consolidated return are recognized in ratemaking and fictitious expenses will not be included in rates charged to ratepayers. (R.D. at 103).

The ALJs also found that the Companies' first proposed modification to the OTS' way of employing the modified effective tax rate method, (of netting both operating income (positive) and losses (negative) from the unregulated affiliates for the period 2003-2005, rather than selectively using only losses), must be rejected. This proposal ignores the very intent of the consolidated tax adjustment, which is to pass through to ratepayers the benefits of filing as part of a consolidated group. It is proper to allocate only the net losses because the OTS consolidated tax adjustment accounts for taxable income of all companies, both regulated and unregulated. The Companies' attempt to improperly change the allocation would allow them to obtain a disproportionate share of the losses by failing to recognize the total savings which would be shared by the consolidated group. As a result, less of the tax savings would be passed on to ratepayers. (MEPN MB at 65; R.D. at 103).

The ALJs noted that the OTS agreed with the Companies' second proposal, that the losses of subsidiaries that existed in 2003 – 2005 but no longer exist today must be excluded, and found that this modification is proper. (R.D. at 103).

Additionally. the ALJs noted that the Companies' third proposal, that the federal tax benefit of merger debt interest expense be removed, has been accomplished in the OTS' and the OCA's exclusion of this item from their proposed capital structures of the Companies. (OTS St. No. 1 at 12; OCA St. No. 3 – S at 13; R.D. at 104).

For the reasons set forth above, the ALJs recommended adoption of the OTS' consolidated tax adjustment of $3,281,070[14] for ME and $212,610 for PN. (OTS St. 2-SR, Exh. 2, Sch. 4, ME/Revised; OTS St. 2-SR, Exh. 2, Sch. 4, PN Revised; R.D. at 104). These revised OTS adjustments account for the proper use of taxable income in lieu of tax liability for 2003 and 2004 as well as the exclusion of subsidiaries which no longer existed in 2005. Additionally, the OTS included other loss subsidiaries that were originally overlooked in its originally proposed adjustment.

3. Exceptions and Replies

MEPN except to the ALJs' adoption of the consolidated tax savings adjustment, which is based upon the modified effective tax rate method and utilized a three year average. Additionally, the Companies state that the ALJs made two technical errors, regarding merger debt interest and the elimination of loss subsidiaries that existed in 2003 – 2005 but no longer exist today. Finally, the Companies believe that the calculation should include both gain subsidiaries and loss subsidiaries. (MEPN Exc. at 29 – 31).

In its Reply Exceptions, the OTS states the ALJs correctly held that ME's and PN's calculation of federal income tax liability on a stand-alone, separate company basis violates the actual taxes paid doctrine because it does not recognize tax savings that arise out of participating in a consolidated return. The OTS states 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, the ALJs' adoption of the OTS consolidated tax adjustment properly recognized tax savings arising out of participation in a consolidated return and ensured that fictitious expenses will not be included in rates charged to ratepayers. (OTS R.Exc. at 14; R.D. at 103). Further, the

[14] In Reply Exceptions the Parties agreed to Tables showing the OTS' adjustment to be ($5,364,000) for ME and ($212,610) for PN.

OTS states, in its Reply to this issue, that it has eliminated merger debt interest from the capital structure of the Companies thus removing the potential for any double accounting. (OTS R.Exc. at 15, n. 21, OTS St. No. 1 at 12). Lastly, the Companies' Exception asserting the ALJs failed to net the losses of all unregulated subsidiaries against their gains, in OTS' opinion, ignores the intent of the consolidated tax adjustment by failing to recognize the total savings which will be shared by the consolidated group. (OTS R.Exc. at 16).

In its Reply Exceptions, the OCA states that the Companies Exception regarding adoption of the modified effective tax rate method should be denied because to grant the Exception would not be in accord with Pennsylvania law. (OCA R.Exc. at 19 – 20).

4. Disposition

The OTS has employed the modified effective tax rate method utilizing a three year average, to compute its consolidated tax adjustment. Upon review of the OTS computation, the Companies offered refinements to the subsidiaries included within the three year average data. These refinements, along with several others, were incorporated into the final adjustments adopted by the ALJs. We believe that the ALJs properly rejected the Companies modification to net operating income as well as operating losses from unregulated affiliates to compute the tax savings. To do this, as explained by the ALJs, would ignore the intent of the adjustment. We also agree with the ALJs finding that the OTS and OCA's exclusion of merger debt from the capital structure is a proper reflection of that debt interest and it need not be removed from the computation of federal income tax also, as it pertains to the issue of consolidated tax savings.

Accordingly, we shall adopt the recommendation of the ALJs and accept the consolidated tax savings adjustments as provided in the consensus tables provided by the Companies.

G. Investment Tax Credits and Excess Deferred Income Taxes

1. Positions of the Parties

Without proposing any particular adjustment, the OCA claimed that the Companies incurred a 'windfall' associated with the treatment of unamortized Investment Tax Credits (ITC) and Excess Deferred Income Taxes (EDIT) under the Restructuring Settlement. However, the OCA acknowledged that the Companies' affiliate Jersey Central Power & Light (JCP&L) sought and obtained a Private Letter Ruling from the Internal Revenue Service (IRS) in which the IRS determined that to flow-back the ITC and EDIT would constitute a tax normalization violation. Despite this fact, the OCA still insists the Companies obtained a 'windfall' and should have taken action directly with the IRS. (R.D. at 104).

2. ALJs' Recommendation

The ALJs agreed with the Companies that for them to have filed anything with the IRS after JCP&L received a Private Letter Ruling would have been futile. The ALJs found that because the Companies retained no benefit they were not permitted to have (i.e. they were not required to flow back these ITC and EDIT), there can be no 'windfall' as OCA alleged. The prevailing IRS view is that the accumulated tax benefits of the ITC and EDIT cannot be flowed back to customers.[15] The Companies' stranded cost determinations in 2000 already reflected that view and, as such, there is no need to

[15] Under IRS Regulation 1.46-6(b)4, a normalization violation would also occur if an indirect reduction in rates is intended to achieve a similar cost of service or rate base reduction.

make any adjustment to stranded costs for these items in this proceeding, which would result in a tax normalization violation. (R.D. at 104).

The ALJs found that there is no basis for any adjustments to the Companies' stranded costs as a result of the treatment of ITC and EDIT under the Restructuring Settlement.

3. Disposition

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

H. Decommissioning Costs

1. Positions of the Parties

The Companies' claims for TMI-2 decommissioning expenses reflect a decrease of $6.635 million for ME and a $7.817 million increase for PN. These revised estimates are based on a 2004 site specific study. The Companies stated that these revised decommissioning costs will ensure adequate funding for important health and safety issues. The Companies are seeking additional decommissioning funding in the amount of $15,600,000 (32% share) for ME and of $11,700,000 (24% share) for PN of Saxton[16] expenditures since 1999. These additional decommissioning costs are proposed

[16] The Saxton nuclear facility, located in Bedford County, Pennsylvania began operations in November 1961 and shut down in May 1972. It had a net power output of 23.5 MW-thermal, and its purposes were primarily to research various aspects of nuclear reactor technology and to train personnel. The owners/operators were Saxton Nuclear Experimental Corp (SNEC) and GPU Nuclear. The plant has been decommissioned, and in November, 2005 the NRC released the site for unrestricted use. (http://en.wikipedia.org/wiki/Saxton_Nuclear_Generating_Station)

to be reflected in the Companies' CTC rates, to enable full recovery from customers by December 31, 2010, for ME and December 31, 2009, for PN. The Companies point out that the Competition Act supports the recovery of decommissioning costs based on new information that was not previously available, citing Section 2804(4)(iii)(F) of the Code, 66 Pa. C.S. § 2804(4)(iii)(F). (MEPN Sts. 4 at 34 – 38; R.D. at 105).

In its testimony, the OCA rejected the Companies' TMI-2 decommissioning claims on two grounds: first, that a license extension may be filed for TMI-2; second, that the nineteen percent contingency for TMI-2 decommissioning is not appropriate. The OCA accepted the Companies' decommissioning claims for Saxton, because these costs were not known during restructuring and were incurred after 1998. (R.D. at 105).

In their Recommended Decision, the ALJs mistakenly determined that the OCA did not brief its position regarding a decommissioning funding allowance for TMI-2 as part of its stranded cost requirement. Therefore, the ALJs determined that 'consequently, [their arguments] are waived. The ALJs then concluded that the Companies' decommissioning expense increase claims are supported by a preponderance of the evidence and should be approved. (R.D. at 105 – 106). The OCA did address the Companies' proposals in both Main and Reply Briefs. (OCA MB at 87 88; OCA RB at 53). Therefore, the ALJs' comment that OCA waived this issue is in error.

The OCA advocated that the Companies' estimates of the appropriate level of decommissioning funding for TMI-2 should be rejected and the allowance for TMI-2 decommissioning as part of stranded cost in this case should be set at zero ($0). (OCA MB at 87).

The OCA stated that the Companies' claims are overstated due to their assumptions that the anticipated life extension request for the TMI-1 plant should not be reflected and the Companies' use of an unnecessarily high contingency factor. (OCA MB at 87). The OCA stated that any allowance for TMI-2 decommissioning costs must consider the life extension request of TMI-1. (OCA MB at 87 citing OCA St. 3 at 26). This postponement 'will reduce the need for additional funding contributions because the earnings in the decommissioning fund asset are expected to exceed decommissioning cost escalation. (OCA MB at 87 quoting OCA St. 3 at 27).

The OCA stated further that the Companies' estimated contingency allowance was more than twice the amount approved by the Commission in the Companies' restructuring proceedings and the contingency allowance approved in the last electric utility rate proceeding before restructuring. (OCA MB at 87 citing OCA St. 3 at 28). Therefore, the OCA believes that no additional contributions are required beyond that already scheduled for the Companies, even assuming no life extension occurs and utilizing only a 10% contingency allowance. (OCA MB at 88, citing OCA St. 3 at 28, Exh. TSC-3 at 2 and TSC-4 at 2).

The OCA stated that, even if the life extension is not filed, 'the decommissioning process is scheduled to take over 20 years. This will certainly provide Met-Ed and Penelec adequate time to collect any additional funds necessary and still take advantage of the [decommissioning] synergies available. (OCA RB at 53, quoting OCA St. 3S at 17).

Accordingly, the OCA believes that there is substantial record evidence that the Companies' stranded cost recovery allowance for funding TMI-2 nuclear decommissioning costs should be set at zero ($0) in this case. (OCA Exh. at 33 – 35; TS-3 at 2 and Exh. TS 4 at 2).

2. ALJs' Recommendation

In its testimony, the OSBA does not address the claim with respect to ME, where there is a net decrease in all nuclear decommissioning costs (i.e. TMI-2 and Saxton) suggesting concurrence with the ME claims. With respect to PN, where there is a net increase in all nuclear decommissioning costs, the OSBA appears to oppose the request for funding. (R.D. at 105).

The OSBA did not brief these issues. Consequently, their arguments are waived. *Jackson v. Kassab*, 2002 Pa. Super. 370, 812 A.2d 1233 (2002), *appeal denied, Jackson v. Kassab*, 573 Pa. 698, 825 A.2d 1261 (2003), *Brown v. PA Dep't of Transportation*, 843 A.2d 429 (Pa. Cmwlth. 2004), *appeal denied*, 581 Pa. 681, 863 A.2d 1149 (2004).

The ALJs found that MEPN's TMI-2 decommissioning expense claims are supported by a preponderance of the evidence, are just and reasonable, and should be approved.

Additionally, the ALJs also found that the Companies' claims for additional Saxton decommissioning expense are supported by a preponderance of the evidence, are just and reasonable, and should be approved. (R.D. at 106).

3. Exceptions

The OCA excepted to the ALJs' finding that they did not brief this issue and has provided a detailed explanation of their position within their Main Brief and Exceptions. Notably, the OCA contends that the Companies' claims for decommissioning of TMI should be rejected as explained above.

In reply, the Companies state that the ALJs' holding regarding ME's TMI-2 decommissioning expense claim (a decrease of $6.6 million) and PN's $7.8 million decommissioning expense increase, is supported by a preponderance of the evidence, is just and reasonable, and should be approved. MEPN state that it is not appropriate to reject the TMI-2 claims based upon the unsupported assertion that a delay in decommissioning may occur due to the granting of a license extension for TMI-1. (MEPN R.Exc. at 14 15; R.D. at 105-106).

4. Disposition

We have reviewed the record evidence regarding the Companies' claimed decommissioning expense and find that the ALJs recommendation is reasonable. We do not find the arguments of the OCA to be persuasive, therefore, we shall adopt the recommendation of the ALJs and allow the Companies' claimed expense for decommissioning.

I. Community Action Association of Pennsylvania (CAAP) Claim

1. Position of the Parties

CAAP seeks an increase in the Companies' low income usage reduction programs (LIURP), called WARM, commensurate with any approved residential rate increase. CAAP explains that the Companies' WARM programs are designed to help low income customers reduce their energy consumption through education and conservation measures. In the current proceeding, for their WARM programs, ME proposes to spend $1,826,000 in 2006 while PN proposes to spend $1,962,000 in that same year. Those proposed spending levels are the same as the Companies' spent in 2002. In the present proceeding, if the Companies' requests are granted, rates for residential customers will increase and in order to ensure that the Companies' WARM programs remain appropriately funded and available, it is necessary to increase funding for those programs commensurate with any rate increase imposed upon the residential class.

CAAP also points out that in its Declaration of Policy, the Competition Act provides in pertinent part that: 'The Commonwealth must, at a minimum, continue the protections, policies and services that now assist customers who are low income to afford electric service. Section 2801(10) of the Code, 66 Pa. C.S. § 2801(10).

CAAP argues that allowing residential rates to increase without a commensurate increase in the Companies' WARM programs would not comport with this express policy of the Competition Act.

Citizen Power states that CAAP's proposal is modest, and should be accepted.

2. ALJs' Recommendation

CAAP chose to brief only one of its five proposals, namely that each Company's LIURP program be increased by the same percentage amount of any rate increase granted in this proceeding. Accordingly, the ALJs determined that CAAP's remaining proposals were waived. *Jackson v. Kassab*, 2002 Pa. Super. 370, 812 A.2d 1233 (2002), *appeal denied*, *Jackson v. Kassab*, 573 Pa. 698, 825 A.2d 1261 (2003), *Brown v. PA Dep't of Transportation*, 843 A.2d 429 (Pa. Cmwlth. 2004), *appeal denied*, 581 Pa. 681, 863 A.2d 1149 (2004).

The ALJs found that by providing an increase to the Companies' WARM programs' funding levels commensurate to the increase allowed in residential rates, the Companies' LIURP protection and services will continue to be maintained as envisioned by the Competition Act. Accordingly, the ALJs found that CAAP's proposal should be approved.

3. Disposition

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

J. Conservation and Renewable Initiatives: Retention of Riders and PennFuture Initiatives

1. Sustainable Energy Fund Riders

a. Positions of the Parties

The Companies proposed to eliminate both ME Rider G and PN Rider I from their tariffs. MEIUG, PICA and IECPA support the Companies' proposal while the Community Foundations[17] and Citizen Power seek to retain these Riders. (SEF MB; Citizens MB at 40; R.D. at 108).

Each Rider states that '[t]he Company will establish a sustainable energy fund which shall be funded from the Distribution Charges in each Rate Schedule at the rate of 0.01 cents per KWH (less applicable gross receipts tax) on all KWH delivered to all Customers beginning on January 1, 2008 and continue until the Commission establishes new Distribution Charge rates. (Electric Pa. P.U.C. (Sup. 37); Second Revised Page 168; Effective: August 23, 2005).

[17] Sustainable Energy Fund administrators for MEPN are the Berks County Community Foundation and the Community Foundation of the Alleghenies respectively.

At the time of the Restructuring Settlement, on December 31, 1998, the Companies funded the SEF through a combined lump sum payment of $12.1 million, $5.7 million from ME and $6.4 million from PN. This payment delayed implementation of the 0.01¢ per kWh charge for each Company until January 1, 2005, when the transmission and distribution rate caps were set to expire. (ALJ Exh. 1 at 49). In effect, the Companies agreed to forego 0.01 cents per kWh of distribution revenues to which shareholders would otherwise have been entitled as part of the unbundling of rates for purposes of funding the SEF. As part of the settlement resolving the GPU/FirstEnergy merger in 2001, the Companies agreed to provide another lump sum payment totaling $5 million, thereby further delaying implementation of the 0.01¢ per kWh charge until January 1, 2008. Thus, the burden of this funding has never been borne by the ratepayers; rather, the Companies' shareholders have shouldered these costs. (R.D. at 109).

b. ALJs' Recommendation

The Commission has previously determined that SEF funding through distribution charges is to be terminated. Citing to 'the Legislature's creation of a permanent statutory funding source"[18] for endeavors such as those supported by SEF. the Commission held at page 52 in *Pa. PUC v. PPL Electric Utilities Corp.* Docket No. R-00049255 (Order entered December 22, 2004), that 'now is the appropriate time to begin eliminating the use of distribution revenues to support the SEF. *See, also, Pa. PUC v. PPL Electric Utilities Corp.* Docket No. R-00049255, (Order entered April 1, 2005), where the Commission stated that it had accepted PPL's Compliance Filing which included an SEF Rider that phases out PPL's .01 cent per kWh charge to zero as of January 1, 2007 (R.D. at 110).

[18] The reference is to the Alternative Energy Portfolio Standards Act (AEPS) signed into law by Governor Edward G. Rendell on November 30, 2004.

The Commission's stated goal of making the SEF self-sustainable will be advanced by permitting the Companies to eliminate ME Rider G and PN Rider I from their tariffs. As MEIUG and PICA and IECPA point out, if the Companies desire to continue funding the SEF from shareholder funds they are free to do so. (MEIUG/PICA MB at 72; R.D. at 110, 111).

The ALJs stated that the effect of retaining ME Rider G and PN Rider I in their tariffs will be to impose upon ratepayers, commencing January 1, 2008, a charge they have hitherto not paid. MEIUG and PICA and IECPA oppose this shifting of the costs of SEF to ratepayers, in conjunction with the other rate increases proposed in this proceeding, as unduly burdensome. (R.D. at 109, 110).

Based upon the reasoning above, the ALJs support the position of the Companies and recommended elimination of Rider G from ME's tariff and Rider I from PN's tariff. (R.D. at 111).

c. Exceptions

The SEFs except to the ALJs' analysis and recommendation concerning continued funding which concluded that removal of the funding Riders is both just and reasonable and in the public interest. The SEFs stated that their initiatives ultimately assist ratepayers with education and implementation of conservation and renewable initiatives that encourage customers to conserve, among other things. As asserted by the SEFs, when properly viewed in this way, ratepayer funding of such initiatives is not a burden at all. To the contrary, the rate-paying public actually benefits from SEF initiatives. In its Exceptions, the SEFs state that there is undisputed evidence of record which demonstrates that projects they have funded provide benefits to the distribution system and also to distribution service customers. Additionally, from a ratemaking point of view, there is a return to distribution service and to its customers from the funding of SEF projects – a return that justifies continued SEF funding through distribution rates. (SEF Exc. at 2).

The SEFs also except to the ALJs' finding that their interpretation of *Lloyd* is incorrect by finding that the Commonwealth Court did not address the question in this case of whether or not SEF has to be provided at all. (SEF Exc. at 11, R.D. at 110).

Lastly, the SEFs contend that the initiation of the Commission's *Investigation of Conservation, Energy Efficiency Activities, and Demand Side Response by Energy Utilities and Ratemaking Mechanisms to Promote Such Efforts,* Docket No. M-00061984 (Order entered October 11, 2006), supports the continued funding of SEF. (SEF Exc. at 11).

In their Reply to the Exceptions of PennFuture on these issues, MEIUG/PICA support the finding of the ALJs regarding *Lloyd* and stated that the issue in this case is whether the Companies' ratepayers should provide funding at all and does not address continued funding, actually the phase-out of funding, as in *PPL.* (MEIUG/PICA R.Exc. at 22).

In their Reply Exceptions, the Companies state that the Commission's clear position in *PPL* was that 'now is the appropriate time to begin eliminating the use of distribution revenues to support the SEF. (R.D. at 110, quoting *PPL* at 52). According to the Companies, the ALJs further noted that MEPN have already made available significant amounts ($17.1 million) of seed money to the SEFs. (R.D. at 110). In addition, MEPN have already funded SEF through December 31, 2007 (ME St. 4 at 55; PN St. 4 at 49). The Companies contend that the ALJs properly observed that *Lloyd* does not address the question raised in this proceeding, i.e. 'whether or not SEF has to be provided at all. (R.D. at 110). The Companies assert that since the opposing Exceptions offer nothing new on this issue, the ALJs' finding is appropriate. (MEPN R.Exc. at 16).

d. Disposition

Upon review of the record on this issue as well as the Exceptions and Replies of the Parties, we shall adopt the reasoning and recommendation of the ALJs, which is supported by our recent decision in *PPL,* the Companies significant financial contribution to the SEFs, and the ALJs' interpretation of *Lloyd.*

2. PennFuture's Renewable Energy Initiatives

a. Positions of the Parties

PennFuture proposes a variety of renewable energy initiatives to be implemented by the Companies. Only one of the proposals is supported by the Commercial Group; a voluntary real time pricing rate schedule.

The Companies make the following observation about the renewable energy proposals in their Main Brief:

> These new funding initiatives, however well intentioned, were not accompanied by any proposal addressing recovery of program costs. While [the Companies] are not opposed to implementing these types of programs, like [PennFuture's] $30 million for renewable energy programs, the additional $5 million for consumer education regarding the rate caps and [PennFuture's] request for $30.6 million for DSM/energy efficiency expenditures, they can and will do so only if there is a clear and unequivocal rate mechanism in place for allowing for full and timely recovery of all costs incurred/expended in connection with these programs

(MEPN M.B. at 68 – 69).

The OSBA, MEIUG, PICA and IECPA generally argue that PennFuture proposals should not be adopted. However, the OSBA does not oppose PennFuture's real time pricing proposal so long as participation is strictly voluntary and the program costs are recovered solely from participating customers. Additionally, MEIUG and PICA and IECPA do not oppose PennFuture's real time pricing proposal so long as it is limited to generation costs and is strictly voluntary. (R.D. at 111).

b. ALJs' Recommendation

Initially, the ALJs found that PennFuture bears the burden of proof as to its proposals to have the Companies incur expenses that the Companies did not include in their filings. As the proponent of a Commission order with respect to its proposals, PennFuture bears the burden of proof as to those proposals. 66 Pa. C.S. § 332(a). 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[19] 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. (R.D. at 117).

Further, the ALJs found that PennFuture had failed to bear its burden of proof with respect to its rate increase proposals. According to the ALJs, PennFuture provided general ideas, but failed to address specifics for implementation and demonstrate that the proposals are in the public interest. While renewable energy initiatives may well be a laudable goal, credible evidence of their supposed benefits must be adduced. PennFuture has not done so. (R.D. at 118).

[19] 1 Pa. C.S. § 1922(1), *PA Financial Responsibility Assigned Claims Plan v. English*, 541 Pa. 424, 64 A.2d 84 (1995).

The ALJs determined that PennFuture did not prove by a preponderance of the evidence that the additional rate increases it proposed are just and reasonable and in the public interest. PennFuture did not prove by a preponderance of the evidence that imposing standards that exceed those of AEPS with respect to the Companies' inclusion of a specific percentage of electricity from alternative resources is just or reasonable or in the public interest. The ALJs also determined that PennFuture did not prove by a preponderance of the evidence that the implementation of time-of-day pricing on a per kWh basis for the Companies' transmission and distribution rates is just or reasonable or in the public interest.

Accordingly, the ALJs recommended that the proposals put forward by PennFuture should be rejected.

c. Exceptions

In its Exceptions, PennFuture avers that the ALJs erred when they rejected its proposals[20] because (a) the Companies did not oppose the PennFuture proposals, (b) the Recommended Decision misapplied recent Commonwealth Court precedent, (c) the ALJs ignored substantial record evidence regarding the effectiveness and benefits of PennFuture-supported programs, and (d) the ALJs erred in applying AEPS. The PennFuture Parties submit that the Commission should reject the ALJs' recommendation and require the adoption of the renewable energy and other programs described in our testimony and briefs.

[20] R.D. at 111-19; 155-59; 223-26; 235; 255-57. The ALJs also rejected related proposals by other Parties for continued funding of the Sustainable Energy Funds. See, e.g. R.D. at 108-111.

d. Disposition

In deciding this issue, we focus on the provisions of 66 Pa. C.S. § 315(a) regarding burden of proof. Here, PennFuture attempts to place a significant amount of new costs upon the Companies for which the Companies have not requested recovery within their case-in-chief. When this occurs, the burden of proving these new costs are just and reasonable does not shift to the Companies but remains with PennFuture. We agree with the ALJs that PennFuture has not met its burden of proof regarding these new costs. Accordingly, we shall adopt the recommendation of the ALJs on this issue.

IX. RATE OF RETURN

A. Capital Structure

1. Positions of the Parties

MEPN proposed a capital structure consisting of 51% long-term debt and 49% common equity. (MEPN St. 7 at 7) Neither the OCA nor the OTS disagreed and stated that this is reasonable. (OTS St. 1, at 9-10; OCA St. 4, at 10-13). The OTS accepted this capital structure for the purpose of establishing appropriate returns in this proceeding as it is within the range of capital structures used by its witness. (OTS Exh. 1, Sch. 2.). The OCA recommended a capital structure consisting of 51% debt and 49% common equity, based upon its similarity to the Companies' pre-merger capital structures, the proxy group used by its witness and its support of a strong single A credit rating. (OCA St. 4 at 12 & 19: OCA St. 5S at 2). Included in ME's and PN's proposed capital structure are portions of FirstEnergy's merger acquisition debt.

The OCA and the OTS both objected to the methodology by which MEPN arrived at this proposed capital structure. The OCA objected to the methodology because it contends the methodology improperly includes goodwill and amounts to a request by

MEPN to impose an acquisition premium upon the ratepayers. The OCA contended that a condition of the Commission's approval of the FirstEnergy/GPU merger was that the Companies should not reflect in retail rates the acquisition premium. If the ratemaking capital structure is based on the goodwill amounts on the MEPN balance sheets, the OCA argued the acquisition premium is included in setting the authorized rate of return on the rate base for retail delivery service. The OCA concluded that this is improper and inconsistent with the Commission order prohibiting recovery of an acquisition premium through retail rates. (OCA St. 4 at 12-13. OCA St. 4S at 5-6).

Additionally, the OCA argued that while the Companies' method results in a reasonable capital structure in this case, it may not in future cases. (OCA St. 4 at 11-12). According to the OCA, the Companies' method artificially increases the embedded cost of debt component. (OCA St. 4 at 11-12). The OCA argued that the Commission should reject the Companies' procedure that allocates FirstEnergy's acquisition debt to MEPN. (OCA St. 4, at 10-13).

The OTS also argued that the Companies' capital structure is based on the misallocation of debt. To the extent that the Companies calculate the claimed capital structure by including a proportional share of FirstEnergy's debt securities used to finance the acquisition of GPU, the OTS argued the calculation is improper in this proceeding. According to the OTS, only debt used to finance the Companies' rate base is properly included in this proceeding. The OTS contended that including debt for the acquisition of GPU is not appropriate in determining the Companies' capital structure. (OTS M.B. at 32).

In response to the OTS and OCA position opposing allocation of FirstEnergy's acquisition debt to MEPN, the Companies replied that since the acquisition, they have incurred depreciation and amortization expenses and these expenses have altered the equity component of capitalization. MEPN opined that it is unreasonable to assume that an amount equal to the goodwill associated with the acquisition premium continues to be reflected in the equity balance. MEPN stated that an adjustment for any alleged goodwill would be unwarranted and arbitrary. (MEPN 7-R, pp.2-3).

MEPN contended that their recommended capital structure does not attempt to recover the acquisition premium through rates. They noted that when the Commission approved the merger, the Commission did not address determination of the Companies' capital structure for ratemaking purposes nor did the Commission address the appropriate ratemaking treatment of any modifications or adjustments to the capital component due to merger accounting. Therefore, MEPN concluded that their proposed capital structure does not violate the Commission order prohibiting recovery of an acquisition premium through rates. (MEPN 7-R, at 3-4).

MEPN also argued in rebuttal that imputing portions of FirstEnergy's merger acquisition debt to MEPN is entirely appropriate because FirstEnergy used that debt to pay for the assets of the Companies. MEPN also pointed out that the FirstEnergy debt allocated to them was based on ten year and thirty year rates of 4.25% and 4.94%, respectively. These rates are historically among the lowest rates for ten and thirty year debt over the past twenty years. (MEPN 7-R, at 4-6).

2. ALJs' Recommendation

The ALJs recommended adoption of a capital structure of 51% long-term debt and 49% common equity. The ALJs found that all of the Parties agreed that this capital structure is appropriate, and concluded that it was reasonable to adopt it. (R.D. at 121).

In regard to the OTS and the OCA disagreement with the MEPN methodology used to arrive at this capital structure, the ALJs agreed with the OCA and the OTS position and rejected ME's and PN's methodology. The ALJs noted that MEPN stated that their proposed capital structures contain a portion of the FirstEnergy merger acquisition debt. According to the ALJs, a portion of the money that FirstEnergy borrowed to finance the merger represents the premium it paid to acquire GPU. The ALJs reasoned that if ME's and PN's proposed capital structure includes FirstEnergy debt, it would have to include a portion of the money borrowed to pay the acquisition premium for GPU. Therefore, rates based on a capital structure that includes a portion of the money borrowed to pay the acquisition premium would allow recovery of the premium through those rates. The ALJs concluded that ME's and PN's methodology is inconsistent with previous Commission rulings in the Merger Savings Remand Proceeding that the Companies should not collect the acquisition premium in retail rates. (R.D. at 121-122).

B. Cost of Capital

1. Positions of the Parties

MEPN proposed an average effective cost of debt of 6.088% for ME and 6.557% for PE (MEPN Exhs. JFP-26 and JFP-27) and weighted average cost of debt of 8.98% for ME and 9.22% for PN. (MEPN St. 7 at 11 and MEPN Exh. JFP-28). According to the Companies, the only substantive dispute concerning the determination of the appropriate weighted average cost of debt relates to the recognition of the actual cost of the FirstEnergy debt that was imputed to MEPN. MEPN argued that recognition of this debt is appropriate because it represents debt issued to pay for the assets of MEPN and the proceeds have assisted FirstEnergy in providing financial support to MEPN. (MEPN St. 7-R, at 4-6).

The OTS proposed a cost of long term debt for ME in this proceeding of 5.10% and 5.83% for PN. (OTS St. 1, at 11-12). The OTS based long term debt on the Companies' contractual obligations for capital used to finance their rate base. These cost rates represent the obligations used to finance the Companies' rate base and are consistent with the obligations of companies of similar size and risk characteristics. The OTS argued that inclusion of any debt that is used for purposes other than the financing of the rate base is inappropriate and must be rejected. The OTS contended that the Companies' proposed debt costs are flawed since they include a proportional share of FirstEnergy's debt that was issued in the acquisition of GPU. As a portion of the Companies' debt cost in this proceeding includes debt used to finance the acquisition of GPU, the OTS averred that its use in this proceeding is inappropriate. (OTS M.B. at 32-33).

The OCA proposed that ME's and PN's costs of debt are actually 5.051% and 5.83% respectively. The OCA argued that the Companies' proposal inflates them to about 6.09% and 6.56%, respectively, because it allocates debt and the cost of parent company debt in its adjusted capital structure. The debt of FirstEnergy, according to the OCA, carries a higher cost rate than either of the Companies' actual embedded cost of debt. (OCA St. 4S at 2). In particular, the FirstEnergy debt reflects FirstEnergy's business and financial risks, including the risks associated with unregulated generation costs. (OCA St. 4S at 6). The OCA contended that the Commission should not impose the FirstEnergy debt cost premium on MEPN customers. The OCA opined that customers should not be required to pay for the higher FirstEnergy cost of debt. (OCA St. 4 at 12). Instead, according to the OCA, the cost of debt should be based on each of the Companies' own cost rate of actual long-term debt on December 31, 2006. (OCA St. 4S at 2) (OCA M.B. at 53-54).

2. ALJs' Recommendation

The ALJs recommended adoption of the OCA position. The ALJs found that MEPN customers should not pay for the higher FirstEnergy cost of debt reflecting FirstEnergy business and financial risks, including the risks associated with unregulated generation costs, nuclear assets and environmental compliance. According to the ALJs, MEPN are regulated entities that do not have risks of this type. The ALJs agreed with the OCA that the cost of debt should be based on each of the Companies' own cost rate of actual long-term debt at December 31, 2006 and, concluded that the MEPN costs of debt are 5.051% and 5.83%, respectively. (R.D. at 123).

3. Exceptions

In its Exceptions, MEPN states that its proposed 51%/49% debt-to-equity capital structure reflects a significant reduction to the equity component of their capital structures, which is the most expensive component of capital. MEPN claims that by reducing the equity, this modified capital structure benefits customers through a lower overall cost of capital. The Companies note that this proposed capital structure was accepted by both the OTS and the OCA, the only parties to address capital structure, and was adopted by the ALJ's. (MEPN Exc. at 31-32).

MEPN states that it derived this modified capital structure by imputing to MEPN an appropriate portion of the Merger acquisition debt incurred by FirstEnergy to pay for the assets of MEPN. MEPN claims that the portion of the FirstEnergy debt allocated to MEPN was based on the percentage of the net Merger purchase price allocated to MEPN, not on the goodwill allocation as erroneously found by the ALJs in FOF No. 204. MEPN also claim that contrary to the erroneous conclusion by the ALJs in FOF No. 206, the imputed debt does not uniformly carry a higher cost rate than the stand-alone MEPN debt. Rather, according to the Companies, the imputed FirstEnergy debt carries a lower cost rate than some MEPN debt. (MEPN Exc. at 32).

MEPN note that neither the OTS nor the OCA offered an alternative rationale for deriving the favorable capital structure it proposed. Nonetheless, according to the Companies, the ALJs reject the inescapable implications of the only rational basis for deriving the adopted capital structure that appears in the record, and refuse to recognize the associated cost of the imputed FirstEnergy debt. MEPN requests that the Commission correct this error so as to ensure that the logical consequences of the capital structure ratemaking determinations are properly reflected in the end result of this proceeding. (MEPN Exc. at 32-33).

Additionally, MEPN notes that the ALJs accept the arguments of the OTS and the OCA that reflection of the cost of the imputed FirstEnergy debt would somehow violate a Commission prohibition on the recovery of the Merger acquisition premium. MEPN opines that this conclusion is erroneous, as the Commission prohibition was designed to preclude the amortization of goodwill in MEPN's cost of service. MEPN argues that the Commission has never addressed capital structure/cost of debt issues in the context of any rulings on the Merger. Therefore, according to the Companies, because it is not seeking to amortize goodwill in their cost of service, recognition of the cost of the imputed FirstEnergy debt does not violate the prohibition on the recovery of the acquisition premium. (MEPN Exc. at 33).

In reply, the OCA rejoins that the ALJs correctly concluded that FirstEnergy debt should not be included in the cost of debt for MEPN. The OCA avers that the method used by the Companies to reach the debt-to-equity ratio improperly brings goodwill, an accounting concept, into Pennsylvania ratemaking and improperly imposes the merger acquisition premium on ratepayers. The OCA opines that the Companies are incorrect to claim that neither the OCA nor the OTS offers alternative rationales to the Companies' that would support the 51/49 debt-to-equity capital structure. The OCA states that its witness noted that a 51/49 debt-to-equity capital structure is reasonable in this case because it is similar to the Companies' pre-merger capital structures, the equity ratio is similar to the OCA proxy group, and the ratio is supportive of a strong single A credit rating. (OCA R.Exc. at 20-21).

In regard to the embedded cost of debt, the OCA notes that the Companies' argument in favor of imputing FirstEnergy debt, that reflects total corporate risks, into the capital structures of ME and PN have been demonstrated to be unsound, based upon both contradictory statements and factual errors, and as such should be rejected. The OCA requests that the Commission adopt the ALJs' conclusion that recommends a capital structure of 51/49 debt-to-equity and the use of the actual cost rate of debt for MEPN rather than the inflated cost rate from imputing FirstEnergy debt. (OCA R.Exc. at 21).

The OTS, in its Reply Exceptions, rejoins that the Companies' argument relies heavily on a misguided discussion as to the determination of the capital structure adopted in this proceeding. The OTS avers that it adopted the Companies' proposed capital structure as it was representative of the capital structures routinely found in this industry. OTS claims that at no point did it adopt the Companies' methodology as it has consistently maintained that their claimed hypothetical capital structure is based on the misallocation of debt. The OTS states that the proper capital structure only includes debt that was used to finance the Companies' rate base. Furthermore, the OTS notes that the record clearly indicates that the imputed debt for ME carried a cost rate of 6.45%, which is significantly higher than the 5.051% cost rate determined on a stand-alone basis for ME. Similarly, OTS avers that for PN, the imputed FirstEnergy debt has an issue rate of 7.375% in contrast to the stand-alone debt cost of 5.83%. According to the OTS, these facts indicate that including the misallocated debt from FirstEnergy improperly inflates the appropriate debt cost for MEPN in this proceeding. (OTS R.Exc. at 16-19).

4. Disposition

The resolution of both the appropriate Capital Structure and allowable Cost of Capital rate are dependent upon whether MEPN should be permitted to include a portion of FirstEnergy's merger acquisition debt within its claims in this proceeding. Our review of the record evidence leads us to adopt the recommendation of the ALJs to not allow for the allocation of this acquisition debt to the Companies. As a result, we are in agreement with the ALJs that the Companies proposed 51% long-term debt and 49% common equity capital structure, as agreed to by the OTS and the OCA, is reasonable, but that the Companies' methodology for arriving at this capital structure should be rejected.

Similarly, we are in agreement with the ALJs that the appropriate cost of debt for ME should be 5.051% and the appropriate cost of debt for PN should be 5.83%, which were derived by eliminating the imputed FirstEnergy acquisition debt from the calculations. Specifically, we adopt the position of the OCA that the cost of debt should be based on each of the Companies' own cost rate of actual long-term debt at December 31, 2006.

MEPN have not demonstrated that its proposal to allocate FirstEnergy's acquisition debt to MEPN is appropriate. We are in agreement with the position of the OCA that the Companies' methodology artificially increases the embedded cost of debt component and in agreement with the position of the OTS that only debt used to finance the Companies' rate base is properly included in this proceeding. We reject the contention of the Companies that its customers should be subjected to the higher FirstEnergy cost of debt which reflects FirstEnergy's business and financial risks associated with unregulated generation costs, nuclear assets and environmental compliance. As noted by the ALJs, MEPN are regulated distribution entities that do not have risks of this type. Accordingly, the Exceptions of MEPN are denied and the recommendations of the ALJs are adopted.

C. Return on Equity

Although there are various models used to estimate the cost of equity, the Commission favors the Discounted Cash Flow (DCF) Model. The DCF model assumes that the market price of a stock is the present value of the future benefits of holding that stock. These benefits are the future cash flows of holding the stock, i.e. the dividends paid and the proceeds from the ultimate sale of the stock. Because dollars received in the future are worth less than dollars received today, the cash flow must be 'discounted' back to the present value at the investor's rate of return.

The following table summarizes the cost of common equity claims made, and methodologies used, by the Parties in this proceeding.

Methodology	MEPN	OCA (5)	OTS (6)
DCF	9.3 to 10.3 (1)	9.6 to 10.1	9.5 to 10.0
CAPM/ECAPM	10.8 to 12.5 (2)	n/a	n/a
CAPM/	n/a	9.2 to 11.0	n/a
Range Recommendion	11.5 to 12.25 (3)	9.6 to 10.1	9.5 to 10.0
Point Recommendation	12.0 (4)	9.7	9.75

(1) MEPN St. No. 8, Table MJV-7, MEPN M.B. at 71.
(2) MEPN St. No. 8 at 55, 62.
(3) MEPN St. No. 8 at 64.
(4) MEPN St. No. 8 at 63.
(5) OCA St. No. 4 at 4-6.
(6) OTS St. No. 1 at 27.

1. Positions of the Parties

MEPN proposed a return on equity of 12.0% for both Companies as just and reasonable. (MEPN St. 8, at 62-63). The Companies used the Capital Asset Pricing Model (CAPM) combined with the Empirical Capital Asset Pricing Model (ECAPM) to calculate a return on common equity. (ME/PE St. 8, at 22-27). The Companies advocated what their witness terms a Market Risk Premium of 6.5%-8.0% as an adjustment. This represents the risk that investors take by investing in stocks instead of risk-free Treasury bills. (ME/PE St. 8 at 28-30). The Companies argued that because of this greater risk, the Commission should allow a higher return on equity.

The Companies also advocated an adjustment to recognize financial risk. The underlying principle is that an equity investor intrinsically faces increased financial risk as the proportion of debt used to finance an investment increases. MEPN stated that applying this principle to determine the cost of equity involves two steps: (1) determine a market-derived overall cost of capital for a proxy group of companies of comparable business risk; and (2) use that overall cost of capital to derive the subject company's cost of equity by substituting its regulatory capital structure in the equation. According to MEPN, the two steps together recognize both business and financial risk and bring the Companies' cost of equity to a level that represents the rate of return that investors could expect to earn elsewhere without bearing more risk. (MEPN St. 8-R at 38).

The OCA used a cost of common equity analysis in which it relies on the Discounted Cash Flow (DCF) methodology, checked by a CAPM analysis, to recommend a 9.7% return on common equity for each company. When combined with its recommendation on capital structure and cost of debt, this produces an overall rate of return of 7.33% and 7.72% for MEPN, respectively. According to the OCA, the Commission has stated on numerous occasions that it prefers using the DCF method. The OCA admits that its recommendation is at the low end of the reasonable range because of what it characterizes as ME's and PN's ongoing service problems that affect customers. (OCA St. 4 at 5).

To estimate the cost of equity, the OCA used a proxy group of similar companies, because as wholly-owned subsidiaries of FirstEnergy without publicly-traded stock, the market valuations for MEPN are unknown. (OCA St. 4 at 18). The OCA selected eight companies for its proxy group that: (1) are located in the Mid-Atlantic or Northeast; (2) are members of Regional Transmission Organizations; and (3) have divested most or all of their generation assets, thus operating primarily as delivery service utilities. (OCA St. 4 at 19 & Sch. MIK-3). According to the OCA, the capital structures of this group are similar to that of the Companies, and the average common equity ratio for the OCA's proxy group is 44.6%, a close match to the 49% that is being used for the Companies. (OCA St. 4 at 19, 20 & Sch. MIK-3).

Regarding the dividend yield (D_o/P_o) component in the DCF analysis, the OCA used a 4.9% DCF adjusted yield, based upon the 4.79% dividend yield of the proxy group of similar companies and assuming a half-year growth of 2.5% and a full year growth of 5%. (OCA St. 4 at 21).

Regarding the estimate for the growth rate (g) component of the DCF analysis, the OCA averaged the latest data for its group of proxy companies from four well-known sources of projected earnings growth rates, First Call, Zacks, Standard & Poors (S&P) and Value Line. (OCA St. 4 at 22-23 & Sch. MIK-5). This average of 5.19% represents the upper end of the OCA's growth rate, where the median five year growth rate for the group is 4.7% and the average was artificially inflated by growth rates of 10-11% of one company with a history of slow growth. (OCA St. 4 at 23 and Sch. MIK-5). The OCA's analysis determined that the DCF for its proxy group should result in a cost of equity in the range of 9.6% to 10.1% with a midpoint of 9.85%. (OCA St. 4 at 24).

Based on the above analyses, the OCA found a range for a return on equity of 9.6% to 10.1%. (OCA St. 4 at 24 & Sch. MIK-5). The OCA recommended a return on equity of 9.7% for each of the Companies, at the low end of the reasonable range, due to the Companies' ongoing service quality problems that affect ratepayers. (OCA St. 4 at 5). The OCA contended that MEPN have a long history of failing to achieve reliability standards. In support of its contention, the OCA referred to the Commission's investigation into this issue. *Investigation Regarding the Metropolitan Edison Co. Pennsylvania Electric Co. and Pennsylvania Power Co.'s Reliability Performance*, Docket No. I-00040102 (Order entered November 4, 2004). The OCA pointed out that the Companies have not yet fully achieved the agreed upon standards for reliability or key customer service metrics set forth in the settlement of that proceeding. The OCA concluded that because the Companies have failed to achieve reliability and service quality standards consistent with their obligations, their failure should be recognized in the rate of return.

The OTS also employed the DCF methodology to calculate the cost of common equity. The OTS recommended a 9.75% cost of common equity for MEPN as calculated by the application of the market based DCF. This leads to an overall rate of return of 7.38% for ME and 7.75% for PN. The OTS asserted that this methodology has traditionally been endorsed by this Commission and its continued use is warranted in this proceeding. To properly compute the components of the DCF method, the OTS utilized current, historical and forecasted market data for three different entities. (OTS St. 1).

The OSBA did not perform any calculation to arrive at a cost of equity recommendation. Rather, the OSBA advocated the recommendations of either the OTS or the OCA, given both Companies' poor reliability performance. Like the OCA, the OSBA refers to the Commission reliability investigation at Docket No. I-00040102. The

OSBA asserted that both MEPN have failed to achieve the level of performance to which they agreed in the settlement of the investigation. (OSBA St.1)

The OCA, the OSBA and the OTS all objected to the adjustments advocated by MEPN to recognize financial risk.

The Companies rejected the positions of the other Parties asserting that alleged reliability deficiencies should reduce the return on equity. The Companies argued that their reliability is improving. (ME/PE St. 18R (Revised) at 19-21). The Companies also asserted that they have expended significant amounts to improve overall reliability. The Companies contended that reducing the return on equity on this basis would be counter-productive because it would reduce the dollars available to the Companies to fund reliability improvements and perform maintenance functions.

2. ALJs' Recommendation

The ALJs recommended adoption of the OCA's position. The ALJs noted that while other methods can be used as a check on the results arrived at by use of the DCF method, the Commission has long favored use of the DCF method, tempered by informed judgment. The ALJs referenced the Commission Order at *PA Public Utility Commission v. Pennsylvania-American Water Co.* Docket No. R-00016339, (Order entered January 25, 2002), as support for this position. Additionally, the ALJs stated that because of its strengths, and with its weaknesses ameliorated by informed judgment, primary reliance on the DCF method by the Commission is in the public interest. (R.D. at 125-127).

Furthermore, the ALJs found that MEPN have been unable to achieve reliability standards. The ALJs agreed with the Parties that the Companies have failed to achieve reliability and service quality standards consistent with their obligations and this should be reflected in the approved rate of return. As a result, the ALJs recommended that the MEPN returns on equity should be 9.7%. (R.D. at 128-129).

Based upon the testimony and evidence of record, the ALJs recommended the following overall rate of return for each Company:

ME

Capital Type	**Percent of total cost** (%)	**Cost Rate** (%)	**Weighted Cost** (%)
Long-term Debt & Allocation Of Parent Debt	51	5.051	2.58
Preferred Stock	0	0	0
Common Equity	49	9.7	4.75
Total	*100*		*7.33*

PN

Capital Type	**Percent of total cost** (%)	**Cost Rate** (%)	**Weighted Cost** (%)
Long-term Debt & Allocation Of Parent Debt	51	5.83	2.97
Preferred Stock	0	0	0
Common Equity	49	9.7	4.75
Total	*100*		*7.72*

3. Exceptions

In its Exceptions, MEPN argues that the 9.7% return on equity recommended by the ALJ is 100 basis points lower than the return on equity deemed reasonable two years ago for another electric utility in Pennsylvania in *Pa. PUC v. Pennsylvania Power and Light*, Docket No. R-00049255 (Order entered December 22, 2004). This is so even though interest rates have increased since that time, opines the Companies. MEPN states that the ALJs' recommendation is inadequate and unreasonable due to several significant errors. MEPN notes that the ALJs failed to recognize the impact of financial risk, failed to recognize that MEPN's business risk is greater than that of the proxy group because of the burden imposed by their POLR responsibility. failed to give any consideration whatsoever to alternative analyses such as risk premium or CAPM, failed to reflect application of informed judgment and improperly reduced the allowed return based on alleged poor reliability. MEPN avers that application of Commission precedent to the facts here warrants a move upward from the market derived baseline cost of equity to reflect financial risk, increased business risk and consideration of alternative analysis and informed judgment. (MEPN Exc. at 33-37).

MEPN states that the reduction in allowed return based on alleged poor reliability is improper. The Companies aver that the ALJs erroneously stated that they missed 2005 reliability targets by 70-100 minutes (R.D. at 230) because that target is a comparison to a goal set by the Reliability Settlement for year end 2007 not 2005. MEPN avers that they are, in fact, trending to meet that goal, having already spent $282 million on reliability improvements in 2005. Also, MEPN notes that the ALJs fail to consider properly the evidence in MEPN's Joint 2nd Quarter Service Reliability Report[21] that shows that reliability is improving. Additionally, MEPN avers that in 2005, they met 95% of the requirements of the Reliability Settlement.[22] As further evidence of improved reliability, the Companies claim that ME has experienced a 53% reduction in service quality complaints and PN has realized a 44% reduction.[23] MEPN rejoins that reducing their rate of return based on a flawed perception of poor performance will only impair their ability to continue reliability related spending. They request that the better approach is to follow the process already agreed upon in the Reliability Settlement. (MEPN Exc. at 37).

[21] OCA Cross Exh. 8, App A.

[22] MEPN St. 18-R (Revised).

[23] MEPN MB at 72.

In reply, the OCA rejoins that the Companies arguments are without merit. First, the OCA avers that its witness demonstrated that the Companies proposed financial risk adjustment is a conceptual argument that may only be valid in a non-regulated setting. The OCA also notes that even if the concept were to be considered valid, the overall business and financial risk of the proxy group on average is very close to that of the Companies in this case, so that no adjustment would be necessary. Second, the OCA refers to the Companies argument that their greater business risk compared to the proxy group should be recognized and increase the ROE allowance by 25 basis points. The OCA avers that the Companies failed to develop this issue on the record and have failed to show that they have any above-average risk pertaining to their distribution service as compared to the proxy group. As a result, the OCA opines it must be rejected as wholly unsupported by the evidence. (OCA R.Exc. at 21-24).

Furthermore, the OCA notes that the Companies arguments that the ALJs erred by reducing the cost of equity based upon poor reliability are incorrect. First, the OCA notes that this will not affect reliability related spending as these dollars are expense dollars that are fully reflected, without adjustment, in the Companies revenue requirement. Second, the OCA avers that the ALJs did not reduce the ROE but found that the lower end of the range of reasonableness was more appropriate. Third, the OCA claims that the Companies failed to meet service quality thresholds set forth in settlement. It points out that both MEPN failed to achieve actual year-end 2005 SAIDI that were required by the Settlement, and instead recorded SAIDI measurements that indicated worsening reliability. The OCA requests that the ALJs' recommendation for a ROE set at the lower end of the reasonable range should be adopted by the Commission. (OCA R.Exc. at 24-25).

The OTS replies that the Companies' Exceptions lack foundation in the record and should be dismissed. The OTS avers that the Companies mistakenly believe that a prior Commission decision has somehow established the minimum return on equity allowance for the entire industry. The OTS avers this error is further exacerbated by an unsupported claim with respect to interest rates and their relative impact on the calculation of a return on common equity allowance. According to the OTS, it is a well established axiom that utility regulation in Pennsylvania is based on the facts of a specific proceeding and that precedent merely establishes a benchmark as to the regulatory treatment of a particular issue, it does not create a specific standard upon which all subsequent cases must depend. Additionally, the Companies statement concerning interest rates is unsupported in the record and is faulty as the OTS witness testified that long term bond rates are at historic low levels and are expected to remain relatively stable. (OTS R.Exc. at 19-20).

Next, the OTS states that the Commission's long-standing acceptance of the DCF method as the preferred method of determining an appropriate return on equity is not disputed in this proceeding. The OTS explains that the DCF method takes into account several factors in the determination of the fair rate of return: (1) preferences of investors; (2) equity financing; (3) risk; and (4) inflation. It opines that the Companies' myriad of adders and adjustments are unnecessary as the DCF method inherently accounts for these influences in its determination. According to the OTS, additional adjustments to a properly calculated equity allowance based on the DCF method would result in certain economic factors being counted twice which is improper and should be rejected. (OTS R.Exc. at 20-22).

The OTS further rejoins that the Companies' Exceptions mischaracterize the Recommended Decision with respect to the role of reported poor reliability in the rate of return calculation. Contrary to the Companies' erroneous assertion that its rate of return was reduced, the ALJs properly determined that the rate of return calculation must include consideration of the reliability shortcomings of the Companies. There was no stated reduction to the DCF findings per the Companies, as the ALJs' resulting recommendation remained within the range of DCF results calculated by the intervening

Parties. OTS avers that the higher end of the calculated results is simply not warranted based on the record in this proceeding. (OTS R.Exc. at 22-23).

The OSBA also replies that the ALJs did not err in reducing ME's and PN's rate of return based on their poor reliability. The OSBA avers that despite the Companies' effort to portray their reliability in a favorable light, both Companies' reliability has been, and continues to be, far below adequate. The OSBA notes that both Companies' SAIDI scores are worse now than they are required to be at year-end 2007 that ME's SAIDI score is worse now than it was at year-end 2003, that ME does not meet the Commission standard for SAIDI, that both Companies' SAIFI scores are worse than the Commission standard and benchmark and that both Companies' CAIDI scores do not meet the Commission benchmark. Despite these shortcomings, the OSBA notes that the Companies are advocating upward adjustments in the calculated DCF results to reflect claimed financial and business risks. The OSBA opines that it would be inconsistent to approve any upward adjustments to compensate stockholders when the Companies' ratepayers have been forced to accept inadequate service. (OSBA R.Exc. at 8-10).

4. Disposition

As noted previously, we have primarily relied upon the DCF methodology in arriving at our determination of the proper cost of common equity. However, we agree with the ALJs' statement that other methodologies can be used as a check on the reasonableness of the results arrived at by the use of the DCF method, tempered by informed judgment. We note that both the Companies and the OCA have done so in the instant proceeding. We will also use the results of the CAPM and ECAPM methods as a check of the reasonableness of our DCF derived equity return calculation.

Based upon our analysis and review of the record evidence, the Recommended Decision and the Exceptions and Replies thereto, we reject the ALJs' recommendation to adopt the low end of the OCA's unadjusted DCF return of 9.7%. We note that the OCA recommended a return on equity range from 9.6% to 10.1%, but utilized a point near the lower end of the range due to the Companies ongoing service quality problems. While we acknowledge that the Companies have experienced reliability problems in the past and have been subject to a Commission investigation, we do not agree with the ALJs that it is necessary to reflect this situation by going to the lower end range of equity return.

Other factors must be considered in this proceeding. Based upon the evidence of record, we find that the OCA's recommended range of reasonableness from 9.6% to 10.1% is appropriate. We conclude that within that range, a cost of common equity of 10.1% is reasonable and appropriate to incorporate into our return determinations under the circumstances of this proceeding. This recommendation is based upon the high end of the OCA recommended range of reasonableness giving deference to the business risk faced by the Companies under the current electric industry environment and to the cost of equity results from the other methodologies, as well as recent Commission precedent. We note that the OTS recommended a range of reasonableness from 9.5% to 10.0% based upon the DCF methodology. The Companies DCF calculations, adjusted to remove their financial risk adders, resulted in a range of reasonableness from 9.3% to 10.3%. Also, the OCA calculated the range of reasonableness based on the CAPM methodology from 9.2% to 11.0%, while the Companies CAPM calculations indicated a range from 10.8% to 12.5%. Based upon these findings, we are of the opinion that an equity return of 10.1% is reasonable.

Accordingly, the Exceptions of MEPN are granted, in part, and denied, in part, to the extent consistent with the foregoing discussion.

The following table summarizes our determinations concerning the Companies' capital structure, cost of debt and cost of common equity, as well as the resulting weighted costs and overall rate of return:

ME			
Capital Structure	**Ratio** (%)	**Cost Rate** (%)	**Weighted Cost** (%)
Debt	51.00	5.051	2.58
Common Equity	49.00	10.1	4.95
	100.00		7.53

PN	Ratio (%)	Cost Rate (%)	Weighted Cost (%)
Capital Structure			
Debt	51.00	5.83	2.97
Common Equity	49.00	10.1	4.95
	100.00		7.92

X. COST OF SERVICE

A. ALJs' Interpretation of *Lloyd v. Pa. PUC*, 904 A.2d 1010 (Pa. Cmwlth. 2006), Petitions for Allowance of Appeal Pending

1. Positions of the Parties

The Companies submitted unbundled cost of service studies (COSS) based on data gathering systems (AM/FM, CREWS) and analytics (TACOS Gold) that allocate generation, transmission, and distribution system costs to establish a revenue requirement for each customer rate schedule. (MEPN M.B. at 77; MEPN St. 5 at 4; MEPN St. 5-R at 6-7). MEPN claims that this is consistent with the Commonwealth Court's determination in *Lloyd v. Pa. PUC*, 904 A.2d 1010 (Pa. Cmwlth. 2006), petitions for allowance of appeal pending, which requires that in this new era of unbundled generation, transmission and distribution services, rates must be set primarily based on a COSS. (MEPN M.B. at 77).

The Companies argued that because the statutory generation rate cap period has expired, latitude in generation cost allocation is permitted pursuant to Section 2804(4) of the Code, 66 Pa. C.S. § 2804(4). (MEPN M.B. at 78; MEPN Sts. 5-R at 13-15). MEPN proposed allocating generation costs to customer rate schedules by using three year average, historic LMPs weighted by customer consumption data. (MEPN M.B. at 77· MEPN Sts. 5 at 6). The Companies claim that allocating 100% of costs on LMP is a superior method for tracking cost causation as it recognizes which customers use more load in expensive LMP hours and which have flatter load shapes. (MEPN Sts. 5-R at 13-15).

MEPN initially proposed allocating transmission costs on a kWh basis, but later concurred with the Industrials and the OSBA that allocation of these expenses on a demand/energy basis is more reflective of cost of service. MEPN witness Stein provided a cost allocation of projected transmission costs using demand and energy allocators. (MEPN M.B. at 78; MEPN Exh. EBS-8-R Revised). The Companies opined that transmission costs should be allocated on a demand/energy basis, but that rate design should reflect a uniform kWh rate, by rate schedule, to keep the customers' price to compare easily discernable. (MEPN M.B. at 78; MEPN St. 4 at 22; Tr. at 874).

MEPN stated that its COSS accurately identifies the costs to provide distribution services and should be adopted without adjustment. Distribution plant assets were classified and allocated to primary and secondary customers using a combination of cutting-edge and historically used methods such as a minimum grid study. (MEPN M.B. at 79: MEPN St. 5 at 4, 12). The COSS sub-functionalized certain distribution plant (poles overhead and underground conductors and conduit), and allocated these costs to three rate schedule groups, primary customers (higher voltage), secondary customers (lower voltage) and primary/secondary (all customers). (MEPN M.B. at 79: MEPN St. 5 at 7, 11).

MEIUG, PICA, and IECPA opined that the Companies' distribution COSS are reasonable and should be adopted. (MEIUG/PICA/IECPA St. 1 at 48).

The OCA opined that a COSS serves as a guide that rates must be set consistent with the principle of cost causation. (OCA M.B. at 62; OCA St. 5 at 14). According to the OCA, other ratemaking principles such as gradualism, rate continuity, simplicity, and public policy goals must be considered in tandem with an accurate and reliable COSS if rates are to be set fairly. (OCA M.B. at 62; OCA St. 5 at 14). The OCA argued that both the Companies' distribution and generation COSSs are flawed. OCA witness Smith stated that the COSSs allocate more distribution costs to secondary service customers and to residential customers than can be justified by cost causation. (OCA St. 5 at 5). Additionally, the OCA contends that not only is the generation COSS flawed in that it fails to allocate generation in a manner that reflects how the Companies incur costs, it is improper pursuant to 66 Pa. C.S. § 2804(4) because generation costs cannot be allocated in this case due to the rate caps. (OCA M.B. at 63).

The OCA argued that MEPN's allocation of distribution costs and revenues understates the cost of serving large customers who take service at primary voltage and thereby overstates the cost of serving residential customers. (OCA M.B. at 63). OCA witness Smith requested that the Companies prepare revised cost of service studies with the following adjustments: (1) increase the portion of accounts 364-367 that is treated as primary service related; and (2) increase the demand-related portion of account 368. (OCA St. 5 at 12). The modified studies showed that the primary classes (GP for Met-Ed and GP and LP for Penelec) would earn much lower rates of return than the Companies' studies showed, and were paying less than the system average rate of return under the

Companies' proposals. (OCA M.B. at 64; OCA St. 5 at 14-15 (Tables ME1 and PN 1)). The OCA recommended that its distribution cost allocation should be adopted, and its proposed revenue requirement allocation should be scaled back across the board, by equal percentage, among all customer classes if the Companies' distribution revenue requirements are modified by the Commission. (OCA M.B. at 69).

The Commercial Group opined that the Companies' new methodology for classifying distribution costs is flawed and inconsistent with the generally accepted *NARUC Electric Utility Cost Allocation Manual.* (CG M.B. at 18). With respect to this classification step for Plant Accounts 364-369, the Companies' witness, Mr. Stein, testified that, 'the NARUC manual recommends dividing the mass distribution property (Plant Accounts 364-369) into two components, customer and demand' with the 'customer component [being] determined through a minimum grid study which is calculated by pricing the poles [Account 364], conductors [i.e. wires in Accounts 365 and 367 and underground pipe in Account 366], transformers [Account 368] and service drops [Account 369] at the installed cost of the equipment that would at a minimum be required to serve a customer in each of the accounts. (MEPN St. 5 at 12). The Commercial Group points out that this is the way the Companies have historically performed their cost of service studies. (Tr. at 764). The Commercial Group stated that here, the Companies chose not to perform this analysis and instead arbitrarily declared all costs in the secondary distribution sub-function category as demand costs and classified zero costs as customer costs. (CG St. 1 at 24). The Commercial Group argued that not only is the Companies' new method of classifying secondary costs in Accounts 364 to 367 unreasonable, the results obtained are unreasonable as well. In prior cases, the Companies determined that the minimum costs (customer costs) represented 62.7% (Met-Ed) and 72.3% (Penelec) of their cost of poles (Account 364); 39 % (Met-Ed) and 31.1% (Penelec) of wire (Account 365) costs were customer-related; and 66.7% (Met-Ed) and 45.3% (Penelec) of underground wire and conduit costs (Accounts 366-367) were customer-related. MEPN now claims that these costs are wholly attributable to differences in voltage demand between customers. (CG Exh. KCH-2, CG St. 1 at 28). The Commercial Group rejects MEPN's position that none of those secondary costs are customer-related. (CG Exh. KCH-2, CG St. 1 at 28). (RD at 135-137).

Using the parameters developed by the Companies in their last rate case, CG re-calculated the revenue changes by rate class necessary to achieve the Companies' requested revenue requirements based on the classification of an appropriate share of distribution system costs as customer-related. (CG M.B. at 22). The Commercial Group recommended that any overall rate increase for the four major secondary rate schedules – RS, RT GS, and GST – be established on an equal percentage basis (in the case of Met-Ed) or be established within a specified bandwidth (in the case of Penelec). *Id.* With respect to Met-Ed, the Commercial Group's witness concluded that the adjusted cost-of-service analysis supports an equal percentage rate increase for the major secondary voltage classes on the Met-Ed system. With respect to Penelec, the Commercial Group's witness concluded that an equal percentage rate increase for the major secondary voltage classes on the Penelec system, with the exception of GS in Penelec, which due to its significantly lower revenue deficiency, warrants a percentage rate change that is 80% of the secondary voltage group as a whole. (CG M.B. at 13).

2. ALJs' Recommendation

The ALJs found that demand/energy transmission cost allocators are appropriate, but that rate design should reflect a uniform kWh rate, by rate schedule to keep the customers' price to compare simpler. (R.D. at 130). The ALJs agreed with the OCA that any changes to generation rates would be in violation of the generation rate caps established pursuant to the 1998 Restructuring Settlement. The ALJs rejected any changes to the design of the generation rates, with or without an increase in the overall generation rates, as inconsistent with the generation rate caps. (R.D. at 132). The ALJs found that MEPN did not meet their burden of proving that their cost of service study methodology which categorized a small subset of distribution costs as primary costs, and the remaining distribution costs to secondary customers based on voltage peak demand was reasonable. (R.D. at 138). The ALJs recommended the adoption of the Commercial Group's proposed distribution cost allocation methodology shown at Exhibits KCH-2A and 2B as a basis for the increase allocated to rate classes RT. RS, GS, and GST (R.D. at 139).

3. Exceptions

The OCA argues that to the extent that the ALJs' decision can be read to interpret *Lloyd* in a manner that strictly confines Commission approval of rate setting and design solely to cost of service study results, it is erroneous. (OCA Exc. at 7). The OCA explains that while the *Lloyd* Court held that cost of service is the primary basis for setting rates and rate structures, it also held that there are other factors such as cost causation that should be considered by the Commission when examining rate designs. *Id.*

The OCA submits that each rate element, distribution, transmission, and generation must be evaluated separately according to *Lloyd. Id.* The OCA excepts to the ALJs' reliance on exhibits that bundle together the rate elements as contrary to *Lloyd.* (OCA Exc. at 9).

MEPN rejoins that the OCA's Exception regarding the ALJ's interpretation of *Lloyd* should be rejected because the ALJs did not hold that a COSS is the only factor upon which the Commission can establish utility rates. (MEPN R.Exc. at 16). The Commercial Group rejects the OCA's Exceptions regarding the COSS and urges adoption of the RD on this issue. (CG R.Exc. at 3-8). The OSBA replies that the ALJs' recommendations are not based on a misinterpretation of *Lloyd.* (OSBA R.Exc. at 11).

The OCA next argues that the ALJs did not sufficiently articulate how the distribution revenue change should be allocated to the various customer classes. (OCA Exc. at 8). The OCA argues that after adopting the Commercial Group's modification to the distribution cost of service study of the Companies, the ALJs do not clearly recommend any allocation of the distribution rate changes to the various customer classes. *Id.* The OCA states that Conclusion 164 on page 261 of the Recommended Decision could be interpreted as a recommendation that any rate changes be spread in a manner consistent with the Commercial Group Exhibits KCH-2A at 1, l. 17 and KCH-2B, p.1, l. 17 According to the OCA, Line 17 of each of these exhibits represents the total percentage increase that would be needed for each class to provide the precise system average rate of return under the Companies' full revenue requirement increase request, including generation service. (OCA Exc. at 9). The OCA submits that if it was the intent of the ALJs to allocate the distribution revenue change on this basis, such recommendation would be in error, because it includes generation charges.[24]

The OCA further argues that the allocation of the distribution revenue change to the various customer classes must recognize all elements of the distribution rates – distribution base rates and universal service charges. (OCA Exc. at 11). The OCA submits that the residential rate schedules are providing returns on distribution service that are at or above the system average rate of return under the Companies' the OCA's, and the Commercial Group's cost of service studies. *Id.* The OCA requests that the residential rate schedules receive a percentage rate change that is equal to the percentage change in distribution revenues, inclusive of the universal service revenues. *Id.*

[24] It should be noted that Commercial Group's witness, Mr. Higgins, recommended using line 20 of his exhibits for allocation purposes, not line 17 as stated in the Recommended Decision (OCA Exc. at 9, Commercial Group St. 1 at 30).

In reply to the OCA's Exceptions, MEIUG/PICA state that the ALJs correctly determined that the Companies generally presented a reasonable distribution COSS, which should be used to allocate any resulting distribution revenue changes. (MEIUG/PICA R.Exc. at 17). With regard to the OCA's request that the Commission take into consideration the impact of the ALJs' recommendation to allocate USP costs solely to the residential class in any determination regarding distribution rates, MEIUG/PICA cautions against any modification to distribution rates that would result in inappropriate USP cost shifting to other classes. (MEIUG/PICA R.Exc. at 18).

The OSBA states that the required distribution rate change should be calculated on a distribution-only basis and applied to distribution revenues at present rates, excluding universal service costs. (OSBA R.Exc. at 12). The OSBA submits that the ALJs properly denied the OCA's and the Companies' request that universal service costs be recovered from all customer classes. (OSBA R.Exc. at 13).

4. Disposition

The ALJs' did not misinterpret the holding in *Lloyd* with regard to the relationship between COSS and ratemaking. It is clear that the ALJs fully understood *Lloyd's* holding that 'rates must be set *primarily* based on COSS. (R.D. at 130) (emphasis added). This statement is in accord with the Commonwealth Court's finding that the cost of providing service is the polestar of ratemaking which trumps other concerns such as gradualism or rate shock. *Lloyd v. Pa. PUC*, 904 A.2d 1010, 1020. The ALJs correctly concluded that the proper interpretation of *Lloyd* is that a COSS is the primary, but not the only, basis for cost allocation for each unbundled element. Accordingly, the OCA's Exception on this issue is denied.

The ALJs allocated transmission costs on a demand/energy basis and recommended a uniform kWh charge for each customer rate schedule. The ALJs adopted the Commercial Group's modification for Accounts 364-367 as discussed above. This approach will result in proper transmission cost allocation to the various rate classes, and simultaneously simplify future retail choice decisions for consumers once rate caps are lifted. We will reject the OCA's proposed modification to the Companies' distribution COSS as it is inconsistent with the Commercial Group's revenue allocation and would be a backdoor way to make the GS and GST classes share in the cost of universal service. We note that the ALJs' decision to more closely follow COSS results is consistent with the *Lloyd* decision. The OCA's Exceptions on this issue are, therefore, denied.

XI. RATE DESIGN

The ALJs found that there were only a few challenges to the Companies' proposed rate design. The summaries set forth below are the major rate design changes proposed by MEPN that were unopposed by the Parties. The ALJs recommended that they be accepted without modification. (R.D. at 139). The summaries are those found at Pages 139, 140 and 141 of the Recommended Decision.

A. Metropolitan Edison Company Unopposed Rate Design Changes

Rate Schedule	Company Proposed Modification	Company Testimony Reference
Rate Schedules Borderline Service, Street Lighting Service, Ornamental Street Lighting Service & Outdoor Lighting Service	Assign Company average rate increase to these bundled services	Met-Ed Exhibit GRP-2. New rates included in schedules – not specifically addressed in testimony
Traffic Signal & Telephone Lighting Service	Eliminate – move customers to GS-fixed usage rate	Met-Ed Statement No. 6 p. 44, line 20
Fire Alarm Box Lighting Service	Eliminate – move customers to GS-fixed usage rate	Met-Ed Statement No. 6 p. 45, line 15
Rate GS-Small	Include a fixed-usage provision	Met-Ed Statement No. 6 p. 39, line 7
Rate RT – Provision D Solar Water Heating	Restrict	Met-Ed Statement No. 6 p. 35, line 17

Rate GS – General Provisions D – Churches and Parochial Schools, E-General Heating, Cooking and Air Conditioning, G- Time of Day Service under 10 kW & H – Time of Day Service Greater than 10 kW	Eliminate	Met-Ed Statement No. 6 p. 39, line 16 (Prov D only) Also Met-Ed GRP-7
Rate GP – General Provision A – Voltage Discount – 34.5 kV or Greater	Eliminate	Met-Ed Statement No. 6 p. 41, line 22
Rate QF – Interruptible Backup provision	Eliminate	Met-Ed Statement No. 6 p. 31, line 8
Rate MS – General Provisions A – Space Heating and B – Church-Operated Schools	Eliminate	Met-Ed Statement No. 6 p. 41, line 9

B. Pennsylvania Electric Company Unopposed Rate Design Changes

Rate Schedule	Company Proposed Modification	Company Testimony Reference
Rate Schedules Borderline Service, High Pressure Sodium Vapor Street Lighting Service, Municipal Street Lighting Service, Outdoor Lighting Service	Assign Company average rate increase to these bundled services	Penelec Exhibit GRP-2. New rates included in schedules – not specifically addressed in testimony
Traffic Signal Service	Eliminate – move customers to GS-fixed usage rate	Penelec Statement No. 6 p.41, line 20
Rate GS-Small	Include a fixed-usage provision	Penelec Statement No. 6 p. 36, line 15
Rate GS-Large	Restrict Off-Peak Thermal Storage provision	Penelec Statement No. 6 p. 38, line 21
Rate GS – General Provisions – D Service to Schools and Churches, E-General Heating, Cooking and Air Conditioning, G-Off-Peak Water Heating Service, H- Service to Churches	Eliminate	Penelec Statement No. 6 p. 37 line 1 (Prov D only) Also Penelec GRP-7
Rate GP – General Provisions A- Service to Schools and Churches, B- Multi-Point Delivery, and C – Transformed Service	Eliminate	Penelec GRP-7
Rate QF – Interruptible Backup provision	Eliminate	Penelec Statement No. 6 p. 30, line 11
Rate RT – Provision D Solar Water Heating	Restrict	Penelec Statement No. 6 p. 34, line 22

The ALJs stated:

> Met-Ed and Penelec allege that their rate design is based on the cost of service study (COSS) for generation and distribution rates, with minor deviations. The transmission rates contain the kWh and demand allocators reflected in Met-Ed and Penelec's oral rejoinder testimony. Those rates and allocators will be included in the TSC Rider.

(R.D. at 141).

1. Disposition

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

C. Disputed Rate Design Issues

1. Rates RS and RT

a. Positions of the Parties

The Companies proposed an increase in the customer charge for Schedules RS and RT The Companies asserted that the increases are consistent with the COSS results. The Companies also proposed shifting the time differential in distribution rates, arguing that the shift is consistent with their over-all rate design approach because investment in the distribution system is not dependent on time of energy use. Also, ME argued that its proposed fixed distribution charge for Schedules RS and RT is similar to other utilities in Pennsylvania. (R.D. at 141).

OCA objected to the Companies' proposal to increase residential customer charges and lower the per kWh charges to increase revenues through fixed charges. OCA stated that the ME proposed increase for the RS customer charge is a 25.5% increase while ME is simultaneously proposing a decrease in its distribution rate. OCA also stated that PE's proposed customer charge will increase 24.5% while the distribution rate will only increase by 6%. According to the OCA, this change in rate design will result in small residential customers on ME's system receiving an overall increase in distribution charges while large customers will receive a decrease. OCA asserts that for PE's system, small customers will receive a much larger increase than large customers. OCA proposes that residential customer charges should not be changed and any additional revenue for residential classes should be obtained through the per kWh charges. (R.D. at 142).

OCA also opposed the Companies' proposal to eliminate existing time-of-day rate differentials in the distribution portion of the rate for residential time of day rate schedules RT. Elimination of time-of-day rates will eliminate any incentive for customers on that rate to manage their load. Also, customers will lose the opportunity to benefit from conserving at peak hours since Schedule RT has a flat generation charge. OCA also argued that customers would lose the ability to budget and exert control over the amount of their bills. (R.D. at 142).

b. ALJs' Recommendation

The ALJs recommended that the Companies proposal for Rates RS and RT be accepted. They determined that the increases are 'fully consistent with COSS results. (R.D. at 142). The ALJs also found that shifting the time differential in distribution rates to generation rates is consistent with *Lloyd v. Pa. PUC*, 904 A.2d 1010 (Pa. Cmwlth. 2006), because investment in the distribution system is not dependent on time of energy use. The ALJs determined that while OCA may have been correct that the changes could affect conservation and usage by customers, those issues were generation related and not distribution issues. The ALJs stated that *Lloyd* requires that each unbundled element of service must support itself and shifting the time differential is consistent with that concept. (*Id.* at 143).

c. Exceptions

In its Exception No. 5, OCA argues that the ALJs erred by recommending approval of the increase to customer charges. OCA asserts that the ALJs' recommendation is not supported by their statement that the increases are consistent with COSS results. According to OCA, 'customer charges should be based only upon basic and direct consumer costs, such as those associated with meters, meter reading, billing and collection costs. (OCA Exc. at 12). (Citation omitted). OCA argues that this basic customer cost standard has been applied to several major electric utilities and that standard should be maintained here. *Id.*

OCA asserts that the Companies have made no showing that their direct customer costs exceed the current customer charge. Accordingly, there should be no increase in those charges. (OCA Exc. at 12). OCA also states that the Companies justify their proposed increases with a general statement that the increased customer charges would be comparable to other utilities in Pennsylvania. However, OCA argues that the Companies also opined that each utility's cost and cost studies are unique. *Id.* OCA also asserts that it is inappropriate to provide for an increase in customer charges while overall distribution rates decrease. (OCA Exc. at 13).

OCA's Exception No. 6 claims error in the ALJs' recommendation to accept the Companies' proposal to shift the time differential from distribution rates to generation. OCA argues that such a shift will disturb the generation rate design established in the Restructuring Settlement and violate the generation rate cap. OCA notes that the ALJs refused to recommend approval of changes to the generation rate design when they rejected seasonal rates. OCA argues that the same result should occur here in the context of time of use rates. OCA asserts that 'the flat generation rate for

Rate RT with the on-peak/off-peak charges for distribution and competitive transition charges, must remain during the rate cap period. (OCA Exc. at 14).

The Companies respond to OCA's Exception No. 5 and argue that regardless of whether there is an overall distribution rate decrease, that is irrelevant to whether there should be an increase to the customer charge. The Companies disagree with OCA's argument that the increase in customer charges is not supported by COSS or that it violates the principle that such costs should reflect certain basic customer services. The Companies argue that the 'COSS clearly shows the fixed costs associated with meters, meter reading, billing and collection, etc., justify even *larger increases* in the customer charges' than those proposed. (Companies R.Exc. at 17-18). The Companies also assert that the proposed increases are not solely based upon a comparison with other utilities. That comparison was only one factor in supporting the design. (*Id.* at 18).

The Companies' response to OCA's Exception No. 6 asserts that the proposal to shift the time differential from distribution to generation does not violate the rate cap provisions of the Restructuring Settlement. The Companies argue that since the statutory rate cap has expired, the Commission has more discretion regarding the rate cap imposed by the Restructuring Settlement. Also, the rate cap applies to 'customers' in the aggregate, not individual customers. According to the Companies, the generation rate cap applies to each specific rate class. The Companies argue that this is consistent with the Act's provisions which provide authority to the Commission to approve flexible pricing and flexible rates (Sections 2806(h) and 2804(2) of the Code, 66 Pa. C.S. §§ 2806(h) and 2804(2)). The Companies assert that introduction of the time of date differentials into the residential generation rates do not result in an increase in the rates charged to the rate classes in the aggregate. (Companies R.Exc. at 19-20).

d. Disposition

OCA's Exception No. 5 is denied. The ALJs determined that the Companies' proposal is fully consistent with the COSS put forward in this case. As noted by the Companies in their Reply Exceptions, the record clearly supports an increase in customer charges based upon COSS elements which include basic customer services such as meters, meter reading, billing and collection. (Companies R.Exc. at 127). OCA's suggestion that the only support advanced for the customer charge increase in Rate RS is a comparison to other utilities in the Commonwealth is not borne out by the record, nor the ALJs' determination.

We will also deny OCA's Exception No. 6 regarding moving the time differential from distribution to generation. As noted by the ALJs, the shift is consistent with *Lloyd*'s requirement that unbundled services must stand on their own. The time differential is a generation issue, not distribution. This is made even clearer by OCA's arguments regarding conservation and usage which are obvious generation-related concerns.

2. Rates GS and GST

a. Positions of the Parties

The Companies and OTS agreed that the customer charge for rate GS should be $21.52 per month, and that any revenue shortfall should be collected through the distribution demand charge on a per kW basis. ME and OTS also agreed to maintain the GST fixed distribution charge at $60.98 per month. Any excess revenue generated by that change would be credited to the GS distribution demand charge. PE and OTS agreed to maintain the current customer charge of $60.98 per month for rate GST Any excess revenue will be credited to the distribution demand charge in rate GST PE advocated a distribution demand charge of $7.78 per kW OTS argued that was too high, producing a rate of return for the GST class of 10.42%, which is well above the system average rate of return of 9.23%. OTS argued that the GST distribution demand charge should be $7.40 per kWh. PE argued that was not high enough.

b. ALJs’ Recommendation

The ALJs recommended adoption of rates as agreed to by the Companies and OTS. With regard to PE’s distribution demand charge in Schedule GS, the ALJs recommended adoption of PE’s proposed $7.78 per kW The ALJs found that this charge ‘is more consistent with COSS than any other proposal. We do not see the 10.42% rate of return to be either excessive or unreasonably high compared to the system average of 9.23%. (R.D. at 144).

c. Exceptions

OTS’ Exception No. 1 claims error in the ALJs’ recommendation to adopt PE’s proposed distribution demand charge of $7.78 per kW in Schedule GS. OTS reiterates its argument that the demand rate should be lower ‘because the rate of return for the GST class under the Company proposed rates is 10.42%, which is well above the system average of 9.23%. (OTS Exc. at 4). OTS asserts that the ALJs’ determination that the class rate of return is not excessive is inconsistent with their finding that *Lloyd* requires that rates must be set primarily based upon COSS. Given the excessive return produced by the Companies’ proposal, OTS asserts that its proposal of $7.40 per kW ‘would clearly bring the rates closer to the cost of service. Accordingly, OTS argues that its proposal should be adopted. (*Id.* at 5).

d. Disposition

OTS Exception No. 1 primarily uses the system average rate of return as a gauge to suggest that PE's proposed demand charge for Rate GST is too high. However, as found by the ALJs, the proposed demand charge of $7.78 per kW for Rate GST ‘is more consistent with COSS than any other proposal. We agree. The primary focus on this issue is the COSS. *Lloyd*. While comparisons of system average rate of return to a rate class rate of return may be instructive and signal problems, the driver on this issue is COSS. With the record showing that PE's proposed $7.78 per kW is more consistent with COSS than any other proposal, we will deny OTS' Exception No. 1. In our view. *Lloyd* would permit use of a rate of return comparison if the issue was close or the record presented a confusing picture. However, that is not the case here.

3. Eight Hour on-Peak Time of Day Option (ME)

ME proposed to eliminate this provision and change it to a twelve hour on-peak period on the basis that it is not consistent with PJM's 16 hour on-peak period or cost causation principles. ME also asserted that the eight hour time period insulated customers from the true wholesale price of energy. (R.D. at 144). MEIUG/PICA and Sheppard challenged ME's proposal. (R.D. at 145-147).

The ALJs recommend rejection of ME's proposal on the basis that ME had failed to show that the revision was just and reasonable. (R.D. at 147).

a. Disposition

No exceptions have been filed to this determination. Finding the ALJs' recommendation to be reasonable, appropriate and in accordance with the record evidence, it is adopted.

4. Rates GP and LP

PE and OTS agreed to hold the fixed distribution charge increase for these schedules to 30%, with any revenue shortfall to be reflected in the distribution demand charge for these rate schedules. The GP customer charge should be $277.50 for primary service and $82.00 per month for qualifying service and the LP customer charge should be $991.00 per month. The ALJs recommended adoption of the Parties' agreement.

a. Disposition

No exceptions have been filed to this determination. Finding the ALJs' recommendation to be reasonable, appropriate and in accordance with the record evidence, it is adopted.

XII. Tariff Provisions

A. Metropolitan Edison Company Unopposed Tariff Changes

Company Proposed Modification	Proposed Tariff Reference	Company Testimony Reference
Insulation Requirements – Update/clarify standards	Rule 8	Met-Ed Statement No. 6, P. 19, L. 14 through P. 21, L.4
Modification/Clarification of when customer is entitled to historic billing information at no charge	Rule 12 a.(2)	Met-Ed Statement No. 6, P. 21, L. 6 through L.21
Seasonal Billing – Restricted and terminate	Rule 12 b.(10)	Met-Ed Statement No. 6, P. 22, L. 15 through, P. 23, L.15
Advanced Payment Billing – Restricted and terminate	Rule 12 b.(11)	Met-Ed Statement No. 6, P. 23, L. 17 through, P. 24, L.16

Due Date for Bills – Extend the due date for customers 60 years of age or older who receive Social Security or similar pension benefits	Rule 13 a.	Met-Ed Statement No. 6, P. 24, L. 18 through P. 25, L.12
Conditional Power Service – Terminate the tariff provision		Met-Ed Statement No. 6, P. 26, L. 16 through P. 30, L.11
Backup and Maintenance Service – Eliminate 'Interruptible Backup Service' provision	Rule 19 and Rate Schedule QF	Met-Ed Statement No. 6, P. 30, L. 13 through P. 31, L.17
Rate RT – Restrict 'Solar Water Heating' provision to existing customers	Rate Schedule RT	Met-Ed Statement No. 6, P. 35, L. 1 through P. 36, L.2
Non-Residential rate schedules minimum charges – Separate charge for full and delivery service customers combined into a single charge	Non-Residential rate schedules	Met-Ed Statement No. 6, P. 36, L. 8 through L.9
Non-Residential rate schedules Off-peak service – Eliminate provision	Non-Residential rate schedules	Met-Ed Statement No. 6, P. 36, L. 10 through L.11
Rate GS Volunteer Fire Company – Separate rate schedule – new	Rate Schedule GS – Volunteer Fire Company	Met-Ed Statement No. 6, P. 38, L. 8 through P. 40, L.6
Rate GS Small – Separate rate schedule – new	Rate Schedule GS – Small	Met-Ed Statement No. 6, P. 38, L. 8 through P. 40, L.6
Rate GS Medium – Separate rate schedule – new	Rate Schedule GS – Medium	Met-Ed Statement No. 6, P. 38, L. 8 through P. 40, L.6
Rate GS 'General heating, cooking and air conditioning' provision – Eliminated	Rate Schedule GS – Medium	Met-Ed Statement No. 6, P. 38, L. 10 through L.17
Rate GS Service to Schools and Churches provision Eliminated	Rate Schedule GS – Medium	Met-Ed Statement No. 6, P. 39, L. 16 through L.18
Rate GST – Renamed to Rate GS Large	Rate Schedule GS – Large	Met-Ed Statement No. 6, P. 40, L. 8 through L.19

Rate MS 'Space Heating Restricted' provision Eliminated	Rate Schedule MS	Met-Ed Statement No. 6, P. 40, L. 21 through P. 41, L.16
Rate GP Voltage discount provision – Eliminate for customers taking service from the 34.5 kV wye configuration	Rate Schedule GP	Met-Ed Statement No. 6, P. 41, L.1 8 through P. 42, L.4
Private Outdoor Lighting Service – Restrict to existing customers and phase out	Outdoor Lighting Service	Met-Ed Statement No. 6, P. 42, L. 6 through P. 44, L.12
Traffic Signal and Telephone Booth Lighting Service – Eliminate schedule and serve customers under Rate GS-Small	Rate Schedule GS – Small	Met-Ed Statement No. 6, P. 44, L. 14 through P. 45, L.7
Fire Alarm Box Lighting Service – Eliminate schedule and serve customers under Rate GS-Small	Rate Schedule GS – Small	Met-Ed Statement No. 6, P. 45, L. 9 through P. 46, L.2
CTC and Generation Charges Rider – Eliminate and include in applicable rate schedules		Met-Ed Statement No. 6, P. 46, L. 6 through L.22
Curtailable Service Rider – Eliminate		Met-Ed Statement No. 6, P. 46, L. 6 through L.22
Economic Development Rider – Eliminate provisions relating to economic and rename as Short Term Demand Utilization Rider	Rider N Short Term Demand Utilization	Met-Ed Statement No. 6, P. 46, L. 6 through L.22
Business Development Rider (New and Existing Service Locations) – Eliminate		Met-Ed Statement No. 6, P. 46, L. 6 through L.22
Residential Experimental Time of Use Rider – Eliminate		Met-Ed Statement No. 6, P. 46, L. 6 through L.22
Sustainable Energy Fund Rider – Eliminate		Met-Ed Statement No. 6, P. 47. L. 1 through L.6

B. Pennsylvania Electric Company Unopposed Tariff Changes

Company Proposed Modification	Proposed Tariff Reference	Company Testimony Reference
Insulation Requirements – Update/clarify standards	Rule 8	Penelec Statement No. 6, P. 19, L. 15 through P. 21, L.8
Modification/Clarification of when customer is entitled to historic billing information at no charge	Rule 12 a.(2)	Penelec Statement No. 6, P. 21, L. 10 through P. 22, L.2
Seasonal Billing – Restricted and terminated	Rule 12 b.(10)	Penelec Statement No. 6, P. 22, L. 19 through P. 23, L.19
Due Date for Bills – Extend the due date for customers 60 years of age or older who receive Social Security or similar pension benefits	Rule 13 a.	Penelec Statement No. 6, P. 23, L. 21 through P. 24, L.15
Conditional Power Service – Terminate the tariff provision		Penelec Statement No. 6, P. 25, L. 19 through P. 29, L.14
Backup and Maintenance Service – Eliminate 'Interruptible Backup Service' provision	Rule 19 and Rate Schedule QF	Penelec Statement No. 6, P. 29, L. 16 through P. 30, L.21
Rate RT – Restrict 'Solar Water Heating' provision to existing customers	Rate Schedule RT	Penelec Statement No. 6, P. 34, L. 6 through P. 35, L.6
Non-Residential rate schedules minimum charges – Separate charge for full and delivery service customers combined into a single charge	Non-Residential rate schedules	Penelec Statement No. 6, P. 35, L. 8 through L.14
Rate GS Volunteer Fire Company – Separate rate schedule – new	Rate Schedule GS – Volunteer Fire Company	Penelec Statement No. 6, P. 35, L. 16 through P. 37. L.14
Rate GS Small – Separate rate schedule – new	Rate Schedule GS – Small	Penelec Statement No. 6, P. 35, L. 16 through P. 37, L.14
Rate GS Medium – Separate rate schedule – new	Rate Schedule GS – Medium	Penelec Statement No. 6, P. 35, L. 16 through P. 37, L.14
Rate GS Service to Schools and Churches provision Eliminated	Rate Schedule GS – Medium	Penelec Statement No. 6, P. 37. L. 1 through L.3
Rate GST – Renamed to Rate GS Large	Rate Schedule GS – Large	Penelec Statement No. 6, P. 37. L. 16 through P. 38, L.8
Rate GST Off-Peak Thermal Storage Service provision – Restrict to existing customers	Rate Schedule GS – Large	Penelec Statement No. 6, P. 37. L. 16 through P. 39, L.7
Private Outdoor Lighting Service – Restrict to existing customers and phase out	Outdoor Lighting Service	Penelec Statement No. 6, P. 39, L. 11 through P. 41, L.15

Traffic Signal Service – Eliminate schedule and serve customers under Rate GS-Small	Rate Schedule GS – Small	Penelec Statement No. 6, P. 41, L. 17 through P. 42, L.9
CTC and Generation Charges Rider – Eliminate and include in applicable rate schedules		Penelec Statement No. 6, P. 42, L. 13 through P. 43, L.4
Incubator Economic Development Rider – Eliminate		Penelec Statement No. 6, P. 42, L. 13 through P. 43, L.4
Economic Development Rider (Existing Service Locations) – Eliminate		Penelec Statement No. 6, P. 42, L. 13 through P. 43, L.4
Economic Development Rider (New Service Locations) – Eliminate		Penelec Statement No. 6, P. 42, L. 13 through P. 43, L.4
Residential Experimental Time of Use Rider – Eliminate		Penelec Statement No. 6, P. 42, L. 13 through P. 43, L.4

The ALJs recommended approval of the foregoing tariff changes.

1. Disposition

No exceptions have been filed to this determination. Finding the ALJs' recommendation to be reasonable, appropriate and in accordance with the record evidence, it is adopted.

C. Resolved Tariff Issues

1. Rule 15d – Exit Fees

a. Positions of the Parties

MEPN proposed eliminating the year of 1996 from this rule for determining any exit fee that may be payable to the Companies if a customer either installs or extends on-site generation and reduces consumption. (MEPN St. 6 at 24-26; PN St. 6-R at 17· ME St. 6-R at 11-12). This change is needed since computer modifications have made 1996 customer billing determinants unavailable. MEPN proposed using an average of the customer's average billing demand and energy based on the four years immediately preceding the customer's request to invoke Rule 15d. (R.D. at 153).

MEIUG/PICA suggested two alternatives: (i) MEPN and the customer jointly develop a reasonable estimate of the customer's 1996 billing determinants and/or (ii) MEPN obtain from the customer any actual billing or other data that could be used to establish 1996 billing determinants. (MEIUG/PICA St. 1 at 50-52). The Companies agreed to modify Tariff Rule 15d consistent with MEIUG/PICA's approach, but also clarified that if no mutually acceptable data points can be established, MEPN will use the oldest billing determinants available to quantify the appropriate exit fees, taking into consideration any adjustments customers show to be relevant. (PN St. 6-R at 17· ME St. 6-R at 11-12; Tr. at 879). (R.D. at 153).

2. Limitation of Liability

The Companies proposed modifying existing Tariff Rule 26 regarding liability to comply with the Commission's statement of policy at 52 Pa. Code § 69.87 issued April 24, 1999 at Docket Nos. M-00960882 and M-00981209. (Met-Ed/Penelec St. 6 at 31-34). The revised tariff rule limits Met-Ed and Penelec's liability for actual property damage due to variations in electric supply resulting from their negligent acts and omissions. MEIUG/PICA withdrew its challenge to the modification. (Tr. at 1089; R.D. at 153-154).

3. Business Development Riders (BDRs)

The Companies placed these riders in their tariffs in 2000 as a business development tool to allow for the forgiveness of CTC for new incremental load for customers taking service under large commercial and industrial rate schedules (LP for Penelec and TP for Me-Ed). (PN St. 6 at 43-45; ME St. 6 at 47-48) No customers are served on these riders at Met-Ed and eleven total customers are served at Penelec. Met-Ed and Penelec intended the riders to serve as an economic development tool by attracting new load into the Companies' service territories. The Companies initially proposed eliminating the riders at Met-Ed and restrict them to existing customers at existing locations at Penelec. These grandfathered riders will expire at Penelec on December 31, 2009, at the conclusion of Penelec's generation rate cap. MEIUG/PICA withdrew its opposition to the elimination of the BDRs after receiving assurances that one of its corporate clients, PPG, would still be grandfathered until December 31, 2009. (MEIUG/PICA St. 1 at 53; Tr. at 1089-1090). Met-Ed and Penelec now propose that the Commission approve Penelec's grandfathering of the BDRs until December 31, 2009, and Met-Ed's elimination of the BDRs. (R.D. at 154).

4. Rule 12b(9) Transformer Losses Adjustment

The Companies proposed modifying this rule so the 2.5% adjustment applies to kWh (energy) in addition to demand. MEPN contend that this change modifies the tariff language so that it is consistent with the way it is actually administered. (MEPN St. 6 at 22; PN St. 6-R at 16; ME St. 6-R at 11). MEIUG/PICA explained that this modification allows the Companies to adjust the energy charges on customers' bills by 2.5% to compensate for losses in the event that meters are placed at the high or low side of Company owned transformers. (ME St. 6 at 22, PN St. 6 at 22). MEIUG/PICA expressed concern regarding the revenue impact of this proposal noting an apparent increase in customer charges due to the modification. According to MEIUG/PICA, the current tariffs permit the Companies to only adjust customers' demand charges. (MEIUG/PICA St. 1 at 49).

The Companies satisfied MEIUG/PICA's concerns by explaining that this modification is not a change from the Companies' current practice, but rather, a clarification of the tariff language and that no change to revenue will occur due to the modification. (ME St. 6-R at 10-11, PN St. 6-R at 16). As such, the Companies request approval of the modification to Tarff Rule 12b(9) as originally proposed. (R.D. at 154-155).

a. ALJs' Recommendation

The ALJs recommended that the Commission accept the above discussed tariff changes without modification. (R.D. at 152).

b. Exceptions

No parties excepted to the above resolved tariff issues.

c. Disposition

It should be noted that the Parties were able to reach a consensus on the above-discussed tariff changes. We find these unopposed tariff changes to be reasonable and in the public interest. As such, they will be adopted without modification.

D. Disputed Tariff Issues

1. Real Time Pricing (RTP) Rate

a. Positions of the Parties

PennFuture proposed that the Companies develop a RTP rate. Penn Future opined that real-time pricing encourages customers to reduce usage in high-cost, high-load periods and reduces future distribution costs. (PF St. No. 3-S at 4). According to PennFuture, peak-period energy charges, not demand charges, best reflect costs that are driven by both peak demands and energy use. (PF St. No. 3-S at 4). PennFuture stated that transferring cost recovery off demand charges onto peak-period energy charges by real-time pricing would encourage customers to reduce usage in high-cost, high-load periods, when transmission and distribution equipment is heavily loaded. (PF St. No. 3-S at 4). PennFuture further stated that decreases in existing loads could avoid future distribution costs by freeing up existing distribution capacity and by reducing the use of existing equipment. (PF St. No. 3-S at 4-5). PennFuture advocated hedging as solution to manage the risk of price volatility for consumers. (PF St. No. 3 at 17).

PennFuture advocates that the Commission require the Companies to expand their offerings of market-responsive rates, to include smaller customers. This process would include installing appropriate improved metering for all customer groups for which the metering appears to be cost-effective and developing new rate designs. (R.D. at 156; PF St. No. 3 p. 31). In order to fund its proposal, PennFuture asserts that the Commission should order the Companies to defer the incremental costs of equipment and projects required to implement real-time pricing and to propose a mechanism for recovering the balance of program costs. (R.D. at 156; PF St. No. 3 p. 29-30).

The Companies agree that a real-time pricing rate sends the correct market signal to customers but assert that it is inappropriate to design and implement such a program at this time. (R.D. at 156; Met-Ed St. No. 6-R at 19-20). The Companies argue that any real-time pricing tariff should be voluntary, require customers to pay for metering, be implemented after the conclusion of this proceeding, and not be subject to any prevailing generation rate cap. (R.D. at 156; Met-Ed St. No. 6-R at 20). Met-Ed and Penelec believe it is premature to implement a RTP rate now before POLR customers are paying full market rates. (R.D. at 156; Penelec St. 6-R at 21, Met-Ed St. 6-R at 19-20).

The OSBA points to Duquesne Light Company's (Duquesne), implementation of real-time pricing for Large C&I customers. According to Duquesne's comments in *Policies to Mitigate Potential Electricity Price Increases*, Docket No. M

00061957 Duquesne's Large C&I customers have taken fixed price service from EGSs rather than accept hourly pricing. (OSBA M.B. at 53). The OSBA opines that real-time pricing would not alter the consumption patterns of small businesses either. *Id.* The OSBA argued that PennFuture's proposal would require the installation of expensive time-of-use meters and that PennFuture fails to set forth the cost of installing the meters. OSBA asserts that under PennFuture's proposal, customers would bear the costs of installing time of use meters. (OSBA M.B. at 54-55).

MEIUG/PICA states that the real-time pricing proposals of PennFuture are not appropriate. (MEIUG/PICA St. No. 1-R at 22-25). Specifically, MEIUG/PICA opposes a per kWh charge, arguing that since distribution costs are fixed, that cost must be allocated on a demand basis. (MEIUG/PICA St. No. 1-R at 23) MEIUG/PICA also asserts that since transmission costs are a function of peak demand, they are more properly billed on the basis of single coincident peaks. (R.D. at 157).

The Commercial Group supported PennFuture's recommendation that the Companies implement an RTP rate schedule. (CG M.B. at 25). According to the Commercial Group, the RTP rate could benefit both the utility and customers and result in peak demand reductions. (*Id.* CG St. 1-R at 6).

b. ALJs' Recommendation

The ALJs determined that it was premature to implement a RTP rate in this proceeding. (R.D. at 158). The ALJs concluded that PennFuture failed to meet its burden of proving that a RTP would be appropriate and did not set forth the cost of implementing the rate. (R.D. at 157). The ALJs further concluded that PennFuture failed to prove that a RTP rate would shift or reduce load. *Id.* The ALJs noted the OSBA's observation that real time pricing had not altered large and commercial customers' consumption patterns in Duquesne Light Company's territory. *Id.*

c. Exceptions

According to PennFuture, the ALJs ignored substantial evidence regarding the benefits of real-time pricing. PennFuture argues that their testimony shows that real-time pricing offers various benefits to both participants and non-participants, including saving money to customers; improved reliability; reduced market prices for energy; reduced line losses; and reduced transmission and generation costs. (PF Exc. at 10). PennFuture claims that customer response to real-time pricing would tend to reduce a number of costs for all customers, including those not on real-time rates, by reducing demand for the most expensive generators, reducing the ability of generators to exercise market power, reducing peak capacity demand, and reducing upward pressure on natural gas costs. (*Id.* PF St. No. 3 at 23-24). PennFuture notes that its RTP proposal differs from Duquesne's and states that there are flaws in Duquesne's estimate regarding customer participation as well as the absence of hedging and other price risk reduction tools in the Duquesne program. (PF Exc. at 11). PennFuture requests that the Commission consider allowing hedging and day-ahead pricing here to protect against risk. (*Id.* PF R.B. at 5; PF St. No. 3-S at 10-11, 17-19). PennFuture excepts to the ALJs' failure to evaluate its evidence on these issues. (PF Exc. at 11).

The OSBA rejoins that PennFuture's proposal for real-time pricing would require the installation of time-of-use meters, the cost of which would be placed on the ratepayers. (OSBA R.Exc. at 18). The OSBA notes that PennFuture failed to set forth an estimate of the costs of implementing the RTP rate. *Id.* The OSBA states that the ALJs were correct in concluding that the Commission should have all pertinent facts before making a determination regarding the RTP proposal, namely, whether RTP will actually alter consumption patterns and how much the proposal would cost. *Id.*

MEPN states that the introduction of time-of-day differentials into the residential generation rates does not result in an increase in the rates charged to the rate classes in the aggregate, and is lawful and fully supported by the record. (MEPN R.Exc. at 20).

d. Disposition

It is premature to implement a RTP rate in this proceeding. In light of capped generation rates, this provision is premature and unlikely to result in substantial customer participation at this time. Moreover, this issue is more appropriately addressed in the POLR proceeding. To the extent that a large customer currently wants a RTP supply service, it can likely obtain this product from an EGS right now. As such, we will deny PennFuture's Exception on this issue.

E. Wind Product

1. Positions of the Parties

PennFuture argued that the Companies should develop a wind product like that being offered by PECO Energy and offer it to its customers at a separate rate. (PF St. 1 at 27). PennFuture recommended that the wind product should be comprised of at least 75% renewable energy. generated in Pennsylvania.

The Companies stated that they would be willing to develop a wind product subject to Commission authorization of full and timely compensation for costs incurred. (MEPN M.B. at 91).

2. ALJs' Recommendation

The ALJs concluded that PennFuture has not met its burden of proof to demonstrate that Met-Ed and Penelec should develop a wind product and offer it to their customers at a separate rate at this time. (R.D. at 158). The ALJs noted that PennFuture failed to set forth the cost of implementing the RTP rate. *Id.*

3. Exceptions

PennFuture Parties submits that the Commission should reject the Recommended Decision and require the adoption its proposed wind product. (PF Exc. at 1).

4. Disposition

We concur with the ALJs that it would be inappropriate to develop a wind product at this time absent more details. As the Companies noted, Met-Ed and Penelec have not been provided with any information on the cost of implementing such a product or how much customers would have to pay for such a product in order for Met-Ed and Penelec to fully recover those costs. As such, we will deny PennFuture's Exception on this issue.

F. Hourly Pricing

1. Positions of the Parties

Constellation argued that in order to develop a competitive market during the transition period and have it firmly established when the rate caps expire, the Companies' POLR service must introduce market-responsive pricing such as hourly priced service for the largest of C&I customers. (CNE M.B. at 24; CNE St. 1 at 9-14).

Constellation stated that the Commission should require the Companies to gradually introduce hourly priced POLR service for the largest C&I customers, those with monthly peak load contributions of 500 kW and higher, for the remainder of the transition period. *Id.* Constellation noted that 500kW is the threshold load contribution under consideration in the Commission's proposed POLR rules. Constellation explained that the 500kW threshold would ensure that the customers receiving hourly service are only those that are most sophisticated in the purchase and use of energy, and would keep the number of customers receiving hourly POLR service manageable for the Companies. *Id.*

MEIUG/PICA opposed Constellation's proposal regarding hourly pricing for large customers. MEIUG/PICA argued that the issue is outside the scope of this proceeding and should be the subject of a post rate cap POLR proceeding under Section 2807(e). (MEIUG/PICA M.B. at 82). MEIUG/PICA stated that while it is true that large customers spend a significant amount on energy, this does not mean that all large customers are able to manage the volatility inherent with hourly pricing. (Id. MEIUG/PICA St. No. 1-R at 29-30). MEIUG/PICA opined that Constellation's proposal would expose the large customers, who should be receiving generation rates under the rate cap levels, to hourly pricing, regardless of whether these customers' loads and/or manufacturing processes are equipped to handle such volatility. (MEIUG/PICA M.B. at 83).

MEPN stated that it is premature to implement a RTP rate now before POLR customers are paying full market rates. (MEPN M.B. at 90; PN St. 6-R at 21, ME St. 6-R at 19-20).

2. ALJs' Recommendation

The ALJs concluded that Constellation did not meet its burden of proving that the Companies should develop hourly pricing and offer it to their large commercial and industrial customers. (R.D. at 161). The ALJs found that Constellation failed to set forth the cost of implementing hourly pricing or whether the Companies' large commercial and industrial customers have the necessary resources to take advantage of the benefits it claims for hourly pricing. *Id.*

3. Exceptions

Constellation takes exception to the ALJs' determination that it failed to set forth whether the largest C&I customers (500 kW and above) have the necessary resources to take advantage of hourly pricing. (CNE Exc. at 11). Constellation also argues that the ALJs' arbitrary evidentiary standard is inconsistent with the Commission's *Duquesne Light POLR III* Opinion and Order which directed Duquesne Light to gradually introduce hourly priced service as the exclusive POLR product for large C&I customers of 300 kW and above. (CNE Exc. at 11). According to Constellation, the ALJs further erred in rejecting the introduction of hourly pricing until the generation rate caps expire and/or the Commission completes its POLR Rulemaking. (CNE Exc. at 13). Constellation opines that if the Commission authorizes the Companies to raise their rate caps, the gradual introduction of hourly priced POLR service to the largest C&I customers (500 kW and above) will be a legal and necessary step in fashioning a transition plan that furthers the purposes of the Choice Act and the Settlement. *Id.*

MEIUG/PICA rejoins that implementation of hourly-priced service would inappropriately subject customers to volatile pricing without adequately considering whether these customers are equipped to handle such volatility. MEIUG/PICA R.Exc. at 21). MEIUG/PICA states that the ALJs ruled correctly to reject Constellation's proposal based on the evidence of record. *Id.*

4. Disposition

With regard to hourly pricing, we agree with the ALJs that it is inappropriate to develop hourly pricing at this time. We base this conclusion on our belief that it premature to develop hourly pricing before the rate caps expire and the POLR regulations are in place. This issùe would be more appropriately addressed in the generic POLR proceedings. Accordingly, Constellation's Exceptions regarding hourly pricing are denied.

G. Seasonal Time of Day Provisions (Met-Ed)

1. Positions of the Parties

MetEd proposed elimination of the Seasonal time of day (TOD) service on Schedules GS, GST GP and TP (ME St. 6-R at 17-18). MetEd noted that the seasonality to be eliminated is currently built into the CTC component of these rates and that regardless of their origin, CTC rates have ceased to have any connection to generation. (ME St. 6-R at 18). MetEd included seasonality in its generation rates for cost causation reasons and eliminated that feature from the other rate components on the same principle – including CTC. *Id.* According to the Companies, when looking at all rate components as an integrated package, the total rate design for Schedules GS, GST GP and TP including the elimination of the CTC seasonal component, is appropriate and fully justified. (MEPN M.B. at 93).

MEIUG/PICA witness, Mr. Baron, claimed that eliminating the CTC seasonality is inconsistent with MetEd's approach to seasonality in generation rate design. (MEIUG/PICA St. No. 1 at 61-62). MEIUG/PICA opposed the discontinuance of the seasonal time of day provision stating that to do so raises inter and intra-class rate design issues since it has the effect of shifting costs from one group of customers to another in violation of the Restructuring Settlement and Competition Act.

(MEIUG/PICA M.B. at 79-80). MEIUG/PICA argued that any modification to this rate design would contravene the requirements of the Competition Act, result in a modification to the generation rate cap, and would detrimentally affect ratepayers. (MEIUG/PICA M.B. at 81).

2. ALJs' Recommendation

The ALJs approved the Companies' request to eliminate the Seasonal Time of Day Service for Schedules GS, GST GP and TP in the CTC component of these rates. (R.D. at 162). The ALJs concluded that shifting the seasonality differential to generation rates is consistent with *Lloyd* because the cost of operating the distribution system does not depend upon when the energy is used. *Id.* The ALJs stated that seasonality appears to be a generation issue and that as set forth in *Lloyd*, each unbundled element of electric service must support itself. *Id.*

3. Exceptions

MEIUG/PICA argue that the ALJs seem to overlook the fact that allowing Met-Ed to eliminate seasonal rates, which were developed as part of the Restructuring Settlement, would violate the terms of the Competition Act. (MEIUG/PICA Exc. at 9). MEIUG/PICA opine because seasonal time-of-day rates were in place prior to the Restructuring Settlement, and specifically considered during the unbundling process, eliminating those rates prior to the expiration of the rate caps would result in improper cost shifting. (MEIUG/PICA Exc. at 9-10). MEIUG/PICA argues that it is clearly inappropriate to eliminate these rates at this time and that any such modification would detrimentally affect ratepayers. (MEIUG/PICA Exc. at 10).

The Companies rejoin that the elimination of the seasonal time-of-day service in Rate Schedules GS, GST GP and TP does not result in an increase in the rates charged to the rate classes in the aggregate, and are lawful and fully supported by the record. (MEPN R.Exc. at 20).

4. Disposition

We will grant MEIUG/PICA's Exception regarding the ALJs' recommendation to allow Met-Ed to discontinue its seasonal time-of-day rate. It is inappropriate to eliminate seasonal time-of-day rates schedules GS, GST, GP, and TP at this juncture. The Company has not proven on this record that all seasonality should be removed from distribution rates. Moreover, it should be noted that seasonal time-of-day rates were in place prior to the Restructuring Settlement, and specifically considered during the unbundling process. This Commission has historically given deference to maintaining rate design stability during the rate cap period to avoid improper cost shifting. As such, the ALJs' recommendation on this issue is rejected.

H. Elkland Rates

1. Positions of the Parties

Former Elkland customers (768 residential, 125 C&I, 25 lighting) have been paying rates far below Penelec's rates since 1987. (PN St. 6 at 46- 48). Penelec proposed eliminating the lower rates for these customers and integrating them into the new Penelec rates over a 90-day period after a final order is entered in this proceeding. *Id.* As an alternative, Penelec proposed a phase-in of these customers onto Penelec's rates by applying stepped discounts to Elkland customers' bills. The discounts would be 40% in 2007, 30% in 2008, 20% in 2009, and 10% in 2010. (PN St. 6-R at 9-11).

The OCA opined that Penelec's proposal to bring the Elkland rates to Penelec rate levels in one step is unreasonable and ignores the principle of gradualism. (OCA St. 5 at 28). The OCA acknowledged that the rates did need to be changed, but noted that it was not the customers' fault that their rates have not been updated in twenty years. *Id.* In the interest of avoiding rate shock to Penelec's Elkland customers, the OCA submitted that Elkland's rates should be moved more gradually to the Penelec rate levels in at least two steps. The first step would be to implement rates from this proceeding, in a separate Elkland tariff, limited to half of the increase they would experience either under the current Penelec rates or the Penelec rates approved in this proceeding, whichever is lower. (OCA St. 5 at 28-29). In the second step, the full amount of the rate increase to Elkland customers would possibly be implemented. (OCA M.B. at 74).

2. ALJs' Recommendation

The ALJs concluded that Penelec's proposal to phase-in rates from 2007 to 2010 is the most reasonable method of bringing the rates of the former Elkland customers into line with the rates of the rest of Penelec's customers. (R.D. at 164). The ALJs stated that Penelec's proposed phase-in for the former Elkland customers via decreasing annual discounts ending in 2010 is reasonable and we will adopt it. *Id.*

The OTS accepted Penelec's proposal to phase in the Elkland rates but requested that the Company reflect the Elkland revenue at Penelec rates in the compliance filing. (OTS St. 3-SR at 19). When the Company failed to accept the OTS alternative proposal described OTS argued that the Commission should limit the increase to these customers to the increase to 60%. (OTS Exh. 3, Sched. 5). OTS witness, Mr. Kubas, stated that the increase in several of the Company's proposed Elkland rates exceed 70%. (OTS St. 3 at 29). OTS asserts any Elkland rate that is not equal to the Penelec rates should be increased to equal the Penelec rates in the next base rate case. (OTS M.B. at 56).

3. Exceptions

OTS argues that Penelec's proposal would increase some rates by more than 72 %. OTS argues that the increase in any rate should be limited to 60% and that the Elkland rates should be increased to equal the Penelec rates in the next distribution base rate case. (OTS Exc. at 6). OTS states that the Company's alternative proposal, a more gradual phase-in by providing discounts of 40 % in 2007 30 % in 2008, 20 % in 2009 and 10 % in 2010, would be acceptable if Penelec is required to reflect the Elkland rates at the 100 % level in the compliance proof of revenue schedules. OTS opines that to allow the Company to reflect anything less than 100 % would provide a revenue windfall to the Company. *Id.* This revenue windfall would occur because the Company would receive more revenue from Elkland customers in the subsequent years than is reflected in the compliance proof of revenues schedules. *Id.*

The OCA, in its Exceptions, argues that the ALJs erred by accepting Penelec's proposal, raised in witness Pleiss's rebuttal testimony. to phase-in the proposed 76% overall rate increase to Elkland residential customers from 2007 to 2010, without further Commission review. (OCA Exc. at 15). The OCA states that in previous Commission cases approving phase-ins of rates, the utilities offered much greater detail regarding the accounting requirements and other effects that would be required or result from the phase-in. *Id.* The OCA suggests that the Commission adopt OCA witness Smith's recommendation that limits the rate increase for Elkland to no more than half of the increase that Elkland customers would receive if they paid the lower of: (1) current Penelec rates or (2) Penelec rates that result from this proceeding. (OCA Exc. at 16). Following implementation of the first step recommended by Ms. Smith, the next step can be established in Penelec's next distribution rate case. (OCA Exc. at 16; OCA R.B. at 45).

MEPN rejoins that the both the OTS' and OCA's Exceptions to the ALJs' recommendation that Penelec reflect revenue from the former Elkland customers at full rates should be denied. (MEPN R.Exc. at 20). The Companies state that neither the OTS nor the OCA provides any support for their assertion that Penelec should reflect Elkland rates at the 100% level. MEPN notes that the OTS raised this issue for the first time in its Reply Brief. (MEPN R.Exc. at 20-21). MEPN explains that it appears that OTS is concerned that if Penelec designed retail rates so that the non-Elkland customers absorbed the difference between the applicable Elkland discount and Penelec's full retail rate, this amount would continue in retail rates beyond 2010 (when the Elkland discounts are scheduled to terminate). (MEPN R.Exc. at 21). MEPN addresses this concern by stating that Penelec intends to file annual changes to its retail tariff to reduce rates for non-Elkland customers by the amount of the change in the discount applicable to Elkland customers. *Id.*

4. Disposition

We agree with the ALJs that Penelec's proposal to phase-in rates from 2007 to 2010 is the most reasonable method of bringing the rates of the former Elkland customers into line with the rates of the rest of Penelec's customers. Penelec will be required to file annual changes to its retail tariff to reduce rates for non-Elkland customers by the amount of the change in the discount applicable to Elkland customers. In this way, there is no 'windfall' and no underrecovery associated with the annual Elkland changes. The OCA's and OTS' Exceptions on this issue are, therefore, denied.

XIII. SECTION 1307 RIDERS

A. Storm Damage Rider

1. Positions of the Parties

MEPN seeks approval of its Storm Damage Rider (SDR) (Rider F MEPN Exhs. RAD-65) in an attempt to recover storm damage O&M expenses above an amount ($4,500,000 (ME) and $4,400,000 (PN)), that will continue to be recovered in base rates. (MEPN M.B. at 82; ME St. 4 at 30; PN St. 4 at 31). According to MEPN, these expenses are substantial, highly volatile, and beyond the Companies' control. (MEPN Exhs. RAD-66). For ME, these expenses ranged from $12,500,000 (2003) to $2,400,000 (2005), while PN's costs have ranged from $16,000,000 (2003) to $4,600,000 (2005). *Id.*

The OTS also opposed MEPN's SDR noting that riders are traditionally used to allow utilities recovery of volatile expenses. (OTS M.B. at 26). The OTS maintained that storm damage is not sufficiently volatile to necessitate rider treatment because the Companies already recover a normalized level of storm damage expense. *Id.* OTS witness, Mr. Keim, reviewed the five year history of storm damage expenses and concluded that the budgeted claim is sufficient to account for yearly fluctuations. *Id.*

MEIUG/PICA argued that the SDR should be rejected because the Companies have not proven that the ratemaking process under which storm costs are normally collected should be circumvented. MEIUG/PICA M.B. at 66; MEIUG/PICA St. 2 at 15-16). MEIUG/PICA opined that the Companies currently have an adequate means by which to collect storm damage costs via both base rate proceedings and accounting deferrals. (MEIUG/PICA M.B. at 68). Even if the Commission determines that additional relief should be provided, this relief must come in the form of an alternative ratemaking option that would benefit both customers and the Companies, as compared to the proposed SDR, which would enable the Companies to flow-through to customers any and all costs even tangentially related to storm damage costs without adequate Commission review. *Id.*

The OCA argued that the SDR constitutes improper single-issue ratemaking and as such should be rejected. The OCA stated that the SDR applies to costs that are part of the normal cost of providing service and do not warrant special recovery separate and apart from other costs included in base rates. (OCA M.B. at 75; OCA St. 3 at 29-32).

The OSBA opposed the Companies' SDR. The OSBA stated that the SDR would provide the Companies with an opportunity to recover selected cost increases without the need for a base rate case subject to regulatory oversight. (OSBA M.B. at 45-46). The OSBA opined that such selective recovery amounts to single-issue ratemaking. (OSBA M.B. at 46). The OSBA continued that allowing MEPN to recover selected cost increases through their riders without a base rate proceeding would be biased against the ratepayers. *Id.* The OSBA acknowledged that there can be an exception to the prohibition against single-issue ratemaking when expenses are extraordinary and nonrecurring but concluded that no such exception exists here. (OSBA M.B. at 46-47). The OSBA further noted that the SDR does not make a distinction as to what kind of storm damage costs would be recovered. (OSBA M.B. at 47).

2. ALJs' Recommendation

The ALJ's found that the arguments of OTS, OCA, OSBA, and MEIUG/PICA were persuasive and determined that the Companies did not meet their burden of proving that the SDR is in the public interest and should be approved. (R.D. at 170, 172). The ALJ's stated that the normalized level of storm damage expense recovered through base rates is sufficient to account for yearly fluctuations in storm damage expenses. *Id.* The ALJ's held that in the event of unusual storm damage, the

Companies could file a petition with the Commission for deferred accounting and seek recovery of the expense in its next base rate filing. *Id.*

3. Disposition

No party excepted to the ALJs' recommendation on this issue. We concur with the ALJs that the Companies did not meet their burden of proving that the SDR is in the public interest. As noted by the ALJs, in the event of unusual storm damage, the Companies can file a petition with the Commission for deferred accounting and seek recovery of the expense in its next base rate filing. As such, we will deny the Companies' proposed SDR.

B. Universal Service Cost Rider

1. Positions of the Parties

MEPN's proposed universal service cost riders (USCR) propose recovery of the costs of the Companies' Universal Service programs, including CARES, CAP WARM, Fuel Fund Administration and uncollectible accounts expense. (MEPN Exh. RAD-63). MEPN wishes the USCR rate to be applied to all kWh sales delivered under the Companies' retail tariffs in order to spread the costs associated with the high levels of poverty and need in MEPN's service territories over the entire customer base. (MEPN M.B. at 83; ME PN St. 4 at 29). The initial rider amount will be 0.1730 ¢/kWh for PN (PN Exh. RAD-64) and 0.1460 ¢/kWh for ME (ME Exh. RAD-64), applied to all rate classes in each case. MEPN stated that if the USCR is not approved in this proceeding, the Companies will limit funding for the various Universal Service program costs to the amounts included in base rates. (MEPN M.B. at 83; MEPN St. 4 at 30).

According to MEPN, uncollectible accounts expense is included in the USCR: (1) to allow any change in the uncollectible expense associated with the operation of the Universal Service programs to be accounted for timely (MEPN St. 4-R at 31-32); and (2) because these expenses are volatile. (MEPN M.B. at 83-84).

OTS witness Keim specifically rejects the inclusion of uncollectible accounts expense in the USCR as contrary to the provisions of Section 1408 of the Code, 66 Pa. C.S. § 1408. (OTS St. 2 at 12-13). OTS recommended that CARES, Fuel Fund Administration, Gatekeeper, WARM, and uncollectible accounts expense not be included in the USCR. (OTS M.B. at 20). OTS allowed CAP expense in the USCR, but rejected the proposed recovery and recommended that such expenses not be reconciled. *Id.* OTS explained that the CARES, Fuel Fund Administration, Gatekeeper, and WARM expenses should be removed from the USCR because they are not subject to volatility: therefore, it is proper to continue to recover these expenses through base rates rather than through the USCR. (OTS M.B. at 20-21).

The OSBA argued that universal service programs are an 'insurance policy' for which the 'insured customers' should pay the 'premiums. (OSBA M.B. at 34). According to the OSBA, MEPN's universal service costs should be recovered solely from non-CAP residential customers. (OSBA M.B. at 35). The OSBA opposed the inclusion of uncollectible account expenses in the USCR arguing that: (1) the volatility of the Companies' uncollectible account expenses can be mitigated by the Companies' determination to increase collection efforts; (2) uncollectible account expenses are within the Companies' control since the Companies have many tools at their disposal to collect bills from those customers who fail to pay: and, (3) if MEPN were allowed to recover their uncollectible account expenses through an automatic surcharge mechanism, there would no longer be an incentive for the Companies to make vigorous efforts to collect unpaid bills. (OSBA M.B. at 37). OSBA's witness Mr. Kalcic testified universal service costs should be allocated either on the basis of cost-causation or on the basis of benefits received. Under both of these approaches, residential customers should be assigned

100% of the cost responsibility for universal service programs. (OSBA R.B. at 17· OSBA St.1-ME at 6; OSBA St. 1-PE at 5).

The OCA argued that the USCR should be rejected because such costs should be collected in base rates. (OCA M.B. at 76). The OCA opined that the USCR constitutes improper single-issue ratemaking, reduces the incentive to properly manage costs, and covers a normal cost of providing service that does not require special treatment. (OCA M.B. at 77· OCA St. 6 at 4-6). The OCA stated that if the USCR were approved, uncollectible expenses should not be included. However, the OCA argued that if the USCR were approved, it should be recovered from all customer classes because all derive some benefit from the programs. (OCA M.B. at 78-79). According to the OCA, '[t]his approach would be consistent with the general statutory framework for allocating universal service costs articulated in Sections 2802(17) and 2804(9) of the Public Utility Code. 66 Pa. C.S. §§ 2802(17), 2804(9) (universal service program costs 'shall be funded in each electric distribution territory by non-bypassable, competitively neutral cost-recovery mechanisms that fully recover the costs of universal service and energy conservation service"). (OCA M.B. at 79).

MEIUG/PICA argued that, under a cost causation theory, because the residential customer class is responsible for 100% of the costs of these programs, this same class should be assigned 100% of the cost responsibility. (MEIUG/PICA M.B. at 55; MEIUG/PICA St. 1 at 43-44). MEIUG/PICA stated that the Companies' proposal to allocate USP costs on a per kWh volumetric basis to all customer classes additionally and unreasonably impacts industrial customers. (MEIUG/PICA M.B. at 60). MEIUG/PICA also oppose the inclusion of uncollectible expenses in the USCR. (MEIUG/PICA M.B. at 61-63).

2. ALJs' Recommendation

The ALJs found that the Companies' proposal to recover universal service costs through an annually reconciled rider that imposes a per kWh surcharge, meets the statutory requirement that universal service costs be fully recoverable by the utility. (R.D. at 175). The ALJs, therefore, recommended the removal of all the revenues and expenses that are associated with universal service costs from base rates, $6,791,000 revenues in Met-Ed's base rates and $7,292,000 revenues in Penelec's base rate. *Id.* The ALJs determined that the agreed upon amounts of $19,072,000 for Met-Ed and $23,132,000 for Penelec for universal service programs shall be entirely collected and expended through the USCR. (R.D. at 175-176). The ALJs rejected MEPN's and the OCA's proposal that the USCR be applied to all customer classes and instead limited it to the residential class. (R.D. at 177-179). The ALJs recommended the addition of a separate line item on the residential customers' bills indicating the amount billed for the universal service costs. (R.D. at 179).

3. Exceptions

The OCA submits that the ALJs erred in recommending approval of the USCR and argues that Rider E should be excluded from the Companies' tariffs and the Companies should continue to collect their universal service costs through base rates. (OCA Exc. at 17). The OCA argues that the USCR is inappropriate because it rests on the premise that a surcharge is needed to fully recover universal service costs. This necessarily assumes that the relationship between costs and revenues has changed merely because certain expenses increase, but totally ignores that other expenses may decrease or that revenues may increase over the same time period. *Id.* According to the OCA, the USCR is inconsistent with traditional ratemaking principles that prohibit single-issue ratemaking. (OCA Exc. at 18). The OCA also states that the ALJ's recommendation should be rejected because rider costs are supposed to be those costs that are beyond a utility's control and those that are difficult to predict. (OCA Exc. at 19). The OCA opines that the universal service costs are neither beyond the Companies' control nor difficult to predict and are therefore not those costs that are appropriately to be recovered through a rider. *Id.* The OCA contends that the ALJ's recommendation should be rejected because of the inherent inefficiencies associated with the use of riders outside of base rates; as an automatically adjusting mechanism, the incentive for efficiency and cost management is greatly diminished. (OCA Exc. at 19-20).

The OCA also takes exception to the ALJ's recommendation that universal service costs should be recovered only from the residential class. (OCA Exc. at 20-27). The OCA states that it has provided substantial record evidence that demonstrates that all customer classes benefit from universal service programs. According to the OCA, benefits include: (1) providing a wage supplement to allow low-income workers to meet their basic needs; (2) decreasing turnover, absenteeism and tardiness; and (3) improving the competitiveness of local businesses. (OCA Exc. at 23).

The OCA further takes exception to the ALJ's recommendation that universal service costs be stated as a separate line item on customers' bills. The OCA argues that this is bad policy and not supported by the record evidence. (OCA Exc. at 27-28).

MEPN rejoins that the recovery of particular costs via a Section 1307 mechanism is a recognized exception to the prohibition on single issue ratemaking. (MEPN R.Exc. at 22). MEPN argues that because universal service costs satisfy the criteria for recovery via a rider mechanism, there is no violation of single issue ratemaking. *Id.* MEPN continues that any consideration of traditional ratemaking principles must yield to express statutory mandates that require full recovery of such costs. *Id.* MEPN cites to the changing needs of customers and the growing levels of poverty in their service territories. (MEPN R.Exc. at 22-23). The Companies note that the Commission has many ways to address the alleged lack of incentive to manage these costs under such a rider, including the: (1) the broad audit and review of the costs and application of the rider mechanism under the terms of the USCR and Section 1307 of the Code; (2) the Commission's Bureau of Consumer Services which oversight of these programs. (MEPN R.Exc. at 23).

Both the OSBA and MEIUG/PICA state that the ALJs properly determined that the Companies request for recovery of universal service program costs should be allocated only to the residential class. (OSBA R.Exc. at 13-16; MEIUG/PICA R.Exc. at 15-17).

4. Disposition

We concur with the ALJs who correctly approved the use of the USCR to recover universal service costs. Further, the ALJs correctly limited recovery of the USCR to residential customers. These recommendations are consistent with the Commission's Order on *Customer Assistance Programs: Funding Levels and Cost Recovery Mechanisms*, Docket No. M-00051923 (December 18, 2006). We disagree with the ALJs recommendation regarding the USCR bill line item. The USCR is just one of the Companies' many operating expenses. No compelling justification has been presented for separately identifying this particular operating expense on residential customer bills. As such, we reject the ALJs' recommendation to itemize the USCR.

C. Government Mandated Programs Rider

1. Positions of the Parties

MEPN proposed a government mandated programs rider (GMPR) (Rider J MEPN Exhs. RAD-67) as a mechanism to recover all of the costs of any program required by legislative action or by a governmental agency. MEPN provided that the

GMPR would remove the uncertainty of recovery for costs over which the Companies have no control, as to amount, timing or the reasons for their incurrence. (MEPN St. No. 4 at 32-33). According to MEPN, some of the possible costs mentioned in this proceeding that could be recovered via the GMPR include the $30 million for renewable energy programs, $5 million in consumer education spending, $30.6 million for DSM/energy efficiency expenditures as proposed by PennFuture witnesses, and new funding for MEPN's Sustainable Energy Funds. (MEPN M.B. at 84-85).

The Companies disputed the Parties' claims regarding single issue ratemaking. According to MEPN, the recovery of a particular set of costs, such as those proposed by the GMPR, via an automatic rate adjustment mechanism under Section 1307 is a recognized exception to any prohibition on single issue ratemaking. (MEPN M.B. at 85). MEPN stated that there are protections built into the rider structure, including annual filings and the Commission's right to audit and review the rider and its charges annually. (*Id.* ME St. 4-R at 44; PN St. 4-R at 43-44).

The OCA opposed the GMPR, stating that the costs are the very type of costs that should be reviewed and evaluated for reasonableness, prudence and eligibility for recovery from ratepayers in a base rate case. (OCA M.B. at 75). The OCA raised the same objections it raised to the SDR noting that: (1) the GMPR covers costs that are already a part of the overall cost of service therefore potentially resulting in a double recovery of costs that are not incremental costs already recognized in setting rates; and (2) the rider reduces the incentive to properly manage and control costs because cost recovery is guaranteed. (*Id.* OCA St. 3 at 29-32).

MEIUG/PICA objected to the GMPR stating that the Companies have not demonstrated that the costs are identifiable, material, volatile, or that they cannot otherwise be addressed through the base ratemaking process. (MEIUG/PICA St. 2 at 9).

OTS argued that not only does the GMPR violate the well established prohibition against single issue ratemaking, the request for an initial rate of $0.00 demonstrates that there is no legitimate need for recovery outside the context of traditional ratemaking procedures. (OTS M.B. at 24-25).

The OSBA opposed the GMPR. The OSBA concurred with MEIUG/PICA's expert, Mr. Kollen, on the following:

> The costs recoverable through the [Government Mandated Program] Riders are not limited in any manner. Any costs the Companies' management determines somehow may qualify as Government Mandated Programs Costs will be eligible for recovery through the proposed tariffs. Taken to an extreme, any costs incurred by the Companies arguably would qualify for recovery through [Government Mandated Program] Riders given the utilities' ultimate obligation to serve, which itself is a government mandate. As evidence of this extreme possibility that any/or all costs may be qualified for recovery through the [Government Mandated Program] Riders, the definition of the eligible Government Mandated Programs includes 'all activities, functions, and/or programs provided by the Company to or for benefit of Customers. The proposed [Government Mandated Program] Riders are open-ended and subject to significant discretion and abuse.

(OSBA M.B. at 51, MEIUG/PICA St. 2 at 13).

2. ALJs' Recommendation

The ALJs agreed with the objecting Parties that the GMPR is an attempt by the Companies to circumvent the ratemaking process and that it should be denied. (R.D. at 184). The ALJs found that the Companies failed to meet their burden of proving that the GMPR is necessary. The ALJs further found that because the costs to be included in the GMPR were not specifically identifiable, the need for the rider is highly speculative. *Id.*

3. Exceptions

No exceptions were filed on this issue.

4. Disposition

We concur with the ALJs that the Companies failed to meet their burden of proving that the GMPR is necessary. The fact that the costs to be included in the GMPR were not specifically identifiable supports the speculative nature of the proposed rider. The ALJs recommendation to reject the GMPR is therefore, adopted.

XIV DIRECTED QUESTIONS OF VICE CHAIRMAN CAWLEY

By Secretarial Letter dated July 14, 2006, all Parties in this proceeding and the presiding ALJs were provided a copy of Vice Chairman Cawley's directed questions to be addressed in this case. The directed questions and the ALJs' summary of the responses are contained in Appendix A attached to this Opinion and Order. In their discussion of the directed questions, the ALJs noted that only seven Parties responded: the Companies; MEIUG/PICA; PennFuture; OCA; and, the Commercial Group. (R.D. at 185). OTS filed its Exception No. 3 and stated that the ALJs had overlooked the OTS' responses. We will grant this Exception and include the OTS' responses in Appendix A.

XV MISCELLANEOUS

In its Exception No. 4, OSBA notes that the ALJs directed the Companies to file tariffs designed to produce revenues not in excess of the total revenue requirements found to be appropriate in this proceeding. OSBA argues that the Companies should be directed to file tariffs which specify the revised rates for each separate service (i.e.

generation, stranded costs, transmission and distribution) for which a change in rates has been approved. OSBA further argues that the Companies should be directed to show the detailed calculations of the adjustments approved by the Commission for each service, the rates the Companies will charge for each service and the proof of revenue for each service. OSBA asserts that this is consistent with Section 2804(3) of the Code, 66 Pa. C.S. § 2804(3), relating to unbundling, and *Lloyd.*

We will grant this Exception and provide the recommended direction.

OSBA also filed its Exception No. 5 and reiterated its request that the Companies be required to include in their compliance filings redlined copies of their compliance tariffs to assist the Parties and the Commission in their review and analysis of the compliance filing. We agree with this suggestion and will provide the necessary direction.

Constellation filed its Exception No. 5 and claims error in the ALJs' failure to recommend the initiation of a working group to develop a competitive wholesale solicitation process for the procurement of POLR supply beginning in 2011. (Constellation Exc. at 15-17). The Companies responded and noted that the Commission has already convened a working group to address request for proposal documents and supplier master agreements for POLR supply at Commission Docket No. M-00061960. The Companies observed that the first meeting of the working group was held on July 26, 2006, and representatives for Constellation attended. The Companies assert that there is no need for a working group focused on the Companies in light of the working group that has already been convened. (Companies R.Exc. at 23). We agree with the Companies and deny this Exception.

Constellation filed Exception No. 6 and argues that the ALJs erred when they failed to direct that the Companies provide programs for customer education regarding competitive markets, pricing and supply acquisition tools. (Constellation Exc. at 18-19). We will deny this Exception. Issues involving customer education will be addressed on a generic basis in the Commission's proceeding on *Policies to Mitigate Potential Electricity Price Increases* at Commission Docket No. M-00061957

Constellation also filed its Exception No.7 and argues that the ALJs erred by failing to ensure that administrative costs for POLR service must be included in the Companies' POLR rates. Constellation asserts that it is not clear that the Companies COSS properly separated out POLR administrative costs from other services. Constellation argues that unless those costs are split out and allocated wholly to POLR service, shopping customers will be paying for services they no longer receive from the Companies. Constellation concludes that the Companies should be required to perform a fully unbundled COSS that accounts for POLR administrative costs. (Constellation Exc. at 19-20).

The Companies respond that Constellation has failed to show that those costs are eliminated for shopping customers since they can return to POLR service at any time. Accordingly, there is no need to break those costs out in a separate fashion and no justification for exempting shopping customers from paying those costs. (Companies R.Exc. at 24). OSBA responds that Constellation's argument ignores the fact that the Companies' generation rates are capped through 2010. In addition, Constellation has failed to produce any evidence to determine whether those costs are already included in the Companies' POLR rates. Accordingly, OSBA argues that Constellation has failed to meet its burden of proof on this issue. (OSBA R.Exc. at 17).

We will deny this Exception. We agree with the OSBA that Constellation ignores the fact that the Companies are currently under rate caps. We also agree that Constellation failed to produce any evidence on the issue of whether POLR administrative costs are already included within the POLR rates or are embedded in some other service.

XVI. CONCLUSION

For the reasons discussed above, we will adopt the Recommended Decision of Administrative Law Judges Wayne L. Weismandel and David A. Salapa as modified by, and consistent with the foregoing Opinion and Order; **THEREFORE,**

IT IS ORDERED:

1. That the Exceptions of Parties are granted or denied, consistent with this Opinion and Order.

2. That Metropolitan Edison Company shall not place into effect the rules, rates and regulations contained in Tariff Electric Pa. P.U.C. No. 49, the same having been found to be unjust, unreasonable and, therefore, unlawful.

3. That Pennsylvania Electric Company shall not place into effect the rules, rates and regulations contained in Tariff Electric Pa. P.U.C. No. 78, the same having been found to be unjust, unreasonable and, therefore, unlawful.

4. That Metropolitan Edison Company's Petition for Approval of a Rate Transition Plan, Docket No. P-00062213, is denied.

5. That Pennsylvania Electric Company's Petition for Approval of a Rate Transition Plan, Docket No. P-00062214, is denied.

6. That Metropolitan Edison Company is hereby authorized to file tariffs, tariff supplements, or tariff revisions containing rates, provisions, rules and

regulations, consistent with the findings herein, to produce revenues not in excess of $1,210,883,000. The compliance filings shall separately state the total amount of revenues for generation, transmission, distribution, universal services, and stranded costs.

7 That Pennsylvania Electric Company is hereby authorized to file tariffs, tariff supplements, or tariff revisions containing rates, provisions, rules and regulations, consistent with the findings herein, to produce revenues not in excess of $1,147,801,000. The compliance filings shall separately state the total amount of revenues for generation, transmission, distribution, universal services, and stranded costs.

8. That Metropolitan Edison Company's tariffs, tariff supplements, or tariff revisions described in Ordering Paragraph No. 6, above, may be filed upon less than statutory notice, pursuant to the provisions of 52 Pa. Code §§ 53.31, *et seq.* and 53.101, and may be filed to be effective for service rendered on and after the date of entry of this Opinion and Order.

9. That Pennsylvania Electric Company's tariffs, tariff supplements, or tariff revisions described in Ordering Paragraph No. 7 above, may be filed upon less than statutory notice, pursuant to the provisions of 52 Pa. Code §§ 53.31, *et seq.* and 53.101, and may be filed to be effective for service rendered on and after the date of entry of this Opinion and Order.

10. That Metropolitan Edison Company shall file detailed calculations with its compliance filings, which shall demonstrate to this Commission's satisfaction that the filed tariffs and adjustments comply with the provisions of this Opinion and Order. The filing shall include a redlined version of the tariff indicating where changes have been made.

11. That Pennsylvania Electric Company shall file detailed calculations with its compliance filings, which shall demonstrate to this Commission's satisfaction that the filed tariffs and adjustments comply with the provisions of this Opinion and Order. The filing shall include a redlined version of the tariff indicating where changes have been made.

12. That Metropolitan Edison Company shall comply with all directives, conclusions and recommendations contained in the body of this Opinion and Order, which are not the subject of any individual directive in these ordering paragraphs, as fully as if they were the subject of a specific ordering paragraph.

13. That Pennsylvania Electric Company shall comply with all directives, conclusions and recommendations contained in the body of this Opinion and Order, which are not the subject of any individual directive in these ordering paragraphs, as fully as if they were the subject of a specific ordering paragraph.

14. That Metropolitan Edison Company and Pennsylvania Electric Company shall retain 100% of the merger savings amount and are not required to allocate any portion of the merger savings to their ratepayers.

15. That Metropolitan Edison Company and Pennsylvania Electric Company shall increase transmission rates, including congestion and other related costs, via a Transmission Service Charge Rider, with such costs to be recovered through both energy and demand allocators in an automatic adjustment mechanism consistent with the provisions of Section 1307 of the Public Utility Code, 66 Pa. C.S. § 1307

16. That Metropolitan Edison Company and Pennsylvania Electric Company shall be permitted to recover their deferred test year transmission costs as set forth in their filing and herein. The deferred 2006 transmission costs shall be bypassable.

17. That Metropolitan Edison Company's and Pennsylvania Electric Company's requests to increase the average retail Competitive Transition Charge rate is denied.

18. That Metropolitan Edison Company's and Pennsylvania Electric Company's requests to accrue carrying charges on deferred NUG stranded cost balances is denied.

19. That Metropolitan Edison Company's and Pennsylvania Electric Company's requests to recover any amount by which the NUG locational marginal pricing and capacity cost (NLACC) exceeds their respective Provider Of Last Resort (POLR) revenues is denied.

20. That except as otherwise provided herein, Metropolitan Edison Company's and Pennsylvania Electric Company's proposed rate changes for schedules RS, RT, GS, GST, GP and LP are approved consistent with this Opinion and Order.

21. That Metropolitan Edison Company's proposal to eliminate the Seasonal Time of Day Services on GS, GST, GP and TP is denied consistent with this Opinion and Order.

22. That Metropolitan Edison Company's and Pennsylvania Electric Company's proposed tariff changes for Rule 15d-Exit Fees, Rule 26-Limitation of Liability, the Business Development Rider and Rule 12b(9)-Transformer Losses Adjustment, having been resolved by the Parties are approved consistent with this Opinion and Order.

23. That Metropolitan Edison Company and Pennsylvania Electric Company shall not include a Real Time Pricing Rate in their respective tariffs, the same having been found to be unjust, unreasonable and not in the public interest.

24. The Metropolitan Edison Company and Pennsylvania Electric Company shall not include a Wind Product Rate in their respective tariffs, the same having been found to be unjust, unreasonable and not in the public interest.

25. That Metropolitan Edison Company and Pennsylvania Electric Company shall not include an Hourly Pricing Rate for their customers of 599 kW and above in their respective tariffs, the same having been found to be unjust, unreasonable and not in the public interest.

26. That Metropolitan Edison Company shall not modify its Tariff rate GST by modification of the time-of-day provisions so as to change the on-peak period from 8 hours to 12 hours.

27 That Metropolitan Edison Company shall be allowed to eliminate Rider G (Sustainable Energy Fund Rider) from its Tariff.

28. That Pennsylvania Electric Company shall be allowed to eliminate Rider I (Sustainable Energy Fund Rider) from its Tariff.

29. That Metropolitan Edison Company and Pennsylvania Electric Company shall not include a Storm Damage Rider in their respective tariffs, the same having been found to be unjust, unreasonable and not in the public interest.

30. That Metropolitan Edison Company and Pennsylvania Electric Company shall include a Universal Service Cost Rider in their respective tariffs, in

accordance with the provisions of Section 1307 of the Public Utility Code, 66 Pa. C.S. § 1307 designed to produce revenues in the amount of $11,978,000 for Metropolitan Edison Company and in the amount of $16,299,000 for Pennsylvania Electric Company. The Universal Service Cost Rider shall apply only to Metropolitan Edison Company's and Pennsylvania Electric Company's residential customer class.

31. That Metropolitan Edison Company and Pennsylvania Electric Company shall not set forth the monthly amount billed to residential customers under the Universal Service Cost Rider as a separate line item on the bill.

32. That Metropolitan Edison Company and Pennsylvania Electric Company shall not include a Government Mandated Programs Rider in their respective tariffs, the same having been found to be unjust, unreasonable and not in the public interest.

33. That the Complaints of Met-Ed Industrial User Group and Industrial Energy Consumers of Pennsylvania, the Office of Small Business Advocate, the Office of Consumer Advocate, R.H. Sheppard Co. Inc. Penelec Industrial Customer Alliance and Industrial Energy Consumers of Pennsylvania, Pierre Fortis, and L.C. Rhodes are, to the extent they have not been previously marked closed, sustained in part and dismissed in part, consistent with this Opinion and Order.

34. That the Pennsylvania Public Utility Commission's inquiry and investigation in Docket No. R-00061366 is terminated and the record closed.

35. That the Pennsylvania Public Utility Commission's inquiry and investigation in Docket No. R-00061367 is terminated and the record closed.

36. That the record at Docket No. P-00062213 be marked closed.

37 That the record at Docket No. P-00062214 be marked closed.

38. That the record at Docket Nos. A-110300F0095 and A-110400F0040 be marked closed.

BY THE COMMISSION,

James J. McNulty
Secretary

(SEAL)

ORDER ADOPTED: January 11, 2007

ORDER ENTERED: January 11, 2007

Tables

Appendix A

DIRECTED QUESTIONS OF VICE CHAIRMAN JAMES H. CAWLEY

The following discussion is the ALJs' summary of the Vice Chairman's Directed Questions and the responses thereto found at Pages 185 – 201 of the Recommended Decision. The discussion has been corrected to include OTS' responses.

By Commission Secretarial Letter dated July 14, 2006, all parties and the presiding ALJs were provided a copy of Vice Chairman Cawley's directed questions to be addressed in this consolidated case. The Vice Chairman's questions were:

> 1. Do fixed charges for residential and small or medium commercial customer distribution services discourage conservation of energy? If so, what other revenue decoupling models can be implemented that would optimally meet the dual needs of providing incentives for consumers to conserve energy, while providing reasonably stable distribution revenues for utilities?
>
> 2. Do demand-based charges remove the incentive for consumers, especially small to medium sized C&I customers, to conserve energy? If so, should demand-based rates for such customers also be phased out over time?
>
> 3. Can and should rate designs vary among customer classes? For example, larger industrial and commercial ("C&I") customers generally have a much smaller percentage of their revenues attributable to distribution services. Given this dynamic, does the commodity design of supply service rates provide adequate incentive for larger C&I customers to conserve energy?

Of the eighteen parties to the consolidated case, eight chose to address the Vice Chairman's questions. The Companies, OCA[25] MEIUG and PICA and IECPA, PennFuture, and the Commercial Group addressed the Vice Chairman's questions both in written testimony and in their respective Main Brief. OSBA and Constellation addressed the Vice Chairman's questions only in their respective written testimony.

The Companies addressed the Vice Chairman's questions in their Main Brief at page 99, and in their written testimony at Met-Ed/Penelec Statement 3-R, at 54-61 and at Met-Ed Statement 6-R, pp.25-30 and Penelec Statement 6-R, pp.25-30.

OCA addressed the Vice Chairman's questions in its Main Brief at pages 96-97 and in its written testimony at OCA Statement 5R, at 6-8 and OCA Statement 6R, at 11-15.

MEIUG and PICA and IECPA addressed the Vice Chairman's questions in its Main Brief at Appendix E, and in its written testimony at MEIUG and PICA and IECPA Statement 1-S at 28-31.

PennFuture addressed the Vice Chairman's questions in its Main Brief at pages 25-26, and in its written testimony at PennFuture Statement 3-S, at 12-16.

The Commercial Group addressed the Vice Chairman's questions in its Main Brief at page 25, and in its written testimony at Commercial Group Statement 1-S, at 6-9.

OSBA addressed the Vice Chairman's questions in its written testimony at OSBA Statement 2-ME/PE, at 14-16.

[25] OCA did not address Question #2 of the Vice Chairman's directed questions.

Constellation addressed the Vice Chairman's questions in its written testimony at Constellation Statement CNE 1-S, at 9-12.

The Companies addressed the Vice Chairman's questions in the following manner. The Vice-Chairman's questions focused on the interplay between fixed and demand charges in rate design and conservation incentives. The fundamental rate design principle is that pricing should be based on costs. Using distribution rates as an incentive to promote conservation of generation resources, if successful, is likely to result in the unintended consequence of the utility failing to be able to recover its allowed revenue. Other pricing arrangements are more effective in attaining conservation objectives, the primary one being setting rates at levels commensurate with current costs, and not under pricing the resource intended to be the target of conservation. Cost-based fixed charges and demand charges in distribution rate design are appropriate to recover fixed costs and should not be misused to attain objectives not associated with distribution cost recovery.

With respect to the Vice Chairman's first question, the Companies do not believe that cost-based fixed charges associated with distribution services discourage conservation. From a rate design perspective, fixed customer charges are utilized to recover the Companies' fixed costs associated with serving the customer. These include the fixed costs associated with such things as meters, meter reading, billing and collection, etc. As currently implemented, fixed customer charges usually represent a relatively small percentage of a customer's total bill for distribution service. However, the Companies' investment in and the size of their distribution system are not dependent upon and are largely unrelated to customer's energy usage. Ideally, more of the Companies' costs would be recovered via the demand component in distribution rates. However, recovery of these costs via demand charges is constrained by, among other things, lack of demand meters at residential customer premises and restrictions on what residential customers can pay. Any reduction or elimination of the existing or proposed customer charge or fixed fee would not measurably encourage customer conservation because these fixed charges represent such a small portion of a customer's typical bill.

With respect to the Vice Chairman's second question, the Companies do not believe that cost-based demand charges remove the incentive for medium sized C&I customers to conserve energy. The Company stated that they really need to think of energy conservation in two terms: (i) demand side management, the reduction in peak usage during peak periods, which presumably limits the need to add capacity and (ii) energy conservation, the overall reduction of energy (kWh) consumption. From a rate design perspective, it makes sense to use demand-based rates to collect fixed costs associated with serving the customer, as in the case of distribution. Since the costs associated with supplying the necessary infrastructure to serve the customer do not vary significantly based on the amount of energy (kWh) consumed, collecting distribution charges on a demand basis provides a modest level of revenue stability to the Companies, and gives customers appropriate incentives to implement demand side management programs. So long as the demand rates are seeking to recover largely fixed costs that are not dependent upon and do not vary based on consumption, such charges can properly co-exist with usage charges and customers will still have the appropriate incentives to conserve energy. For commodity components of the rates (i.e. generation), it makes sense to pass the energy-related pricing signals through to customers. Recovering all generation costs through energy rates is completely consistent with the principle of cost causation which is the underlying basis for all sound rate design. Adherence to cost causation will provide proper price signals to customers and encourage energy conservation by having energy charges more reflective of the underlying commodity based product. Increasing energy charges while decreasing demand charges (or vice versa) provides customers with competing and often contradictory approaches for either employing demand side management or conserving energy. The Companies continue to believe that demand charges are a reasonable and valuable component of pricing.