Allegheny Energy

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July 20, 2006

VIA FEDERAL EXPRESS

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

Re: Policies to Mitigate Potential Electricity Price Increases
Docket No. M-00061957

Dear Mr. McNulty:

Please find enclosed the original and fifteen (15) copies of the Reply Comments of Allegheny Power filed pursuant to the Commission's May 24, 2006 Investigation Order in the above-captioned docket. A copy of Allegheny Power's Reply Comments has been e-mailed to Shane Rooney today.

This filing is made by Federal Express and the filing date is deemed to be today, July 20, 2006.

Very truly yours,

John L. Munsch

John L. Munsch
Senior Attorney

JLM:sac

Enclosures

cc: Shane Rooney (via srooney@state.pa.us)

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Policies to Mitigate Potential Electric Price Increases	**:**	**Docket No. M-00061957**

REPLY COMMENTS OF ALLEGHENY POWER

Allegheny Power submits Reply Comments in the above-captioned investigative proceeding initiated by the Pennsylvania Public Utility Commission to address issues and develop policies to mitigate electricity price increases upon the expiration of generation price caps. The Reply Comments supplement Allegheny Power's main Comments filed June 15, 2006, and also supplement the testimony of Cynthia A. Menhorn submitted on behalf of Allegheny Power at the Commission's en banc hearing of June 22, 2006.

Advanced Metering, Demand Side Response Programs and Consumer Education.

Allegheny Power agrees with the Commission's basic principles that customers in a fully competitive market should receive and understand accurate market signals and that advanced metering technology coupled with effective consumer education will help achieve those goals and promote energy conservation.

In implementing the basic principles, however, Allegheny Power believes that another basic principle is the need for flexibility among the EDCs. In this approach the company agrees with the Comments of PECO and the other EDCs and with the Reply Comments of the Energy

Association. That is, the Commission should avoid major statewide efforts at consumer education and also avoid mandatory uniform electric metering requirements. Each EDC is significantly distinguishable from others in the Commonwealth in the lengths and expiration dates of their transition periods and in their customer demographics. Each EDC's pricing is also unique in the extent of the projected gap between the market price of generation and capped generation rates.

With respect to customer education, for example, Penn Future suggests in its Comments that the Commission should institute a $25 million statewide consumer education project. Such a one-size-fits-all approach would be inappropriate and unsuccessful due to the differences among the EDCs. Allegheny agrees with the Comments of the Office of Consumer Advocate that there is little value in educating consumers until closer to the time that the generation rate caps expire. EDCs have varying rate cap expiration dates, and it is best left to the individual EDCs to design an education effort that is best suited to its customer demographics and the timing of its respective rate cap expiration. While Allegheny believes that the Commission should provide EDCs its input for standardization and uniformity of consumer education approaches, the Commission should not undertake a statewide program.

Allegheny also points out that it has reserved approximately $4.7 million to be used for consumer education, which the company anticipates will be used toward the end of its transition period. Any additional costs for consumer education, above that already confirmed in relevant restructuring agreements or amendments, should be recovered by utilities on a current basis through an adjustable rate under Section 1307 of the Public Utility Code or Section 2802(17) of the Public Utility Code which provides for a 1307-like mechanism for recovery of universal services and energy conservation. Also, Allegheny suggests that any such customer education programs present the opportunity to make consumers aware of the money that they have saved since rate caps have been in place, versus the normal effect of inflation and the staggering increases in fuel costs over the last several years.

A similar principle of flexibility applies to the implementation of real-time meters and pricing for all customers. The Department of Environmental Protection suggests in its comments that the Commission should require the installation of real-time meters for all customers. Allegheny Power emphasizes that such a broad approach would have immediate economic costs for customers because the Competition Act provides that conservation policies, protections and services are to be fully recovered from customers through non-bypassable rate mechanisms. 66 Pa. C. S. §2802(17).

As US Steel submits in its Comments, many industrial customers do not have the operational flexibility to use hourly priced service. This is not only true for many industrial customers, but also for residential and commercial customers that do not necessarily have the resources, expertise or time to manage effectively an hourly priced product. For such customers hourly metering and pricing are irrelevant because level, long-term rates are the only useful form of default generation service. Also, it should be noted that the imposition of an hourly priced service would expose customers to the volatility of the electric market and can result in rate shock, which this Commission is prudently attempting to mitigate.

With regard to Demand Side Management, Allegheny believes that any such programs should not be a function of default service offered by the EDC but should instead be incorporated as an optional product of retail suppliers. DSM should not require subsidies by the load-serving entity unless such costs can be recovered from all customers as a proven societal benefit.

Finally, several of the commenting parties recommend rate design changes to encourage conservation and energy efficiency. However, elimination of declining rate block structures coincident with the end of generation rate caps will result in customers with high load factors experiencing the largest percentage change in electric bills. This is contrary to the Commission's goal to mitigate potential electricity price increases by imposing a punitive rate design on those customers that most effectively and efficiently utilize distribution, transmission and generation facilities. Also, the attempt to improve cost allocations through bidding by rate class should not be a "one-size-fits-all" approach. Electrical load needs to be of an appreciable size to attract wholesale bidders and create competition in the wholesale procurement process. Slicing of the load into increments that are too small may not attract enough interest from wholesale bidders, thereby placing the associated class of customers at a disadvantage with the resultant retail generation rates. Allegheny suggests, therefore, that any proposed rate design changes, such as phasing out declining rate block structures and redesigning customer class rates to improve cost allocations, should be addressed on a utility-by-utility basis in the default service implementation plan filings made at the end of the utilities' transition periods.

POLR Procurement Rules and Process

The commenting parties seem to agree that rules for default service should be developed expeditiously. A long lead-time will allow for thorough development of procurement processes, retail marketer entry, wholesale supplier education and consumer education. Well-defined and stable procurement rules and processes will promote confidence and predictability in the process for retail suppliers and customers.

Allegheny Power agrees that the Commission should not promote high default service rates, or otherwise "ugly" default rates, to provide incentives for shopping. Default service should be an objective, market-based option for customers who cannot shop or prefer not to shop. As the OCA notes, the Competition Act did not intend to create artificial competition by subsidizing retail suppliers at the expense of non-shopping customers. The measure of a successful utility structure is not necessarily the level of retail shopping, but rather that customers are receiving safe and adequate service at prevailing market prices.

Rules should provide that default service rates reflect the prevailing market prices as required by Section 2807 of the Competition Act. In this regard the commenting parties differ from approaches that advocate hourly to monthly pricing for all default service to staggered portfolio procurement with contract terms varying in length between one and three years. Such polar positions will have an effect on shopping with the former forcing customers who are looking for fixed rate stability exclusively to the retail market and away from EDC-procured default service while the latter creates a non-vibrant retail market where marketers can only compete with default service when prices fall significantly. Allegheny believes that neither end of the spectrum creates an optimal market of choice for Pennsylvania customers and thus suggests that a middle approach may better develop a balanced competitive environment for Pennsylvania.

Finally, Allegheny urges the Commission to structure default service rules to include a true-up mechanism to ensure full cost recovery by the utility as the default service provider. A true-up mechanism is a critical component of a fair and balanced default service program to both the EDC and customer.

Alternatives to Avoid Abrupt, Large Price Increases

Allegheny Power emphasizes that its recently approved Joint Settlement amending its restructuring plan greatly alleviates the Commission's concern of abrupt price increases for Allegheny's customers. The company and many of its largest customer constituents, the OCA, OSBA, the Industrial Group, AK Steel, the Constellation companies and others, entered the Joint Settlement, approved May 11, 2005. Among many other points, the Settlement extended the company's generation rate cap from 2008 to the end of 2010, with gradual step increases each year. The Commission approved the parties settlement stating:

> The Amended Joint Petition continues the intent of the 1998 Restructuring Settlement by providing for gradual and measured increases to West Penn's generation rates during the extended transition period to avoid dramatic increases as rate caps expire. Under the 1998 Restructuring Settlement, West Penn's generation rates would increase in 2006 and 2008. Recognizing that West Penn's generation rates were the lowest in Pennsylvania at the time of restructuring the Amended Joint Petition steadily increases generation rates throughout the extended transition period to mitigate the risk of rate shock. The Amended Joint Petition also adjusts the shopping credits for 2009 and 2010 set forth in the Joint Petition in order to better position EGSs and customers for participation in the retail electricity market in 2010 and beyond.

Order entered May 11, 2005, Docket Nos. R-00039022 and R-00973981, p. 24. While Allegheny Power's 2005 Settlement achieved the parties' objectives of rate cap extensions with gradual increases, the Commission's present investigation properly addresses increases beyond 2010.

Of the proposals presented in the various Comments to avoid or defer price increases, Allegheny Power sees unfortunate problems in most approaches. Most problematic is the "after-the-fact deferral" approach, that would defer customer payment of price increases to a future period. This approach creates a deferred regulatory asset to pay the EDCs for amounts they have already spent to purchase default generation service. In doing so the deferral appears merely to postpone and exacerbate potential rate shock for customers. It also compounds regulatory uncertainty for investors about recovery of deferred amounts which inevitably increases costs. This has become evident in the neighboring state of Maryland on July 11, 2006 when Moody's Investors Service downgraded several EDCs to near junk status due to the perceived inability to pass along higher energy costs in a hostile political environment.

By contrast, Allegheny sees the "early phase in" approach as not objectionable, at least from this point in time. "Early phase in" attempts to replace a large increase with earlier step increases, to be refunded over time should the increase not materialize. Although some commenters point out this approach poses "generational" issues of an earlier group of customers financing a later group, the concept is no different than current "after the fact" rate-making methodology in which a later group of customers experience the positive or negative effect of revenues and expenses incurred on behalf of an earlier group of customers.

On Bill Financing

Comments submitted by the Pennsylvania Small Business Development Center and Pennsylvania Food Merchants Association propose that the Commission establish "on bill financing" as a way to help small businesses implement energy efficiency. With "on bill financing" the end user has no up-front out-of-pocket expenses for energy efficiency investment. The utilities provide the user with zero percent interest funding to cover the initial investment costs, with the small business customer continuing to pay its bill at normal or slightly reduced levels until the project is paid off. While Allegheny believes in encouraging energy efficiency, the Company does not support this idea of "on bill financing." In reality, the utilities incur costs to obtain capital and need to pass through the carrying costs. Additionally, such a program would require the development and implementation of systems for tracking purposes, creating costs for the utility. Providing certain small business customers with funding at no cost to them creates a ratepayer subsidy, shifts such costs to other ratepayers, and may be viewed as discriminatory towards other customers not eligible for such a program. This runs contrary to the cost causation principles that the OSBA favors.

Purchase of Receivables

Allegheny does not support the recommendation offered in Dominion Retail's Comments that the Commission should require utilities to purchase the receivables of marketers for whom they are providing consolidated billing services. Dominion Retail says that with the purchase of receivable programs, suppliers would be more willing to serve low-income customers since the supplier would be assured of receiving payment. Allegheny agrees that the risk to the supplier is eliminated, but unfortunately the utility is exposed to a greater degree of financial risk associated with customer non-payment of bills. Allegheny recommends that the Commission not require the purchase of accounts receivable in conjunction with consolidated billing but instead allow EDCs and EGSs to negotiate such arrangements if they so desire.

Comparison of Allegheny's PA, MD and WV Rates

Comments submitted by the Industrial Energy Consumers of Pennsylvania compare the rates for similarly situated industrial customers in Allegheny Power's Pennsylvania, Maryland and West Virginia service territories. Such a comparison is not valid and is like comparing apples and oranges with regard to fuel and purchased power costs. Since Allegheny has not filed a base rate case in West Virginia since 1994, the rates are not reflective of current costs and currently do not include a pass-through of rising fuel and purchased power costs. Allegheny's generation rates in Pennsylvania are currently under a rate cap, with gradual increases, through the end of 2010. Since the generation rates in Maryland are based upon a pass-through of market costs, the only way to make a valid comparison with Pennsylvania and West Virginia is to adjust, at a minimum, the rates to reflect the change in fuel and purchased power costs that would have occurred had there not been rate caps or other agreements that temporarily prevented the incremental cost collection. Allegheny also notes that the comparison was made on 2005 Pennsylvania generation rates, not on the escalated generation rates that will occur after 2010, and which will present a different picture.

Conclusion

The Commission must be commended for its proactive investigation of post-transition electricity markets. Nevertheless, the comments provided by the Edison Electric Institute put the issue of electricity price in clear perspective. EEI points out that the percentage increase in average Pennsylvania retail electric rates, for each class of customer, is less than the national rate of increase for the period 1990 through 2005. It also points out that the increase in electricity prices, on a national basis, falls far behind increases in other consumer goods and services. In the period of 1985 through 2005, for example, health care costs increased 185 percent, natural gas increased 108 percent and food 81 percent, while average national electric retail rates increased only 27 percent. The Consumer Price Index increased 82 percent during that 20-year period. Pennsylvania electric consumers should also recognize the enormous savings they've enjoyed since the enactment of the Competition Act, which along with EDCs restructuring settlements froze electric rates for several years.

In closing, Allegheny Power reiterates that competition is not failing in Pennsylvania, though it has been slower to develop than many anticipated. The market needs certainty to move out of transition. The Commission should stay the course while continuing to provide utilities with the proper regulatory framework to move competition forward.

Respectfully submitted:

Date: July 20, 2006

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