

**Testimony: Leila L. Vespoli**  
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**Pennsylvania House Consumer Affairs Committee**  
**Rep. Keith R. McCall's Phase-In Legislation**  
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Chairman Preston, Chairman Godshall, members of the Committee – good morning, and thank you for the opportunity to address this Committee today on recently introduced legislation related to phasing in potential future electric rate increases. I'm Leila Vespoli, Executive Vice President and General Counsel of FirstEnergy, which is the holding company for three electric utilities in Pennsylvania – Met-Ed, Penelec and Penn Power.

My testimony will address Pennsylvania's recent experiences with electric restructuring, some of the steps Met-Ed and Penelec are taking to help mitigate the impact of future rate increases on our customers, and a few thoughts on issues surrounding House Bill 20, Speaker McCall's recently introduced phase-in legislation.

But first, let me give you some background on FirstEnergy. We're a diversified, investor-owned energy company headquartered in Akron, Ohio, with a long history and a strong presence in Pennsylvania. Our seven electric distribution companies comprise the nation's fifth-largest investor-owned electric system based on customers served. In Pennsylvania, Met-Ed, Penelec and Penn Power serve approximately 1.3 million customers in 49 of the Commonwealth's 67 counties.

We have more than 4,300 employees in Pennsylvania, we pay more than \$280 million annually in state and local taxes, and we purchase nearly \$400 million each year in goods and services from businesses throughout the Commonwealth.

The passage of the Pennsylvania Electricity Generation Customer Choice and Competition Act of 1996 significantly changed our business. Before this law was enacted, every facet of our operations – from power plants to the transmission and distribution system that delivers electricity to homes and businesses – was regulated at

the state level. Prices for the generation and delivery of electricity were determined by the Pennsylvania Public Utility Commission through a process called cost-based regulation, which was designed to ensure that customers benefited from reliable and efficient electric service and that utilities received a fair return on the costs they incurred to serve customers.

Although the transmission and distribution of electricity remained regulated after 1996, Pennsylvania's restructuring law mandated that prices for electric generation would eventually be determined through competitive markets for electricity. As part of the process to transition to competitive generation markets, GPU, Inc. – former parent company of Met-Ed and Penelec – sold its generating plants to non-affiliated, third-party generators, with all \$900 million in net proceeds from the sale of the plants provided as direct savings to customers. This sale was encouraged and approved by the Commission. The generation rates charged by Met-Ed and Penelec have remained capped since 1997. As a result, customers have benefited from below-market prices for most of this period. Today, the rates offered by Met-Ed and Penelec are among the lowest in Pennsylvania, and well below the average for utilities in the Mid-Atlantic region.

Pennsylvania's restructuring law and associated restructuring agreements established that generation prices would remain capped throughout the transition period. And the end-date for the transition period varied from utility to utility. For example, the rate caps have already expired for some utilities, including for our Penn Power company in 2006. Our Penn Power customers are now served through the competitive generation market. That same market will be used to serve customers of our Met-Ed and Penelec companies commencing in 2011.

To serve its customers who decide not to choose their own electricity supplier, Penn Power currently obtains electricity for them through a competitive procurement process. This process requires pre-approval by the Commission, establishes a price for generation, and ensures customers are served by a reliable supply of electricity – and it has worked well for Penn Power and its customers.

The results of Penn Power's move to competitive markets were predictable, given the fact that prices for electric generation had remained essentially the same for at least 13 years, while the real price of producing and delivering electricity had increased dramatically. Although residential customers experienced 20- to 30-percent rate increases following the first competitive bid process in 2006, the increases were consistent with inflation during that time. And, price increases have been minimal since then. In fact, when rates are adjusted to reflect the latest competitive bids, a typical residential customer will experience an 11-percent *decrease*, and a typical commercial customer will see a 13- to 14-percent decrease, beginning in June of 2009.

It's also important to keep in mind that these prices reflect the high water mark – meaning that customers have the option to shop for a better price, but they won't have to pay more than the price resulting from the competitive bid process. And Penn Power's customers have been taking advantage of the opportunity to shop. As of January 1, 2009, approximately 98 percent of industrial customer load, 57 percent of commercial customer load, and 8 percent of residential customer load at Penn Power is served by competitive generation suppliers.

Also, customers have more choices as a result of competition. Currently, out of the seven state-licensed retail suppliers in Penn Power's service territory, there are five registered retail electric generation suppliers offering electricity to Penn Power customers. Prior to the end of Penn Power's rate caps, there were none. Vibrant competition exists in the wholesale market in Penn Power's footprint as well. For example, four different wholesale suppliers are currently supplying power for Penn Power's residential and commercial default service customers – that is, customers that choose not to shop.

Despite this progress, Pennsylvania's legislators are rightfully concerned about the impact that future price increases might have on customers – especially given the significant financial challenges many customers face in this difficult economy. And I commend the Legislature – as well as the Pennsylvania Public Utility Commission – for

the initiatives you've already put into place to create an environment that will help ensure the future stability of electric prices in the Commonwealth.

In fact, utilities throughout Pennsylvania are already moving forward with their own initiatives to mitigate future price increases. These efforts build on the recent policies adopted by the Legislature through the enactment and ongoing implementation of Act 129 of 2008 – as well as the Commission's policies and regulations dealing with default service and price mitigation.

Act 129 included energy efficiency goals and peak load reduction targets, requirements for the installation of smart meter technology, and the establishment of a process for the competitive procurement of electric generation service. The energy efficiency measures mandated by Act 129 will provide customers with a variety of programs to help them reduce consumption and lower their electric bills. Toward that end, our companies already offer a number of programs designed to encourage the wise use of electricity.

For example, our "Online Energy Calculator," available on our Web site, helps customers understand their energy use and identify ways to be more efficient. We also currently offer a number of other energy efficiency programs – including time-of-use rates that help shift energy use off-peak, and energy efficiency seminars for commercial and industrial customers. As a result of the Energy Efficiency and Conservation Plans that utilities will file with the Commission by July 1, additional efficiency and conservation initiatives likely will be introduced and made available to customers.

Customers who participate in these programs should see lower electric bills today, as well as more moderate increases in their bills when generation rate caps are lifted. We intend to aggressively promote these programs over the next few years through new advertising and promotional campaigns designed to encourage greater customer participation.

Another measure aimed at mitigating the impact of future rate increases is our Voluntary Pre-payment Plan, or VPP, which was approved by the Commission last month. Our

plan enables residential and certain small commercial customers of Met-Ed and Penelec to prepay an amount equal to 9.6 percent of their monthly electric bills in 2009 and – absent any increases in other components of rates – an additional 9.6 percent in 2010. The pre-payments will be used to help offset the potential increases in electric rates that may occur beginning in 2011. Customers who participate will receive an attractive 7.5-percent interest rate on their pre-payments – a return that’s hard to match in today’s financial climate. We will begin promoting the program in April through print and radio ads, bill inserts, a 1-800 number and a dedicated Web site.

Earlier, I mentioned the competitive bid process used by Penn Power to secure electricity. Act 129 also requires all utilities to establish similar plans to procure electricity for their customers when rate caps expire. Under procurement plans filed by Met-Ed and Penelec on February 20, which are currently pending at the Commission, an independent consulting firm would conduct multiple bidding solicitations at various times in 2010 through March 2012, with generation prices calculated based on a blended average by customer class. The prudent use of long-term, short-term and spot market generation supplies should provide benefits to customers over time and continue to reflect the advantages offered by competition among suppliers.

Consumer education and outreach will remain essential to the success of these and other efforts aimed at providing rate relief to customers, both now and in the future. We intend to use bill inserts, advertising, our call centers and Web site to help ensure customers are aware of future changes in their electric service, and that they have the opportunity to make the right energy decisions when those changes occur. Basic messages to customers will include the availability of rate mitigation tools such as VPP; details on efficiency, conservation and demand-response programs; and information on competitive choice options.

A carefully crafted phase-in of the initial generation rate increase following the expiration of rate caps is another tool that regulators and utilities could use to help mitigate the impact on customers’ bills. Specifically, the phase-in would enable customers, over a

period of several years, to gradually pay for the full amount of an initial increase in the price of generation.

While offering this clear benefit to customers, any phase-in must be fair to utilities by providing for the recovery of the deferred amounts and associated carrying charges.

Let me offer several key considerations that should be used to determine the basic fairness and legality of phase-in legislation, and specifically the Speaker's bill.

First, utilities must recover carrying costs on deferrals – essentially, the interest utilities would have to pay on the money borrowed to fund the phase-in. Suppliers require utilities to pay the full cost of obtaining electricity at the time the energy is procured. However, under the proposed bill, customers would be paying the utilities less than the full cost, with the utilities funding the difference. In other words, we would be loaning our customers money today that they would repay at the end of the phase-in period.

Based on the Commission's flash-cut analysis of the market price for generation on December 30, 2008, the phase-in language in House Bill 20 would impose approximately \$625 million in additional costs on our Met-Ed and Penelec utilities over the phase-in and recovery period – \$465 million in deferrals and \$160 million in carrying charges.

Let me describe the challenge this way: In 2008, Met-Ed and Penelec had a combined net income of approximately \$175 million – meaning the annual deferrals and carrying charges associated with the phase-in would be more than their annual income and could increase their long-term debt obligation by more than 45 percent at the end of the phase-in period.

By denying recovery of carrying costs – and requiring our utilities to borrow additional money to fund the deferrals – the bill would have a significant impact on our Companies' financial health. These actions could lead to lower credit ratings, higher cost of capital and ultimately fewer resources to spend on infrastructure improvements that would help

maintain future service reliability. It's also important to consider that these negative impacts would occur at a time when access to credit is scarce and costly.

Accordingly, I don't believe that denying recovery of carrying costs is good public policy. Moreover, it's also contrary to federal law. Denying recovery of any cost associated with purchased power would be illegal and would violate the Takings, Due Process and Supremacy clauses of the U.S. Constitution. States are prohibited from setting utility rates at levels that do not permit the utilities to recover their reasonable purchased power costs and to otherwise earn a reasonable return on their investments. And it's important to consider that our utilities do not profit from wholesale purchases of electricity – these costs are simply passed along to customers.

As I mentioned earlier in my testimony, Met-Ed and Penelec sold their generation plants to unaffiliated companies in the late 1990s, as encouraged by the restructuring law and approved by the Commission. Because neither company owns generation to supply customer needs, Met-Ed and Penelec will be required to buy power from the wholesale market for their customers. The cost of buying this power will likely be greater than current rates because Met-Ed's and Penelec's base generation rates have been capped at 1992 and 1986 levels, respectively. The difference between what Met-Ed and Penelec would pay for wholesale power and the lower amounts that customers would pay the companies under a rate cap extension is impossible to predict with certainty, but under the Commission's flash-cut analysis, the Companies would incur an additional \$625 million in costs related to deferrals and associated carrying charges.

Any efforts to extend rate caps, or otherwise to limit the recovery of the Companies' purchased power costs, would be illegal and not sound public policy. Such actions would be unconstitutional under long-standing and clear legal precedent. The Supremacy Clause of the U.S. Constitution precludes state regulation of wholesale energy sales that occur in interstate commerce and are subject to FERC's exclusive jurisdiction under the Federal Power Act. As a matter of federal preemption through the Supremacy Clause, the Filed Rate Doctrine requires that rates set for wholesale power sales must be given

binding effect by states in determining the rates to be charged to retail customers.<sup>1</sup> A rate cap extension or limit on the recovery of purchased power costs would unlawfully result in a retail rate that essentially would “trap” FERC-approved wholesale power costs – a result that is prohibited by federal law.

Trapping these FERC-approved costs would also violate the Takings Clause of the Fifth Amendment of the U.S. Constitution, which is made applicable to the states by the Due Process Clause of the Fourteenth Amendment. Rates that deny a utility the opportunity to recover its prudently incurred costs and a fair rate of return on its investment used for public service are confiscatory and violate rights protected by the Takings and Due Process Clauses.<sup>2</sup> Trapping costs would unlawfully deny utilities the opportunity to recover substantial increases in purchased power costs. This would not only result in under-recovery of legitimate operating expenses – including the payment of debt incurred in order to fund the phase-in – but also prevent utilities from receiving a fair return on their investments used to serve customers. For example, in the above scenario, the denial of carrying charges would substantially reduce the earnings of Met-Ed and Penelec to levels that would be confiscatory.

Finally, there are a number of policy concerns regarding the trapping of FERC-approved costs. This would result in customers being subject to even greater increases after the end of an extension, making the transition to market prices even more difficult. In addition, the conservation benefits envisioned in Act 129 would not be achieved because the savings incentives arising from energy efficiency improvement and smart meter technology would continue to be minimal, since customers who implement conservation measures would not realize enough savings to justify the costs incurred or the changes in lifestyle.

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<sup>1</sup> *Federal Power Commission v. Southern California Edison Co.*, 376 U.S. 205, 215-16 (1964); *Nantahala Power & Light Co. v. Thornburg*, 476 U.S. 953, 966 (1986).

<sup>2</sup> *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U.S. 575, 586 (1942); *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 605 (1944); *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989).

Moreover, the competitive energy market would become dormant because suppliers would be unwilling or unable to offer customers savings compared with the below-market prices being paid. Additionally, extending generation rate caps would have real and immediate negative financial consequences on electric distribution companies, jeopardizing their ability to buy power and provide reliable electric service. Incurring higher power costs without revenue to pay for them would damage the companies' credit ratings and create an immediate, adverse impact on their financial viability.

Another concern involves the language describing the time period in which utilities would recover the deferred amounts. As written, the bill requires that the phase-in take place over a three-year period. But the bill also states that the Commission *may* provide for an additional three-year period for the recovery of deferred amounts. This recovery should not be uncertain, especially given the Constitutional issues I've just discussed. It should be clear that this recovery must be mandatory, and that the recovery of *all* deferred amounts and carrying charges – along with any remaining initial generation increase amounts – *must* take place during the three years following the phase-in.

If there is no recovery of the deferred amounts – or if recovery is substantially incomplete – the current net income of Met-Ed and Penelec could be completely wiped out. This would result in our Companies being forced to operate at a net loss over the phase-in period – or, at the very least, with a significant reduction in net income. Either situation would lead to further deterioration of equity and credit quality and make it even more difficult for the Companies to borrow money – to the extent that access to the credit market is even available. I should point out that Met-Ed and Penelec had more than \$1.3 billion in long-term debt obligations at the end of last year – mainly for infrastructure-related investments. If they are forced to operate at a loss, the Companies would have a difficult time paying off this debt – much less raising the capital needed to invest in future system improvements.

Legislating the impossible would not serve the best interests of our customers, while a carefully crafted phase-in bill would provide the opportunity to help mitigate future increases in generation prices to the benefit of customers.

Finally, we're concerned that House Bill 20, as currently written, provides for a limit of only 15 percent per year for three years, for a maximum increase of 45 percent. Although wholesale market prices have recently dropped, we don't know where prices will be when rate caps are lifted at the end of 2010. We do know, however, that our customers have benefited from artificially low rates since 1997. In fact, rates offered by Met-Ed and Penelec are among the lowest in Pennsylvania. And, based on the Constitutional issues I've already raised, we know that any attempt to trap future prices for generation would violate federal law.

I appreciate the opportunity to discuss these issues with you related to the current version of House Bill 20. We intend to continue working closely with this Committee, the General Assembly and the Public Utility Commission to develop energy solutions that are in the public interest. I look forward to answering any questions you have about these and other energy-related issues. Thank you.