MB at 59-60; R.D. at 92).

The OTS opined that the appropriate recovery period is five years and that the Companies proposed three year recovery period violates the public interest as being unduly burdensome and because the expenses were accumulated over a six year period ending in 2004. (OTS MB at 17 18).

The Companies contended that a three year recovery period is appropriate and that if the OTS' five year proposal is adopted, some of the deferred costs would not be recovered until thirteen years after they were incurred. (MEPN MB at 60).

b. Imposition of Carrying Charges

The Companies have also proposed, as a matter of 'economic fairness, a 6% carrying charge, applicable to the unrecovered balance resulting in a claim of $13,000 and $285,000 by ME and PN, respectively. Additionally, the Companies believe that the absence of specific language in the Restructuring Settlement does not prohibit them from seeking recovery of carrying costs on these deferred expenses. (MEPN MB at 60). OTS argued that the omission of carrying charges on these deferred costs in the Restructuring Settlement was intentional and agreed to by the Companies as a part of that Settlement. (ME Exh. RAD 2 and PN Exh. RAD 4, at 23; MEPN MB at 59 - 60; OTS MB at 18 19: R.D. at 92).

Section I.I.2. of the Companies' Restructuring Settlement states in part that:

> .Only to the extent that the Companies' funding of these programs exceeds the amounts set forth in the Commission Order prior to the end of the distribution and transmission rate cap, may the Companies defer and seek recovery of such costs (net of any cost savings attributable to the programs) after the expiration of that rate cap.

2. ALJs' Recommendation

a. Recovery Period

The ALJs agreed with the OTS' position that the three year recovery period proposed by the Companies would be burdensome because ratepayers will be required to pay the ongoing annual expense plus two years of deferred expenses for each of the next three years. Such a result is unreasonable in light of the fact that these costs were accumulated over a six year period. The ALJs found that the Companies failed to prove that a three year recovery period is either just or reasonable, and that it is in the public interest to mitigate the size of the annual charge to ratepayers while still allowing the

Companies to recover the entirety of these deferred expenses. Consequently, the ALJs adopted the OTS' five – year recovery period for these deferred expenses. (ME Exh. RAD 2, PN Exh. RAD 4 at 23; OTS MB at 20; R.D. at 92 – 94).

b. Imposition of Carrying Charges

The ALJs found that the inclusion of carrying charges would be an alteration of the terms agreed to in the Restructuring Settlement. While the Settlement does not expressly prohibit such charges, the very fact that carrying charges are not specifically provided for in the Restructuring Settlement, according to the ALJs, is sufficient reason to disallow these claims. In the ALJs' opinion, had carrying charges been contemplated and agreed to for deferred universal service costs, such a term would surely have been expressly stated in the Restructuring Settlement. Additionally, the ALJs found that the request for carrying charges must be denied as it violates the prohibition against earning a return on and a return of O&M expenses. As such, the ALJs found that the Companies are not permitted to earn a return on and a return of such operating and maintenance expenses thereby disallowing the $13,000 claimed by ME and the $285,000 claimed by PN. (ME Exh. RAD 2, PN Exh. RAD 4 at 23; OTS MB at 17 – 20; R.D. at 92 – 94).

3. Disposition

No Party excepts to the ALJs' recommendation in regard to this issue. Finding the ALJs' recommendation to be reasonable, appropriate and in accordance with the record evidence, it is adopted.

B. Payroll Expense

1. Positions of the Parties

ME's post-test year payroll claim is $554,000 and PN's claim is $572,000. (ME Exh. RAD-2 at 19: OCA Exh. TCS – 1 and 2 at Schedule 8). The OCA has proposed to eliminate the Companies' post-test year payroll increase adjustments for union and non-union employees. The OCA reasons that these increases are not scheduled to take place until two to four months after the future test year and that the non-union increases are not contractually required. (OCA St. No. 3; PN St. No. 4 – R at 15; OCA MB at 46; R.D. at 94).

The Companies have asserted that '[a]mple precedent supports the allowance of post-test year adjustments as requested in this proceeding' citing *Pa. PUC v. Dauphin Consolidated Water Supply Company*, 55 Pa. PUC 44 (1981) and *West Penn Power Co. v. Pa. PUC,* 412 A.2d 903 (Pa. Cmwlth. 1980). (MEPN MB at 60 – 61, R.D. at 94). It should be noted that in *Dauphin*, the Commission adopted the ALJ's recommendation and rejected inclusion of a pay raise which employees began to receive nine months after the test year end.

2. ALJs' Recommendation

The ALJs found that the OCA's proposal to eliminate the Companies' post-test year payroll increase adjustments for employees should be rejected stating that these costs are known and measurable and are either contractually required by collective bargaining agreements or are reasonable management actions to promote the retention of experienced, skilled non-union employees. *See, Pa. PUC v. Pennsylvania-American Water Co.* 2002 Pa. P.U.C. LEXIS 1, which allowed an annualization of salary increases for union and non-union employees for a six-month period following the future test year. *Pa. PUC v. Pennsylvania-American Water Co.* 1995 Pa. P.U.C. LEXIS 170. In this case the Commission allowed a similar company adjustment which was to be implemented within six months of the end of the future test year. In *Pa. PUC v. National Fuel Gas Distribution Corp.* 73 Pa. P.U.C. 552 (1990), the Commission allowed the company to project both union and non-union payroll increases for five months beyond the end of the future test year. In *Pa. PUC v. UGI Corp.* 58 Pa. P.U.C. 155 (1984), the Commission allowed both union and salary increases imputed by the Company during the first six months following the end of the future test year.

In rejecting OCA's proposal to eliminate the Companies' post-test year payroll increase adjustments, the ALJs also rejected the OCA's proposed incremental benefits expense and payroll taxes adjustments that would have been necessary if the OCA's proposal to eliminate the Companies' post-test year payroll increase adjustments had been accepted. (OCA MB at 46 – 47; R.D. at 95, 96).

3. Disposition

No Party excepts to the ALJs' recommendation in regard adoption of the OCA's adjustments. Finding the ALJs' recommendation to be reasonable, appropriate and in accordance with the record evidence, it is adopted.

C. Pension Expense

1. Positions of the Parties

MEPN claimed test year pension expense of $2,842,000 and $2,827,000, respectively, based upon the service cost component of pension costs under Statement of Financial Accounting Standards (SFAS) No. 87. However, the Companies testimony stated that no actual cash contributions to the pension plan will be made in 2006 or 2007. (OTS Exh. No. 2, Sch. 1). The plans are currently over-funded because of substantial payments made in 2004 and 2005. (R.D. at 95). In 2004 and 2005 ME made pension contributions of $38.8 and $35.0 million and PN made pension contributions of $50.3 and $20.0 million, respectively. (MEPN Sts. 4-R, Exh. RAD – 79).

The OTS contended that the Companies' pension expense claims are not based on sound ratemaking principles and must be rejected. The OTS explained that the purpose of SFAS No. 87 is to allow the user of the financial statements to compare the pension plans and expenses among different companies. SFAS No. 87 does not, however, address funding requirements of pension plans or the ratemaking treatment of the expense; therefore, the amount is not designed to be recovered in a rate proceeding as proposed by the Companies. Moreover, the Companies use of a single cost component to determine their pension expense claims improperly inflated their pension claims for ratemaking purposes because the Companies failed to offset the service cost by the return on plan assets. (R.D. at 95 – 96).

The OCA agreed with the OTS' criticism of the Companies' proposal. The OCA stated that using only the service cost component of pension costs under SFAS No. 87 will always result in a positive outcome whether any cash contribution is made or whether the SFAS No. 87 amount is negative or positive. (OCA MB at 46; Tr. at 931).

Both the OTS and the OCA point out that the Commission has commonly utilized the principle that recovery of pension expense is limited to recovery of actual cash contributions to the pension fund, citing *Pa. PUC v. West Penn Power Co.* 73 Pa. PUC 454, 119 PUR4th. 110 (1990), *Pa. PUC v. Metropolitan Edison Co.* 78 Pa. PUC 124 (1993). Inasmuch as the Companies made no cash contributions to the pension fund in the 2006 future test year, and do not plan to make any cash contributions in 2007 both the OTS and the OCA contend that the Companies' pension expense claims should not be allowed. (R.D. at 96).

The Companies contend that the Commission has departed from the actual cash contribution principle, citing *Pa. PUC v. PPL Electric Utilities Corporation* (*PPL*), Docket No. R-00049255, (Order entered December 22, 2004), in which the Commission approved PPL's calculation of pension expenses on an accrual basis. (R.D. at 96). PPL was permitted to use accrual accounting in its 1995 base rate proceeding and that accounting methodology was reaffirmed in PPL's 2004 proceeding. ME requested to change to accrual accounting in its 1993 rate case and its request was expressly denied by the Commission. *Pa. PUC v. Metropolitan Edison Co.* 78 Pa. PUC 124 (1993).

In the alternative, the Companies argued that if the Commission uses the actual cash allowance method for pension expense, it should take a longer term view and adopt the Companies' method of (i) using actual payments made in 2004 and 2005, (ii) using the appropriate percentage assigned to O&M expenses, and (iii) dividing by ten years to get a normalized pension expense. The Companies contend that this longer term view of periodic cash contributions is consistent with the Commission's calculation of net negative salvage claims which has been a long accepted Commission policy. (R.D. at 97). The portion of pension contributions allocated to O&M expense is 56.52 percent for ME and 44.25 percent for PN. (MEPN Sts. 4 R, Exh. RAD – 79).

The OTS pointed out that this proposal ignores the fundamental principle that ratemaking is designed to be forward looking, and that the purpose of the future test year is to establish an on-going level of expense. The Companies will not make a pension contribution in the future test year or in the foreseeable future; therefore, this alternative proposal must also be rejected. (OTS MB at 16; R.D. at 97).

2. ALJs' Recommendation

The ALJs agreed with the position taken by the OTS and the OCA. The Commission's prior decisions are clear; pension expense should be recovered on a cash only basis. Additionally, the Companies pension trusts are over funded and IRS regulations do not allow for tax deductible contributions in this situation. *Pa. PUC v. West Penn Power Co.* 1994 Pa. PUC LEXIS 144. (R.D. at 96 97).

The ALJs found that the Companies have failed to meet their burden of proof to demonstrate that the Commission should depart from prior practice and calculate pension expense on an accrual basis. (R.D. at 96).

Additionally, the ALJs found that the use of the actual cash contribution method prohibits use of the Companies' normalization proposal. The plain facts are that the Companies made no cash contributions to the pension funds in 2006, do not plan to make any actual cash contributions in 2007 and have no definite plans to make actual cash contributions to their over funded pension plans in the foreseeable future. (R.D. at 97).

For all of the foregoing reasons, the ALJs adopted the OTS' adjustment and found that the claimed pension expense of $2,842,000 for ME and $2,827,000 for PN should be disallowed.

3. Exceptions

In its Exceptions, the Companies contend that the ALJs improperly failed to adopt either their service component or alternative normalization methodologies as a basis to recover pension expense from ratepayers. The Companies assert that the ALJs' disallowances are contrary to recent Commission precedent and sound public policy. (MEPN Exc. at 25 – 26).

In their Reply Exceptions, the OCA pointed out that the ALJs recognized that the Commission has commonly utilized the principle that recovery of pension expense is limited to actual contributions to the fund and that the ALJs correctly noted 'the plain facts are that the Companies made no cash contributions to the pension funds in 2006, do not plan to make any actual cash contributions in 2007 and have no definite plans to make actual cash contributions to their over funded pension plans in the foreseeable future. (R.D. at 96 – 97; OCA R.Exc. at 18). Additionally, the OCA emphasized that the Companies method of using only the service cost component of the pension costs under SFAS No. 87 will ***always*** result in a positive outcome because the service component ignores the extent to which sufficient pension fund assets already exist to meet the pension obligations that result from the service provided by the current employees. (OCA M.B. at 47; Tr. 931; OCA St. 3 at 15; OCA R.Exc. at 19).

The OTS, in their Reply Exception to this issue, addresses the Companies' assertion that the only way to recover pension expense through rates is to contribute to pension funds only when a base rate case is planned. The Companies take this argument one step further and state that this could lead to recovery in rates of substantial pension contributions that would not be replicated for some time. (MEPN Exc. at 26). This slippery slope argument fails to acknowledge that utilities are required to make contributions to pension funds subject to minimum ERISA requirements and maximum limitations of the Internal Revenue Code. These rules ensure that pension contributions are sufficient to meet future obligations and do not result in excessive asset levels. As an added protection against over recovery through rates, the OTS and OCA participate in base rate proceedings and analyze expenses claimed by the utility to ensure that ratepayers will not be harmed. Therefore, the concern of the Companies that use of the actual cash contribution method may harm ratepayers because it sends a signal to utilities to make high pension contributions only when a base rate case is planned, is without merit. (OTS R.Exc. at 10 – 11). At page thirteen of its Reply Exceptions, the OTS states that the Companies' Exceptions fail to recognize that there is long standing Commission precedent controlling the net negative salvage calculation, determining a consolidated tax adjustment based on the modified effective tax rate method, and recovery of pension expense under the actual cash contribution method. Each ratemaking item is dealt with in a separate and very distinct way. The Companies' misguided attempt to compare treatment of pension expense with net negative salvage and consolidated tax savings violates fundamental ratemaking principles and fails to provide a sound justification to grant its request to normalize out of test year pension expense over a ten year period. Therefore, the recommendation to disallow the claimed pension expense should be adopted by the Commission.

4. Disposition

In prior Commission decisions, we have allowed utilities to include within base rates only the amount of actual pension contributions made during the test year. In *PPL* we allowed the company to use an accrual method, similar to what is used to account for benefits other than pensions to retired employees, to develop its expense level for pension contributions. We re-affirmed this accrual method for PPL in its subsequent base rate proceeding. Fundamentally, we believe that, regarding the recovery of pension expense, the alternative method requested by MEPN in this proceeding is fair to both ratepayers and stockholders. The Companies' normalization methodology will provide a more consistent and less variable expense claim to be included within base rates as compared to the more significant sums contributed in the two years preceding the 2006 test year in this proceeding. Additionally, we should not ignore this significant benefit to current and former employees just because the Companies' did not make a contribution to the pension fund during any given year.

We do not find the Companies' being barred from making a tax deductible contribution for federal income tax purposes to be persuasive. The development of base rates and the computation of net income for federal tax purposes may have similarities, but they also have significant differences, and we believe that tax deductibility should not govern the appropriateness of inclusion of any expense item within the development of a utility's revenue requirement.

We shall grant the Companies' alternative normalization methodology for recovery of pension expense over a ten year period. We believe that it is incumbent upon us to develop base rates that are just and reasonable not only to the ratepayer but to the company as well. Therefore, based upon the discussion above we shall deny the Parties Exceptions to this issue and grant the Companies' request. This will provide for an allowance of pension expense of $3,842 million and $2,984 million for ME and PN, respectively.

D. Other Post Employment Benefits (OPEB)

1. Positions of the Parties

ME's test year OPEB expense claim is $1,227,000 and PN's is $1,297,000, based upon the service cost component of SFAS No. 106. The Companies' justification is that the actuarial-determined service cost component of SFAS No. 106 should be used to determine the Companies' OPEB expense in this case for the same reasons the service cost should be used to determine the Companies' pension expense.

The OCA, in an attempt to be philosophically consistent with its argument regarding the need to use all components under SFAS No. 87 in relation to pension expense, argues that the Companies must use the full actuarial cost pursuant to SFAS No. 106. This results in an OCA proposed increase in OPEB expense. (R.D. at 98).

2. ALJs' Recommendation

The ALJs found that the Companies have established the level of expense for OPEB for which they have provided proof. As the parties with the burden of proof on this issue, the ALJs determined that the Companies only proved by a preponderance of the evidence that their just and reasonable OPEB expense is $1,227,000 for ME and $1,297,000 for PN. This is the level of expense of which all other parties and the Companies' customers were given notice. As such, the ALJs opined that the initial claim established a 'cap' on the claim for this proceeding. Consequently, the ALJs recommended rejection of the OCA's adjustment and approval the Companies' OPEB expense claim. (R.D. at 98).

3. Disposition

No Party excepts to the ALJs' recommendation in regard adoption of the OCA's adjustments. Finding the ALJs' recommendation to be reasonable, appropriate and in accordance with the record evidence, it is adopted.

E. Rate Case Expense

1. Positions of the Parties

The Companies requested $2.5 million in rate case expense to be amortized over three years, which results in an annual claim of $833,333. No party has taken issue with the Companies' rate case expense level. However, the OTS seeks normalization over five years rather than three years as proposed by the Companies. (R.D. at 98).

The Companies argued that there is no basis for normalizing this claim over five years. They claimed that the OTS' attempt to analyze historic rate case filings to develop the five year period is misplaced for a few reasons: (i) because of rate caps, there have been very few rate cases for over a decade so no meaningful information can be determined from past history, (ii) since the Companies' transmission and distribution rate caps have now expired, there is a greater likelihood of more frequent rate filings (it has been less than three years since the Companies' T&D rate caps expired and they are already seeking relief), and (iii) PPL's request for a two year normalization of rate case expense in its 2004 distribution rate case was unopposed and adopted by the Commission. (R.D. at 99).

The OTS contends that the arguments posited by the Companies are baseless and must be rejected in favor of the OTS recommended five year normalization period. (R.D. at 99).

2. ALJs' Recommendation

The ALJs explained that with regard to the first argument put forth by the Companies, the OTS recognized that the rate caps prevented a rate case filing in the last decade; however, a review of the filing frequency before the implementation of the rate caps reveals that the Companies had unusually long intervals between rate case filings. For example, ME's most recent rate cases were filed in 1984 and 1992 and PN's most recent rate case was filed in 1984. Although the Competition Act established the rate caps, nothing prevented the Companies from filing rate cases on a regular basis prior to 1996. Although it is convenient to use the rate caps as a justification for an expedited recovery period, a three year recovery period is unwarranted given ME's and PN's history of long stay outs between rate case filings. (R.D. at 99).

Second, the Companies assertion that there is a 'greater likelihood' of more frequent filings now that rate caps have expired is merely a statement of future intentions, which is highly speculative. The Commission relies on a filing history because that history is the most reliable barometer of when future rate cases will be filed. The filing history of MEPN does not support a three year filing cycle. The Companies' request to ignore those facts and instead rely on unpredictable future intentions must be rejected. (R.D. at 99 100).

Finally, the Companies' reliance on the PPL case is wholly irrelevant because normalization periods are specific to each company and are based on the historic frequency of base rate case filings. (R.D. at 100).

Upon consideration of both Parties' arguments, the ALJs recommended adoption of the OTS' position. In *Popowsky v. Pa. PUC*, 674 A.2d 1149 (Pa. Cmwlth. 1996), the Commonwealth Court held that the period of normalization is determined by examining the utility's actual historical rate filings, not upon the utility's intentions. *Popowsky*, 674 A.2d at 1154. The ALJs found that the OTS demonstrated that the Companies' rate case filing history prior to the Competition Act does not justify a 3 year normalization. Adoption of the OTS' proposed 5 year normalization accounts for the Companies' long gaps between filings before the Competition Act prevented filings and the fact that from 1996 until 2004 the Companies were barred from filing. (R.D. at 100).

Accordingly, based upon the discussion above, the ALJs found that the OTS' $333,333 reduction in rate case expense for MEPN must be accepted because it properly normalizes rate case expense over five years in lieu of the requested three year period.

3. Disposition

No Party excepts to the ALJs' recommendation in regard to the adoption of the OTS' adjustments. Finding the ALJs' recommendation to be reasonable, appropriate and in accordance with the record evidence, it is adopted.

F. Consolidated Tax Savings

1. Positions of the Parties

The Companies have developed their normalized federal income tax expense claims of ($39.255) million for ME and ($14.504) million for PN on a stand-alone basis. The OCA and the OTS proposed a consolidated tax savings adjustment based on the modified effective tax rate method[12] with a three year historical average[13] (MEPN MB at 64; R.D. at 100).

The Companies contended that the stand-alone approach to tax expense is appropriate for them because post restructuring, there is no longer any basis for passing unregulated operations' income tax benefits through the consolidated tax process. The Companies believe that what they describe as 'blind adherence to the actual taxes paid doctrine' is inappropriate. The Companies stated that the Commission should use this proceeding to address the economics of the consolidated federal income tax adjustment in a deregulated post-restructuring environment and adopt the Companies' stand-alone approach. (MEPN MB at 64 – 65; R.D. at 101).

In the alternative, the Companies posit that if the Commission nonetheless adopts the modified effective tax rate method to calculate consolidated tax savings, it must, in order to address these issues in a fair and equitable manner, do the following: (i) net both operating income (positive) and losses (negative) of the unregulated affiliates for the period 2003-2005, rather than selectively using only losses; (ii) exclude the losses of FirstEnergy's subsidiaries that existed in 2003-2005 but do not exist today; and (iii)

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12 The Modified Effective Tax Method excludes Investment Tax Credits and losses of regulated companies to prevent the flow-through of accelerated depreciation benefits. These exclusions are made to eliminate any concerns of potential IRS violations in these areas. (OTS St. No. 2 at 22).

13 The time period selected is representative of the prospective period in which the rates being set will be in effect. (OTS St. No. 2 at 21).

remove from the calculation the federal tax benefit of Merger debt interest expense. The Companies stated that if these adjustments are made there is no net tax benefit from blending the tax results of FirstEnergy's unregulated affiliates with the Companies. (MEPN MB at 65; R.D. at 101).

The OTS pointed out that the Companies do not file federal income taxes on a stand-alone basis; rather, their federal income taxes are filed as part of a consolidated group under the parent corporation, FirstEnergy. By filing a consolidated federal income tax return, tax savings arise because companies with negative taxable incomes offset the positive taxable incomes of other companies. Overall, this consolidation creates a lower net taxable income and generates a smaller actual income tax liability than if the same companies filed on a stand-alone basis. (OTS MB at 27· R.D. at 101).

The OTS opines that the Companies' failure to reflect these consolidated income tax savings violates both Pennsylvania judicial and Commission precedent because, for ratemaking purposes, these taxes are not actually payable due to the filing of a consolidated return and each company's participation in that return. Under the 'actual taxes paid' doctrine, enunciated by the Pennsylvania Supreme Court in *Barasch v. Pa. PUC*, 507 Pa. 496, 491 A.2d 94 (1985), the practice of setting rates on a utility's stand-alone tax expense was rejected. The OTS stated that it is improper to include, for ratemaking purposes, tax expenses which, because of the filing of a consolidated tax return, are not actually payable. Accordingly, all tax savings arising out of participation in a consolidated return must be recognized in ratemaking; otherwise a fictitious expense will be included in rates charged to ratepayers. (OTS MB at 27· R.D. at 102).

Similarly, the OCA stated that the filing of a consolidated income tax return results in utility corporations paying less income tax in a given year than would be paid if each subsidiary filed separate returns. The savings result from the ability to take advantage of the losses of the parent and some unregulated subsidiaries on a consolidated basis by utilizing the income of the regulated utilities and subsidiaries with taxable income to offset those losses. (OCA Statement 3 at 20). OCA also argued that giving consideration to such savings is consistent with the requirements of the Internal Revenue Code. (OCA MB at 49: R.D. at 102).

The OTS used the modified effective tax rate method in accordance with *Barasch v. Pa. PUC*, 548 A.2d 1310 (Pa. Cmwlth.1988). *See, also, Pa. PUC v. Pennsylvania Power and Light Co.* 85 Pa. PUC 306 (1995). Pursuant to this case law. the OTS calculated a three year average of FirstEnergy consolidated tax savings and then allocated the tax savings generated by non-regulated companies to all regulated and non-regulated companies that have positive taxable incomes based on the percentage that each member's taxable income bears to the total of all positive taxable incomes in the group. (OTS (ME) St. No. 2 p. 20 – 23, OTS (PN) St, No. 2 p. 21 – 23; OTS MB at 28; R.D. at 102).

The OCA determined the tax savings attributable to the Companies in this proceeding by calculating the difference between the aggregate taxes that would have been paid on separate returns and taxes paid on a consolidated basis, and then determining the Companies' share of that difference. The OCA proposed that the average savings for a three year period be used in order to normalize the results and smooth out any fluctuations from year to year. (OCA MB at 49: R.D. at 103).

2. ALJs' Recommendation

The ALJs supported the OTS' and the OCA's use of the modified effective tax rate method as proper and in accord with Pennsylvania law. This comports with the actual taxes paid doctrine so that all tax savings arising out of participation in a