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ORIGINAL

December 30, 2005

James J. McNulty, Secretary
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DOCUMENT FOLDER

RE: Joint Application of PECO Energy Company and Public Service Electric and Gas Company for Approval of the Merger of Public Service Enterprise Group Incorporated with and into Exelon Corporation
Docket No. A-110550F0160

Dear Secretary McNulty:

Enclosed for filing, please find an original and nine (9) copies of the Reply Exceptions of the Office of Consumer Advocate, in the above-captioned proceeding.

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

Sincerely,

James A. Mullins
Assistant Consumer Advocate

Enclosure
cc: Parties of record
Honorable Marlane R. Chestnut
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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

ORIGINAL

Joint Application of PECO Energy	:	
Company and Public Service Electric	:	
& Gas Company for Approval of	:	Docket No. A-110550F0160
The Merger of Public Service Enterprise	:	
Group, With and Into Exelon Corporation	:	

REPLY EXCEPTIONS
OF THE
OFFFICE OF CONSUMER ADVOCATE

DOCUMENT FOLDER

DOCKETED
JAN 03 2006

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I. INTRODUCTION

On November 30, 2005, the Office of Administrative Law Judge issued the Initial Decision of Administrative Law Judge Marlane R. Chestnut in this proceeding. In the Initial Decision ("I.D."), Administrative Law Judge ("ALJ") Chestnut accepted the Joint Petition for Settlement ("Joint Petition" or "Settlement") of this proceeding filed with the Pennsylvania Public Utility Commission ("PUC" or "Commission") on September 12, 2005 by PECO Energy Company ("PECO"), Public Service Electric & Gas Company ("PSE&G"), the PUC's Office of Trial Staff ("OTS"), the Office of Consumer Advocate ("OCA"), the Office of Small Business Advocate ("OSBA"), the Department of Environmental Protection ("DEP"), the PennFuture Parties, Action Alliance et al., the Energy Coordinating Agency ("ECA"), the Philadelphia Area Industrial Energy Users Group ("PAIEUG"), the Reinvestment Fund/Sustainable Development Fund ("TRF/SDF"), and Senator Anthony Williams. In accepting the Joint Petition, ALJ Chestnut found that the merger Settlement was "in the public interest" and that is "provides substantial, affirmative benefits." *I.D. at 6.*

The OCA submits that the Joint Petition, and the I.D. adopting it, should be accepted by the Commission. Among other things, the Settlement provides benefits through rate reductions, extensions of the transmission and distribution rate caps, improved commitments to reliability and customer service, improved universal service programs, commitments to community presence and corporate giving and contributions to renewable energy and economic development. In addition, the Settlement provides necessary protections for ratepayers regarding the recovery of nuclear costs by PECO and insulates ratepayers from corporate risks through corporate structure protections and provides protections for certain of PECO's workforce positions, particularly those affecting reliability and customer service. The Settlement also calls

for reporting of PJM wholesale market information so that the Commission and parties can better monitor these markets, and it retains the rights of the signatory parties to participate in any further proceedings at the Federal Energy Regulatory Commission ("FERC") regarding appropriate market power mitigation plans. Finally, the Joint Petition calls for a separate fact-finding investigation to examine the issues related to the consolidation of PGW natural gas operations into the natural gas business of Exelon where all issues can be thoroughly explored and all affected parties can participate. In her I.D., ALJ Chestnut addressed these major terms and conditions of the Settlement and discussed each in detail. The ALJ correctly concluded that the proposed merger, subject to the terms and conditions contained in the Settlement, was in the public interest and met the substantial affirmative benefit standard for approval.

ALJ Chestnut also found the Settlement responsive to the "directed" questions of Vice Chairman Cawley and Commissioner Shane embodied in a Secretarial Letter dated July 15, 2005. Of the five questions, four dealt with synergies, while the remaining question dealt with exploration of a combination of the gas operations of PSE&G, PECO and PGW. Judge Chestnut reasoned that the four questions dealing with synergies have been satisfactorily addressed by the Joint Petition, while a subsequent and separate forum for exploration of the fifth question is provided for in the Joint Petition, as well. Consequently, ALJ Chestnut's determination in the I.D. that the five "directed" questions have been addressed by the Joint Petition should not be disturbed.

On December 20, 2005, the City of Philadelphia ("City"), Philadelphia Gas Works ("PGW") and the PPL Companies filed Exceptions to the I.D. Only the City and PGW took issue with the specific terms of the Joint Petition for Settlement. The City argues that the merger, as modified by the Joint Settlement is not in the public interest because the conditions

contained in the Joint Petition do not extend far enough into the future and are not large enough. The City also argues that the Joint Petition does not adequately respond to the Directed Questions. PGW argues that the Settlement does not adequately address the question of the consolidation of PSE&G, PECO and PGW. PGW Exc. at 36.

As explained in more detail below, these challenges to the Settlement fail to demonstrate that the merger, as conditioned by the Settlement, should not be approved. As the OCA has detailed in its Main and Reply Briefs, the Settlement reaches a fair balance of a wide array of interests and is supported by diverse parties. Most significantly, the merger Settlement meets the substantial affirmative benefit standard articulated by the Pennsylvania Supreme Court in the City of York case. See City of York v. Pa. P.U.C., 449 Pa. 136, 295 A.2d 825 (1972). Furthermore, the "Directed Questions" have been addressed as a result of the resolution of this proceeding via the settlement. Consequently, the City's Exceptions to the I.D. and PGW's Exceptions regarding Directed Question 5 should be denied.

II. REPLY EXCEPTIONS

A. OCA Reply to City of Philadelphia Exception 2: The ALJ Correctly Determined that the Merger, as Modified by the Benefits and Protections Contained in the Joint Petition, is in the Public Interest. I.D. at 20-55; OCA M.B. at 7-19; OCA R.B. at 5-9.

1. Introduction

In its Exceptions, the City first criticizes the Joint Petition because it is a result of compromise by a diverse array of parties, and then argues that the Joint Petition is insufficient in that it provides only short term or vague conditions. City Exc. at 15. The City takes issue with the rate reductions and rate caps that will extend until 2010 and argues that PECO's commitments regarding its corporate presence in Philadelphia, its level of charitable giving, and staffing levels only maintain the status quo. City Exc. at 11-12, 8-9. The OCA submits that the ALJ considered the City's arguments and properly concluded that the City's criticisms of the Joint Petition must be rejected.

As an initial matter, the OCA submits that the fact that the Joint Petition was forged through compromise by a diverse array of parties is a strength of the Settlement -- not a flaw in the Settlement. The ALJ recognized this point when she stated:

> Although the City of Philadelphia criticized the parties for compromising their litigation positions (Philadelphia Main Brief at 3, 12-13), the resulting settlement is the product of compromises made by all parties (especially the joint applicants) to reach a comprehensive framework designed to produce the substantial benefits to PECO, its customers and the public generally as required by the City of York standard. It is the Commission's policy to encourage settlements (52 Pa. Code §5.231) and compromise is part of such negotiation. The signatory parties were able to resolve many difficult issues to arrive at a comprehensive plan that satisfies a diverse array of interests and which provides substantial affirmative benefits.

I.D. at 23. The OCA strongly agrees with the ALJ.

As discussed below, the provisions of the Settlement that the City challenges are fully supported by the record and provide substantial benefits to ratepayers, the community, and employees. The Settlement, when taken as a whole, brings substantial, affirmative benefits to PECO's ratepayers, PECO's service territory and Pennsylvania.

2. Rate Reductions And Rate Cap Extension

One of the disagreements with the Joint Petition that the City identifies is that the benefits, such as the rate reductions and the rate caps, do not extend far enough into the future, i.e., beyond 2010. City Exc. at 14. The City also argues that the rate reductions are insufficient. The City's argument is misplaced.

Initially, the OCA would note that the Settlement provides $120 million in rate reductions to all PECO customers - residential, commercial and industrial. This is $120 million that will be placed into the economy of PECO's service territory over the term of the Settlement. Second, the witnesses testifying for rate reductions and rate caps all presented rate plans that extended to 2010. The ALJ points out "none of the settling parities testified in favor of capping rates after 2010; therefore it is unlikely that longer extensions could have been ordered even had the issue been fully litigated." I.D. at 24.

In the context of this merger, the OCA submits that the rate reductions and distribution rate cap extensions capture quantifiable savings for ratepayers. It is also important to note that during this extended rate cap period, PECO has agreed to amortize all the costs and expenses of achieving the merger. As OCA witness Richard LaCapra testified, costs to achieve often carry the potential for significant cost overruns, particularly when those costs are associated with the integration of information and communication technologies as in this proposed merger. OCA St. 1 (Redacted) at 15-16. By requiring that all costs to achieve are

amortized over the rate reduction and rate cap period, ratepayers will be protected from any cost overruns as well as having to shoulder any of these costs in the future rate cases.

The OCA submits that the benefits of the rate reductions and rate cap extensions, coupled with the amortization of the costs to achieve, are substantial. The record supports both the amount of rate relief and the duration of the rate relief contained in the Settlement.

3. Corporate Presence, Charitable Giving and Staffing Levels

The City also argues that the following provisions contained in the Settlement are inadequate: the provision that requires PECO to maintain its corporate headquarters in Philadelphia at least through December 31, 2010; the provision that requires PECO to maintain its level of charitable giving at least at its historic level through 2010; and the provision that requires PECO to maintain staffing levels in certain field force levels through 2011 and to not make reductions in certain specified positions as a result of the merger. The OCA submits that these provisions provide important protections and benefits for PECO ratepayers, PECO employees and the community.

As set forth by OCA witness Alexander, due to the various integration plans for these large electric and gas distribution utilities, as well as for the large fleet of generation assets, the potential for lessening the corporate presence and community giving traditionally in place for PECO can be of concern. OCA St. 4 at 35. The Joint Petition ensures that PECO's presence in the community will not be diminished.

Additionally, as to charitable giving, the City fails to recognize that, with or without the merger, PECO's level of charitable giving was never required to be maintained at its historic levels. In addition to the contributions to the Matching Energy Assistance Fund ("MEAF") agencies called for by the Settlement ($2 million over 4 years), PECO is now

committed to at least $12 million of charitable giving over the period of 2007-2010. This is not an upper limit, but the minimum amount. As the ALJ concluded, "there can be no dispute that a commitment to give at least $12 million over a four-year period is indeed a substantial benefit." I.D. at 30.

The OCA submits that the City's arguments regarding the staffing provisions contained in paragraph 51 of the Settlement are also without merit. The staffing level protections contained in the Settlement provide benefits and are not illusory. As the ALJ recognized, many of the synergy savings from the merger result from reductions in staffing levels. I.D. at 31-32. The Settlement, however, has ensured that field forces are not reduced and that other workforce positions, particularly those related to reliability and customer service, are not reduced as a result of the merger beyond the levels contained in the synergy study that supported the merger.

The ALJ captured the importance of the staffing commitments as follows:

> These are important workforce protections, and reflect the concern that service to PECO's customers not be degraded as the result of the merger, while still allowing PECO (and its customers) to enjoy the synergy savings that are expected to occur.

I.D. at 32.

The OCA would also note that the City's concern that the staffing provisions are illusory since PECO can modify its workforce for reasons other than the merger is misplaced. The City opines that any party claiming an inappropriate reduction in staffing would have to prove it stemmed from the merger. City Exc. at 11. The Settlement does not place such a burden on a challenging party. PECO has agreed not to take certain actions, and PECO will be required to show that it complied with the Settlement if any action is brought to enforce this provision of the Settlement.

The OCA submits that the provisions on corporate protections, charitable contributions, and staffing provide protections and substantial benefits to PECO's ratepayers, employees and its service territory. After considering the arguments of the City regarding these provisions, the ALJ concluded:

> While these concerns may reasonably reflect the specific interest of the city, they do not provide any basis for the Commission to disapprove or modify the proposed transaction as reflected in the settlement. There can be no question that the settlement contains a number of terms that provide significant benefits to the city; the fact that the city thinks they are insufficient does not lead to the conclusion that the settlement is not in the public interest.

I.D. at 29.

4. The Settlement Contains Many More Benefits That, When Taken Together, Provide Substantial Affirmative Benefits.

The City directs its criticism at a few provisions of the Settlement but does not recognize the many other protections and benefits that are part of the comprehensive package of benefits brought about by the Settlement. Of particular note are the significant commitments to enhance PECO's universal service programs, maintain or improve reliability and customer service, and provide significant funding for renewable and sustainable energy projects. The OCA discusses these benefits in detail in its Main Brief at 10-15. The Settlement also provides corporate structure protections and ensures that ratepayers will not bear nuclear costs associated with PSEG's share of nuclear units. See, OCA Main Brief at 9-10 and 16-17. These important protections will insulate ratepayers from risks attendant to non-jurisdictional operations.

The OCA submits that, when taken together, the comprehensive package of protections and benefits contained in the Settlement provide substantial affirmative benefits for PECO ratepayers, PECO's service territory and Pennsylvania. Moreover, some of the protections and benefits of the Settlement, such as improvements to the low-income programs

and corporate structure protections, will continue beyond 2010 as they become a permanent part of PECO's operations. Additionally, environmental and economic development programs that result from the Settlement will continue to provide benefits far into the future. The OCA submits that all provisions of the Settlement must be considered together when determining whether the proposed merger, as modified by the Settlement, is in the public interest.

5. Conclusion

When all the provisions of the Settlement are taken together, the OCA submits that the proposed merger, as modified by the Settlement, will provide substantial, affirmative benefits. While all signatory parties compromised to arrive at this comprehensive framework, it was this very compromise that allowed for the development of a broad-based Settlement that will serve the public interest. The OCA submits that the ALJ properly concluded that the proposed merger, as modified by the Settlement, met the substantial affirmative benefit standard for approval. The City's Exceptions on this point should be denied.

B. OCA Reply to City of Philadelphia Exception No. 3: The ALJ Correctly Concluded that the Settlement Adequately Responds to Directed Questions 1 through 4. I.D. at 49-53.

By Secretarial Letter of July 15, 2005, Vice Chairman Cawley and Commissioner Shane posed a series of Directed Questions to be answered by the parties. Directed Questions 1 through 4 inquired into whether the synergies from the merger can be used to enhance economic development. The Settlement responded to these Directed Questions through several initiatives. As part of the Settlement, PECO will provide $12 Million over a four year period to the Pennsylvania Energy Development Authority ("PEDA") for funding of renewable energy, energy efficiency and energy conservation projects with emphasis on energy conservation projects of benefit to the PECO service territory; it will provide an additional $8 million over

four years to PEDA to be used for energy-related economic development projects and initiatives of benefit to PECO's service territory; and it will provide a lump sum of $7.2 million to the Sustainable Development Fund ("SDF").

The City excepts to the ALJ's conclusion that the Settlement adequately responds to Directed Questions 1 through 4. City Exc. at 15. The OCA submits that the initiatives in the Settlement, along with other provisions of the Settlement, provide substantial benefits to Pennsylvania and to PECO's service territory and are responsive to Directed Questions 1 through 4.

As the ALJ noted, many legal and regulatory hurdles were identified with proposals to address economic development. I.D. at 51. The ALJ found that the settlement overcame these substantive issues. The ALJ, for example, stated:

> To avoid these potential legal and regulatory obstacles, the Settlement Paragraph 52 provides for PECO to contribute $8.0 million ($2 million in each of the years 2007, 2008, 2009, 2010) to PEDA to be used for energy-related economic development projects and initiatives of benefit to the PECO service territory. PEDA will provide to the Commission and the joint petitioner copies of the report it sends annually to the Governor and the General Assembly so that the use of these funds can be monitored.

I.D. at 51. The ALJ found this to be reasonable, particularly since the substantial legal and regulatory obstacles had not been addressed. I.D. at 51.

Moreover, the ALJ properly recognized that the Settlement promoted economic development in other ways, such as through rate reductions. I.D. at 52, See also, OCA St. 1-Supp. At 7-8. The ALJ reasoned:

> Clearly, the settlement does promote economic development in the PECO service territory by providing substantial rate relief and stability to all PECO customers, including the residential, commercial and industrial classes. These benefits, when considered in conjunction with the economic development

> contributions PECO agreed to make, are substantial, will be available sooner, will be shared by more customers and will be allocated more fairly than will the benefits from any set-aside.

I.D. at 52-53.

The OCA submits that the ALJ's decision is well-reasoned and well-supported. The City's Exception on this point should be denied.

C. OCA Reply to City of Philadelphia Exception No. 4 and PGW Exception No. 3: The ALJ Correctly Determined That A Post-Merger Fact-Finding Investigation Regarding A Combination of PSE&G, PECO and PGW Gas Operations Is Appropriate. I.D. at 53-55; OCA M.B. at 18-19; OCA R.B. at 9.

"Directed" question 5 reads: "Would the combination of the PSE&G gas division with the PECO gas division and the Philadelphia Gas Works provide critical mass for a viable, profitable, shareholder owned public utility, assuming a revenue stream from off-system sales from an LNG Facility, and separate resolution of the problem of a billion dollar debt?"

The Joint Petition addresses this question in paragraph 55, which reads:

> The Joint Petitioners agree that the Commission, acting within its authority, may initiate a separate fact-finding investigation following the consummation of the Merger to examine issues related to a potential consolidation of the operations of PGW with and into the natural gas distribution business of EEG. The Commission may assign such investigation to the Office of Administrative Law Judge for the preparation of a report on such issues. PECO agrees to fully cooperate in such fact-finding and other Joint Petitioners may participate in the proceeding if they so elect.

Joint Petition at ¶ 55. In the I.D., Judge Chestnut accepts the Joint Petition's recommendation as to "directed" question 5. However, in its Exceptions, the City argues that such an investigation should be expedited. In its Main Brief, the City had requested that a Final Report issue from the Commission no later than December 31, 2006. City M.B. at 23. PGW also argues that the investigation should begin before the merger is consummated. PGW Exc. at 36-37. The I.D. rejects such a modification to paragraph 55 of the Joint Petition.

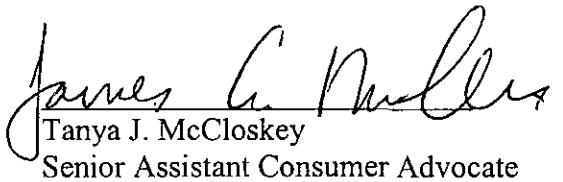
The OCA submits that the process contained in the Settlement provides a reasonable means for consideration of Directed Question 5. The process contained in the Joint Petition would allow consideration of this issue to continue in a forum where the myriad of issues can be thoroughly explored, where all affected parties can participate, and where a reasoned decision can be reached on the issues.

The OCA submits that the ALJ correctly rejected PGW's and the City's requests to modify the Settlement. The Exceptions of the City and PGW should be denied.

III. CONCLUSION

For the reasons set forth above, and in the OCA's Main Brief, Reply Brief, and Statement in Support of the Settlement, the OCA urges the Commission to adopt the well-reasoned decision of Administrative Law Judge Chestnut and approve the Joint Petition for Settlement. The comprehensive Settlement reaches a fair balance of the many issues in this proceeding and is supported by parties with diverse interests. The Settlement ensures necessary protections and brings substantial, affirmative benefits to PECO ratepayers, PECO's service territory and Pennsylvania. The Settlement is in the public interest and should be approved.

Respectfully Submitted,



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Dated: December 30, 2005

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CERTIFICATE OF SERVICE

Joint Application of PECO Energy Company and Public Service Electric and Gas Company for Approval of the Merger of Public Service Enterprise Group Incorporated with and into Exelon Corporation	:	Docket No. A-110550F.0160

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

Dated this 30th day of December 2005.

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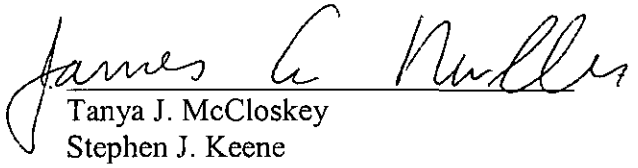

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VIA HAND DELIVERY

DOCUMENT FOLDER

RE: Joint Application of PECO Energy Company and Public Service Electric & Gas Company for Approval of the Merger of Public Service Enterprise Group, Inc., with and into Exelon Corporation; Docket No. A-110550F0160

Dear Secretary McNulty:

Please be advised that the Philadelphia Area Industrial Energy Users Group ("PAIEUG") will not be filing Reply Exceptions to the Initial Decision in the above-referenced proceeding.

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

DOCKETED
JAN 03 2006

Very truly yours,

McNEES WALLACE & NURICK LLC

By Charis Mincavage
Charis Mincavage

Counsel to Philadelphia Area Industrial Energy Users Group

CM/lhe
Enclosures
c: Honorable Marlane Chestnut, Administrative Law Judge (via first class mail)
Certificate of Service

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CERTIFICATE OF SERVICE

I hereby certify that I am this day serving a true copy of the foregoing document upon the participants listed below in accordance with the requirements of Section 1.54 (relating to service by a participant).

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Dated this 30th day of December, 2005 in Harrisburg, Pennsylvania.

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

JOINT APPLICATION OF PECO	:	
ENERGY COMPANY AND PUBLIC	:	
SERVICE ELECTRIC AND GAS	:	
COMPANY FOR APPROVAL OF	:	DOCKET NO. A-110550F0160
THE MERGER OF PUBLIC SERVICE	:	
ENTERPRISE GROUP	:	
INCORPORATED WITH AND INTO	:	
EXELON CORPORATION	:	

EXCEPTIONS OF THE PPL COMPANIES

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I. INTRODUCTION.

In 1996, Pennsylvania undertook a bold initiative and implemented electric retail customer choice for the citizens of the Commonwealth. In taking this step, the legislature recognized that competition was superior to regulation for electric generation. However, it also recognized that a successful customer choice program was contingent upon the development of a robust competitive market. In this regard, the Electricity Generation Competition and Customer Choice Act, 66 Pa.C.S. Ch. 28 ("Competition Act") gave the Pennsylvania Public Utility Commission ("Commission") important new powers to investigate market power issues, and for the first time, required the Commission to examine market power issues when reviewing certain transactions to ensure that the proposed action would not significantly lessen competition.

The Commission has faced a number of important watershed events in implementing customer choice and has had to acquire new expertise to carry out its new obligations under the Public Utility Code. It faces another such challenge in this proceeding. Pending before the Commission is a proposed merger of the holding companies of PECO Energy Company ("PECO") and Public Service Electric and Gas Company ("PSE&G") (collectively, "Joint Petitioners") that will create in Pennsylvania and New Jersey the largest utility in United States history. The proposed new entity is so massive that Joint Petitioners themselves concede that the Merged Entity would have excessive market power. As a result, they have proposed a "divestiture" of generation assets designed to mitigate or reduce this market power to an acceptable level.

After extensive discovery, numerous parties filed testimony opposing the merger on a variety of grounds, including the specter of massive market power in the hands of the Merged Entity. Most of the parties have abandoned their testimony in exchange for a variety of monetary and other concessions by Joint Petitioners. Importantly, none of these concessions relate to, or diminish in any way, the continued presence of market power caused by the proposed merger.

Some parties did not settle, however. The market power issues are still fully contested by the PPL Companies[1] and certain other parties, and thus must be decided by the Commission. No amount of unrelated monetary concessions by Joint Petitioners and *no settlement agreements among other parties can change the statutory obligation of this* Commission to address and decide the market power issues presented in this proceeding.

The Initial Decision approved the merger and the settlement, finding no market power concerns. However, there are at least two fundamental flaws in the Initial *Decision that render it useless to the Commission in deciding this case.* First, the Initial Decision did not follow the law or precedent. Section 2811 of the Public Utility Code plainly requires the Commission to review the proposed merger to determine if it will significantly lessen competition. The Commission has previously interpreted this *provision as requiring such review and has set forth specific standards to be used in* applying Section 2811.[2] Unfortunately, the Initial Decision did not follow Section 2811 or the *DQE* decision. Indeed, the Initial Decision did not decide the market power issues on the merits at all. Rather, it simply refers to and relies upon a prior decision of the Federal Energy Regulatory Commission ("FERC") approving the merger.[3]

There are several problems with this approach. First, the FERC Merger Order is subject to appeal on a variety of grounds, including the failure of FERC to provide for any discovery or hearings despite the presence of clearly disputed material facts. Second, on its face, the FERC decision is not unconditional. Rather, it provides only tentative approval subject to further actions by Joint Petitioners, including a vague and ill-defined

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[1] The PPL Companies include PPL Electric Utilities Corporation; PPL EnergyPlus, LLC; PPL Brunner Island, LLC; PPL Holtwood, LLC; PPL Martins Creek, LLC; PPL Montour, LLC; PPL Susquehanna, LLC; PPL University Park, LLC; and Lower Mount Bethel Energy, LLC.

[2] *Re: DQE, Inc.*, 186 PUR 4th 39, 1998 Pa. PUC LEXIS 48 (1998) ("*DQE*").

[3] *Exelon Corp., et al.*, 112 FERC ¶ 61,011 (2005) ("FERC Merger Order"). *See* Initial Decision at 45-46, where the ALJ lists the principal arguments of the intervenors on market power issues and "resolves" each of them with merely a quote from, and citation to, the FERC Merger Order.

divestiture plan and further review of those actions by FERC. Third, as the Commission has expressly recognized, Section 2811 imposes an independent statutory obligation on the Commission to review and decide market power issues on the merits.[4] The Commission cannot carry out that obligation by simply cross-referencing another agency's decision. This is particularly problematic here, where the issue that the Commission must decide – the impact of the merger on retail competition – is completely beyond FERC's jurisdiction. The Initial Decision failed to follow Section 2811 and controlling precedent in the *DQE* decision. It therefore should be rejected.

Importantly, this is not a theoretical legal problem. The PPL Companies and other parties have identified serious errors in Joint Petitioners' market power analyses, which, at a minimum, require careful review and consideration. For example, Joint Petitioners primarily rely on a geographic market, PJM Pre-2004, which is far too large and masks the impact of the proposed merger on competitive markets. When a proper geographic market is considered, *i.e.*, the PJM Classic market proposed by the PPL Companies, it is apparent that the Merged Entity will have significant market power even after divestiture. Similarly, Joint Petitioners allocate transmission import capacity based upon an arbitrary formula that fails to reflect the ownership of Financial Transmission Rights ("FTRs"). This significantly understates market concentration levels in the PJM East market, where the City of Philadelphia and its suburbs are located. When FTRs are appropriately recognized and imports are allocated correctly, significant market power remains even after divestiture. These are important issues that must be resolved *by the Commission* and cannot be delegated to FERC.

Of perhaps greatest importance, the case as presently positioned simply cannot be decided by the Commission. As noted above, it is uncontested that the proposed merger will create excessive market power. The most critical issue is mitigation of that market

[4] *DQE*, 186 PUR 4th at 46-47.

power, *i.e.*, the proposed divestiture of generation assets. But the divestiture scheme proposed by Joint Petitioners must be seen for what it is – illusory, and so vague and ill-defined as to be meaningless and unreviewable.

There are at least two central problems with Joint Petitioners' proposed divestiture. First, Joint Petitioners propose to divest 6,600 MW of generation, but fail to state what units will be divested. This is a critical and fatal omission. Generation is not fungible. Each unit has its own cost and operating characteristics, which significantly affect the impact of divesting that unit on a competitive market. Joint Petitioners argue that they have classified the "types" of units, *i.e.*, base load or peaking, which will be divested, but this does not address the issue adequately. For example, coal and nuclear units are both base load units, but have very different operating and cost characteristics that make them fundamentally different vis-à-vis their effects on competition. Indeed, Joint Petitioners' entire plan is but a thinly disguised effort to avoid divesting their lowest operating cost generation.

The second problem is that a substantial part of the proposed divestiture is not divestiture at all, but rather an illusory "virtual" divestiture under which Joint Petitioners will continue to own, operate and maintain the generation, but sell their output under ill-specified agreements, thereby giving them both the incentive and ability to exercise continued market power.

So, as this case comes before the Commission, where does it stand? The Commission must deal with a merger that will create the largest utility in the history of the United States – a utility that will have excessive and massive market power. This fact is undisputed. In reviewing the case, the Commission is left with an Initial Decision that does not address the relevant legal issues, but rather simply relies on a FERC decision, which was issued without the aid of discovery or evidentiary hearings and which is still under reconsideration and subject to appeal. And, the Commission must assess the sufficiency of a proposed mitigation plan that fails to identify the generating units that

will be divested and in which a substantial portion of the "divestiture" is not really divestiture at all. In the face of this unprecedented situation, the Commission must do what the Initial Decision did not do: Review the facts, apply the law and protect retail competition and the citizens of the Commonwealth from the excessive market power that will result from the proposed merger. Based upon this review, the Commission should conclude that Joint Petitioners have failed to carry their burden of proof, and thus their Petition should be denied. At a minimum, the Commission should not grant the application and should instead refer the matter and certify its findings to other agencies.

II. STATEMENT OF EXCEPTIONS.

The PPL Companies except to the Initial Decision's recommended approval of the proposed merger.[5] Specifically, as discussed more fully below, the Initial Decision erred in the following respects:

1. The Initial Decision improperly placed the burden of proof on the Intervenors (including the PPL Companies), as opposed to Joint Petitioners.
2. The Initial Decision erred in relying exclusively upon FERC's determinations, as opposed to basing its market power recommendations on the evidence presented in this proceeding, and thereby failed to follow Section 2811 of the Code and controlling Commission precedent established in the *DQE* decision.
3. The Initial Decision incorrectly approved market power mitigation measures that are inadequately defined and insufficient to cure the Merged Entity's market power.
4. The Initial Decision erroneously failed to consider the impact of the proposed merger on the PJM Classic market.
5. The Initial Decision incorrectly failed to allocate transmission import capacity based upon actual ownership of FTRs and thereby understated market concentration in the PJM East market.
6. The Initial Decision inappropriately accepted Joint Petitioners' proposal to reduce their mitigation obligation when capacity is retired.
7. The Initial Decision should have concluded that the proposed merger was likely to harm competition in the Commonwealth, and should have recommended referring those findings to the appropriate regulatory authorities under Section 2811 of the Competition Act.

[5] *See, e.g.*, Initial Decision at 6, 20-21, 47.

III. STATEMENT OF THE CASE.

A. The Joint Application.

On February 4, 2005, PECO and PSE&G filed a Joint Application with the Commission to obtain approval under Chapters 11, 22, and 28 of the Pennsylvania Public Utility law for the merger of Public Service Enterprise Group, Incorporated ("PSEG") the corporate parent of PSE&G, with and into Exelon Corporation ("Exelon"), which will become the ultimate corporate parent of the Merged Entity.[6] The proposed merger between Exelon and PSEG "is the largest utility merger ever proposed in the United States" and, if approved, the Merged Entity will serve over seven million electric customers and two million gas customers.[7] As demonstrated by Joint Petitioners' own analyses,[8] the proposed merger seriously fails the Department of Justice/Federal Trade Commission Horizontal Merger Guidelines,[9] which are also utilized by FERC,[10] and would cause significant damage to Pennsylvania's competitive electricity markets. Therefore, Joint Petitioners have proposed a mitigation plan that includes the sale of

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[6] Joint Application of PECO Energy Company and Public Service Electric and Gas Company for Approval of the Merger of Public Service Enterprise Group Incorporated With and Into Exelon Corporation, Docket No. A-110550F0160, Joint Application of PECO Energy Company and Public Service Electric and Gas Company (filed Feb. 4, 2005) ("Joint Application").

[7] Initial Decision at 40.

[8] Joint Application, PECO Statement No. 3, Direct Testimony of William H. Hieronymus ("Hieronymus Direct Testimony"), Exhibit WHH-1, Exhibit No. J-1 at 47-49. Exhibit WHH-1 to PECO Statement No. 3 includes the testimony and exhibits of Dr. Hieronymus that were submitted to FERC: Exelon Corporation, Public Service Enterprise Group Incorporated, Application for Authorization of Disposition of Jurisdictional Assets, FERC Docket No. EC05-43-000, Exhibit Nos. J-1 through J-16, Prepared Direct Testimony and Exhibits of William H. Hieronymus on Behalf of Exelon Corporation (filed Feb. 4, 2005) ("Hieronymus FERC Direct Testimony").

[9] U.S. Department of Justice and Federal Trade Commission, *Horizontal Merger Guidelines*, 57 Fed. Reg. 41,552 (Sept. 10, 1992), *revised*, 4 Trade Reg. Rep (CCH) ¶ 13,104 (Apr. 8, 1997) ("DOJ/FTC Horizontal Merger Guidelines").

[10] *Inquiry Concerning the Commission's Merger Policy Under the Federal Power Act: Policy Statement*, Order No. 592, 61 Fed. Reg. 68,595 at 68,596, 68607 (Dec. 30, 1996), FERC Stats. & Regs., Regulations Preambles (July 1996 – Dec. 2000) ¶ 31,044 (1996), *order on reh'g*, Order No. 592-A, 62 Fed. Reg. 33,341 (June 19, 1997), 79 FERC ¶ 61,321 (1997).

4,000 MW of fossil fuel generation and 2,600 MW of medium and long-term nuclear generation energy sales contracts, which Joint Petitioners call "virtual divestiture."[11] Joint Petitioners, however, did not identify the specific generating plants they proposed to divest, stating that they would hold an auction after the proposed merger is consummated in which they will sell at their discretion sufficient generation capacity to fulfill their divestiture commitment.[12] In support of their application, Joint Petitioners submitted the testimony of Dr. William D. Hieronymus, Vice President of Charles River Associates.[13]

B. The PPL Companies' Testimony.

The PPL Companies' March 7, 2005 motion to intervene in this proceeding was granted at the initial pre-hearing conference on March 29, 2005.[14] After several rounds of discovery, in accordance with the procedural schedule, the PPL Companies submitted the written direct and surrebuttal testimony of Dr. Joseph P. Kalt on June 28, 2005, and August 26, 2005, respectively.[15] Dr. Kalt testified that Joint Petitioners' market concentration analyses are incomplete, inconsistent with widely-accepted competitive principles, and produce erroneous and unreliable results.[16] Joint Petitioners' analyses omit key markets when attempting to predict the competitive harm of the proposed merger, ignore the Merged Entity's FTRs when allocating imports; and rely on a virtual

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[11] Initial Decision at 40.

[12] FERC Merger Order at P 25-28, 93, 141.

[13] *See supra* note 8.

[14] Joint Application of PECO Energy Company and Public Service Electric and Gas Company for Approval of the Merger of Public Service Enterprise Group Incorporated With and Into Exelon Corporation, Docket No. A-110550F0160, Prehearing Order No. 2 at 4 (issued Mar. 30, 2005).

[15] Joint Application of PECO Energy Company and Public Service Electric and Gas Company for Approval of the Merger of Public Service Enterprise Group Incorporated With and Into Exelon Corporation, Docket No. A-110550F0160, PPL Statement No. 1, Direct Testimony of Joseph P. Kalt, Ph.D. on behalf of the PPL Companies (filed June 28, 2005) ("Kalt Direct Testimony"); PPL Statement No. 1-SR, Surrebuttal Testimony of Joseph P. Kalt on behalf of the PPL Companies (filed Aug. 26, 2005) ("Kalt Surrebuttal Testimony").

[16] Kalt Direct Testimony at 7, 10, 13-15, 31.

divestiture scheme that does little to diminish – and may actually enhance – Joint Petitioners' incentive and ability to exercise market power.[17]

Dr. Kalt concluded that when analyzed properly, the proposed merger repeatedly exceeds the thresholds at which federal antitrust agencies and FERC would conclude that a likelihood of competitive harm exits.[18] Accordingly, unless significant and effective additional relief is ordered, including the specific identification of generation plants to be divested, the pending merger will increase market concentration to unacceptable levels, lessen competition in both wholesale and retail electricity markets, and adversely affect both suppliers and consumers of electric energy in the Commonwealth.[19]

C. The Proposed Partial Settlement.

On September 12, 2005, Joint Petitioners along with the Office of Trial Staff, Office of the Consumer Advocate, Office of the Small Business Advocate, Department of Environmental Protection, Citizens for Pennsylvania's Future, the Action Alliance of Senior Citizens of Greater Philadelphia, the Energy Coordinating Agency of Philadelphia, Inc., the Philadelphia Area Industrial Energy Users Group, The Reinvestment Fund/Sustainable Development Fund, and State Senator Anthony Williams (collectively, the "Settling Parties") filed a Joint Petition for Settlement (the "Joint Petition") which resolves some of the issues raised by those parties regarding the merger application.[20] However, the Joint Petition does not resolve the market power issues raised in this proceeding. Indeed, the only provision in the Joint Petition that purports to address the serious market power concerns raised by the proposed merger is a requirement that PECO provide annual pricing reports and allowing the Settling Parties to

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[17] *Id.* at 14-15, 20, 24-25.

[18] *Id.* at 7-10.

[19] *Id.* at 5-6.

[20] Joint Application of PECO Energy Company and Public Service Electric and Gas Company for Approval of the Merger of Public Service Enterprise Group Incorporated With And Into Exelon Corporation, Docket No. A-110550F0160, Joint Petition for Settlement (filed Sept. 12, 2005).

petition the Commission to investigate potential PECO market power abuses.[21] The PPL Companies are not a party to the settlement.[22]

D. The Evidentiary Hearing.

Three days of evidentiary hearings were held on September 22-23 and 26, 2005 in Philadelphia, Pennsylvania. Five witnesses testified at the hearings under oath and were subject to cross-examination. Joint Petitioners waived cross-examination of several witnesses whose written statements were admitted into evidence by stipulation, including, most notably, PPL Companies' expert witness Dr. Joseph P. Kalt.

E. The Initial Decision.

On November 30, 2005, Administrative Law Judge Chestnut issued her Initial Decision recommending that the proposed merger be approved by the Commission. After noting that, "the concerns raised by the parties who did not join the settlement are valid and well-presented,"[23] the Initial Decision failed to address the market power concerns raised by the intervening parties, including the PPL Companies.[24] Rather, the Initial Decision defers completely to FERC, relying solely upon the FERC Merger Order – an Order issued without the benefit of discovery or a hearing, in contrast to the case here – to support its approval of the Merger.

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[21] *Id.* at Section III.I.

[22] On September 16, 2005, Joint Petitioners and the PPL Companies stipulated that the proposed settlement did not address the market power concerns raised by the PPL Companies, and preserved those issues for consideration by the ALJ and the Commission. Joint Application of PECO Energy Company and Public Service Electric and Gas Company for Approval of the Merger of Public Service Enterprise Group Incorporated With and Into Exelon Corporation, Docket No. A-110550F0160, Stipulation Regarding Market Power Issues (filed Sept. 16, 2005) ("Stipulation Regarding Market Power Issues"). On September 19, 2005, the PPL Companies submitted a statement indicating that they neither supported nor opposed the settlement, and reiterated their belief that the Commission must specifically address the potential of the Merged Entity to exercise market power. Joint Application of PECO Energy Company and Public Service Electric and Gas Company for Approval of the Merger of Public Service Enterprise Group Incorporated With and Into Exelon Corporation, Docket No. A-110550F0160, Statement of the PPL Companies Regarding the Joint Petition for Settlement (filed Sept. 19, 2005).

[23] Initial Decision at 6.

[24] *Id.*

IV. ARGUMENT.

With the passage of the Competition Act and the ensuing restructuring proceedings for each of the Pennsylvania electric distribution companies ("EDCs"), Pennsylvania rose to the forefront of the movement to an unregulated retail market for electric generation supplies. In Section 2802 of the Competition Act, the General Assembly declared that:

> (3) Because of advances in electric generation technology and Federal initiatives to encourage greater competition in the wholesale electric market, it is now in the public interest to permit retail customers to obtain direct access to a competitive generation market as long as safe and affordable transmission and distribution service is available at levels of reliability that are currently enjoyed by the citizens of and businesses of this Commonwealth.
>
> . . . .
>
> (5) Competitive market forces are more effective than economic regulation in controlling the cost of generating electricity.

Thus, as recognized by the General Assembly, the predicate for a vibrant *retail* competitive market for electric generation is the existence of a vibrant competitive *wholesale* market for electric generation.

The General Assembly directed the Commission to take appropriate steps to protect competitive markets. In conjunction with its authority to approve certain transactions involving EDCs or electric generation suppliers ("EGSs"), the *Commission* is required to determine "whether the proposed merger, consolidation, acquisition or disposition is likely to result in anticompetitive or discriminatory conduct, including the unlawful exercise of market power, which will prevent retail electricity customers in this Commonwealth from obtaining the benefits of a properly functioning and workable competitive retail electricity market."[25] The Commission's authority to consider the

[25] Section 2811(e) of the Competition Act, 66 Pa.C.S. § 2811(e).

effects of mergers and acquisitions on competitive retail electric generation supply markets is, therefore, a cornerstone of this Commonwealth's deregulation of the retail electric generation supply market and is critical to the replacement of traditional economic regulation of retail electric generation supplies with competition. The General Assembly has specifically relied upon an effective competitive market to replace the customer protections formerly provided by economic regulation by the Commission. Now, instead of regulating energy prices, the Commission is charged with the responsibility to take appropriate steps to ensure that a vibrant, workable competitive market is in place so that consumers of electricity in Pennsylvania will receive the protections of a competitive market.

It is in this context that Joint Petitioners come before the Commission with a proposal to create the largest electric utility system in the Unites States. The resulting combined entity would be so large that Joint Petitioners could not avoid admitting in the Application that the Merged Entity would have market power over generation. Although the PPL Companies believe that the Merged Entity would have much greater market power than admitted by Joint Petitioners, the real issue is whether the market power mitigation steps proposed by Joint Petitioners are sufficient to protect the interests of Pennsylvania consumers of electricity and to maintain a vibrant competitive retail market for electric generation supplies. That the merger would diminish competition is clear — Joint Petitioners have admitted as much.

This Commission reviewed a similar transaction previously. In its initial review of a merger between EDCs in Pennsylvania, the Commission laid down important principles and standards for approval of such transactions. In *DQE*, the Commission considered a merger of two holding companies, DQE, Inc. and Allegheny Power System, Inc., the approval of which would have resulted in the unification of two of the largest EDCs in western Pennsylvania. A significant portion of the Commission's Order in *DQE* was devoted to Market Power Mitigation measures.

Initially, the Commission reviewed its statutory authority to consider Market Power Mitigation in conjunction with mergers involving EDCs. The Commission stated:

> Before analyzing the effectiveness of each of these mitigation proposals in the context of this proceeding, we believe it would be appropriate to review generally the Commission's authority to impose market power remedies on merging parties before approving the transaction. If the Commission finds that a proposed merger 'is likely to result in anticompetitive or discriminatory conduct, including the unlawful exercise of market power,' section 2811(e)(2) provides that the Commission shall not approve a merger 'except upon such terms and conditions as it finds necessary to preserve the benefits of a . . . competitive retail electricity market.
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> Clearly, the statute gives the Commission broad authority to fashion appropriate remedies to mitigate undue market power created by the proposed transaction. FERC similarly has broad authority under section 203(b) of the Federal Power Act, 16 U.S.C. § 824(b), to approve electric utility mergers and propose 'such terms and conditions as it finds necessary or appropriate' to mitigate market power concerns.[26]

Following this review of its statutory authority, the Commission established the following principles:

- The Commission will not rely on post-merger review or new remedies after a merger is approved. The Commission must find that a merger is consistent with the public interest before it is approved.
- Structural remedies, including divestiture of plants, are preferable because they are the cleanest and most effect means of dealing with market power problems.
- Regulatory conditions that require continuing oversight by a regulatory body to ensure compliance should be avoided because they are less effective in preventing the exercise of market power and more costly to enforce.[27]

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[26] *DQE*, 186 PUR 4th at 67-68.

[27] *Id.* at 69-72.

Unfortunately, the Initial Decision suggests that the Commission should retreat from these strong principles and standards for assuring effective competition in electric generation markets. Contrary to the guidelines enunciated above, the Initial Decision recommends that Joint Petitioners be permitted to merge based upon the sale of unspecified fossil fuel generating plants to unidentified purchasers *after* the merger is approved, and a "virtual" auction of energy sales contracts from base load nuclear generating facilities.[28] The Initial Decision also accepts Joint Petitioners' proposal for post-merger monitoring as a partial cure to the infirmities of their proposed mitigation measures.

Thus, the Initial Decision abandons the principles enunciated in *DQE* by recommending reliance, in part, on post-merger determinations of actual divestiture and virtual, rather than actual, divestiture of plants as well as post-merger regulatory oversight. The series of errors — some procedural and some substantive — that caused the Initial Decision to make such incorrect recommendations are explained below.

A. The Initial Decision Improperly Placed The Burdon Of Proof On The Intervenors, Including The PPL Companies.

The Initial Decision initially recited the correct legal standards for review of mergers of public utilities: Those seeking approval of a utility merger must demonstrate that the merger will affirmatively promote the service, accommodation, convenience or safety of the public in a substantial way.[29] Further, the Commission, in granting a certificate, may impose such conditions for approval as it may deem just and

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[28] Kalt Direct Testimony at 22.

[29] *See* Initial Decision at 8-12; *see also City of York v. Pa. P.U.C.*, 295 A.2d 825, 828 (Pa. 1972); 66 Pa.C.S. § 1102.

reasonable.[30] Finally, the Commission's findings must be based upon substantial evidence.[31]

In addition, a proposed merger involving EDCs and EGSs must be reviewed under Section 2811 of the Competition Act.[32] Specifically, Section 2811(e)(1) requires the Commission *to consider* "whether a proposed merger, consolidation, acquisition or disposition *is likely to result in any competitive or discriminatory conduct, including the unlawful exercise of market power, which will prevent retail electricity customers in this* Commonwealth from obtaining the benefits of a properly functioning and workable competitive electricity market." This new requirement under the Competition Act simply clarifies the older requirement to reflect the fact that the protection of the public interest has shifted from a traditional regulatory regime to a competitive regime.

The placement of the burden of proof upon Joint Petitioners is both logical and compliant with statutory mandates. One test for the placement of the burden of proof is the result that would be reached if no party adduced any evidence on a particular subject. Here, if no party produced any evidence on the likelihood of anticompetitive or discriminatory conduct, the merger would have to be disapproved because the Commission could not make the required findings on competition. Further, under Section 332(a) of the Public Utility Code, the burden of proof is on Joint Petitioners, because they are the proponents of a finding that anticompetitive conduct is not a likely result of the merger.[33]

Despite the foregoing, Joint Petitioners erroneously assert that the burden of proof rests with the intervenors, including the PPL Companies, to demonstrate that

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[30] 66 Pa.C.S. § 1103(a).

[31] 2 Pa.C.S. § 704; *Mill v. Pa. P.U.C.*, 447 A.2d 1100 (Pa. Commw. Ct. 1982); *Norfolk & Western Ry. v. Pa. P.U.C.*, 413 A.2d 1037 (Pa. 1980).

[32] 66 Pa.C.S. § 2811.

[33] 66 Pa.C.S. § 332(a).

anticompetitive or discriminatory conduct is likely.[34] The ALJ accepted Joint Petitioners' misstatement of the law: "As correctly noted by joint applicants in their Main Brief at 17-18, no party asserted or presented evidence that the proposed merger is likely to directly increase the joint applicants' market power in any competitive retail market in Pennsylvania."[35] That burden is not properly placed upon market power intervenors such as the PPL Companies. It is Joint Petitioners' burden to prove that the merger is *not* likely to result in anticompetitive conduct or discrimination, and they have failed to do so.

Importantly, the Partial Settlement, which several of the market power intervenors, including the PPL Companies, did not join, does not alter the burden of proof or the Commission's duty to consider the effect of the proposed merger on competition. These conclusions are especially true here, where the Partial Settlement does not even purport to address the market power issues raised by certain intervenors, including the PPL Companies, and where Joint Petitioners have acknowledged that fact.[36]

This misallocation of the burden of proof was particularly harmful due to the vagueness and uncertainty of Joint Petitioners' proposed market power mitigation measures. Joint Petitioners have failed to indicate what units will be sold, whom they will be sold to, and have proposed an unprecedented, untested and temporary "virtual" divestiture plan. As a result, the PPL Companies were forced to make numerous assumptions in order to perform a meaningful market power analysis. The problems

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[34] Joint Application of PECO Energy Company and Public Service Electric and Gas Company for Approval of the Merger of Public Service Enterprise Group Incorporated With And Into Exelon Corporation, Docket No. A-110550F0160, Initial Brief of Joint Applicants, PECO Energy Company and Public Service Electric and Gas Company at 17-18 (filed Oct. 14, 2005) ("Joint Petitioners' Initial Brief").

[35] Initial Decision at 41.

[36] Indeed, Joint Petitioners and the PPL Companies specifically agreed that the Partial Settlement did not address the market power issues raised by the PPL Companies. *See* Stipulation Regarding Market Power Issues, *supra* note 22.

associated with the vagueness of Joint Petitioners' proposal should not be assigned to the PPL Companies. Instead, they provide compelling evidence that the proposed merger should be rejected.

The burden of proof is with Joint Petitioners to demonstrate that the admitted market power of the Merged Entity would be sufficiently mitigated. Given that they have: (1) understated the market power of the Merged Entity; (2) failed to examine all relevant markets; (3) refused to consider the effect of FTRs; and (4) relied upon the dubious and untested combination of: (a) a novel, untested and temporary, "virtual" divestiture of nuclear generation capacity, (b) a true divestiture of unidentified fossil generation facilities to unidentified purchasers, and (c) post-merger market monitoring, they have failed to meet this burden. The proposed merger should be rejected.

B. The Initial Decision Failed To Follow Section 2811 And Controlling Commission Precedent By Failing To Make Market Power Findings Based On The Evidence In This Proceeding And By Improperly Relying Exclusively Upon FERC's Market Power Determinations.

The Initial Decision stated correctly that the Commission was required to consider whether the merger would be likely to result in anticompetitive conduct, to make findings on that subject, and base those findings upon the record evidence.[37] As explained above, these requirements are clearly established by Section 2811 of the Code and the Commission's *DQE* decision. Having so stated, however, the Initial Decision failed to follow these mandates. Instead, on market power issues, the Initial Decision relied exclusively upon FERC's determinations.[38] Specifically, the Initial Decision summarized the principal contentions of the market power intervenors, including the PPL Companies, and "resolved" each issue by briefly quoting from the FERC Merger Order. Such exclusive reliance upon the FERC Merger Order is improper because it violates principles of Pennsylvania law that: (1) impose responsibilities and duties upon the

[37] Initial Decision at 12, 38.

[38] *Id.* at 38-49.

Commission to make detailed findings on specified subjects, and (2) require the Commission's findings to be based upon the record evidence.[39]

The Initial Decision's reliance upon the FERC Merger Order is particularly inappropriate for the following reasons:

- FERC reached its conclusions without the aid of discovery or an evidentiary hearing on many of the issues raised by the parties opposing the merger;[40]
- FERC ignored many of the issues raised by the parties opposing the merger;[41] and
- FERC accepted an unprecedented, untested and highly suspect "virtual" divestiture mitigation scheme that is contrary to this Commission's standards adopted in *DQE*.[42]

Further, the FERC Merger Order is subject to appeal on several grounds. In short, the FERC Merger Order is both suspect and may not be the final word on FERC's consideration of the proposed merger. The Commission may not and should not rely on the FERC Merger Order as the basis for any finding in this proceeding.

Under the Competition Act, the Commission has exclusive jurisdiction over the retail electricity market in Pennsylvania, which it cannot cede to FERC. As the PPL Companies have demonstrated, even if Joint Petitioners are not active in retail electricity markets in Pennsylvania, the merger threatens retail competition. The reduction in competition in wholesale electricity markets resulting from the increased market power of the Merged Entity will have a direct effect on both Pennsylvania ratepayers' retail rates and the ability of EGSs to compete.[43] As suppliers pass through the resulting increased cost for wholesale power, Pennsylvania retail customers will suffer.[44]

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[39] *Id.* at 45-46.

[40] Kalt Surrebuttal Testimony at 2.

[41] *Id.*

[42] *DQE*, 186 PUR 4th at 61.

[43] Kalt Direct Testimony at 4.

[44] *Id.*

Although most regulated electric utilities in Pennsylvania currently provide generation service under negotiated price caps that are lower than wholesale electricity prices, whenever wholesale prices have been below these price caps, retail competitors have been able to capture electric utility customers, clearly revealing the linkage between wholesale and retail electricity prices.[45] Moreover, when existing price caps expire, retail electricity prices increase and decrease in step with wholesale power prices.[46] Thus, to the extent the Merged Entity causes wholesale prices to increase through an exercise of market power, retail prices will move in tandem, leading to higher costs for electricity.[47]

Moreover, if the Merged Entity can exercise market power, it could drive existing EGSs from the Pennsylvania retail electricity market and discourage new EGSs from entering. As long as most electric distribution companies in the Commonwealth remain under price caps, EGSs will be viable competitors only if wholesale prices remain below the retail shopping credit. By exercising market power and increasing wholesale prices in Pennsylvania, the Merged Entity may be able to squeeze or eliminate the profits of EGSs and prevent them from offering (and hence customers from receiving) competitive products and services.[48] Thus, the Commission cannot cede jurisdiction to FERC and thereby ignore the proposed merger's effect on PJM wholesale markets, for any such failing ultimately will be borne by Pennsylvania's retail customers.

C. Mitigation Measures Approved By The Initial Decision Are Inadequately Defined And Insufficient To Cure The Merged Entity's Market Power.

Joint Petitioners would have the Commission believe that they have "committed" to a "robust mitigation plan,"[49] an essential piece of which involves actually "divesting

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[45] *Id.* at 5-6.

[46] *Id.* at 6.

[47] *Id.*

[48] *Id.*; Tr. 428.

[49] Joint Petitioners' Initial Brief at 9.

certain generation assets."[50] The record evidence demonstrates the opposite. Joint Petitioners' proposed mitigation plan is vague, uncertain, insufficient, and will not cure the Merged Entity's market power, and thus should not be accepted by the Commission.[51]

1. Joint Petitioners' Market Power Mitigation Proposal Should Be Rejected Because It Is Ill-Defined, Cannot Be Evaluated Finally Until After The Merger Is Consummated, And Requires Continued Regulatory Oversight By The Commission.

Joint Petitioners' divestiture scheme involves two principal parts. The first involves the sale of 4,000 MW of fossil fuel generation. Joint Petitioners, however, have not identified with any specificity the units to be sold. Therefore, this Commission cannot know the identity or characteristics of the units, or the effect the sale of such plants will have on competition. Clearly, different units have different characteristics in terms of reliability, fuel type, age, remaining life, efficiency, etc. Further, until the fossil fuel plants are sold, which under Joint Petitioners' proposal would take place after the consummation of the merger, the identities of the buyers of the units are unknown. The efficacy of the sale of fossil fuel plants as a mitigation of market power cannot be known until specific plants, as well as the purchasers, are known. But if HHI screen failures persist after the divestiture sales, then it will be too late because the merger will have already taken place.

The Initial Decision's solution to this obvious shortcoming was to place competition's fate in the Commonwealth, and its vulnerability to the Merged Entity's ability to exercise market power, completely in the hands of FERC.[52] FERC of course did not even allow discovery or hold a hearing. Nevertheless, the Commission

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[50] *Id.* at 11.

[51] The insufficiency of Joint Petitioners' mitigation plan is explained in Sections IV.C.1 to IV.C.3 of these Exceptions.

[52] Initial Decision at 46, 58 (Ordering Paragraph 2).

essentially entrusts FERC with the job the Commission is bound by law to do: Protect Pennsylvania electricity consumers and competitive retail electricity markets.

The second part of the divestiture scheme involves the "virtual" divestiture of 2,600 MW of base load nuclear energy using, at the Merged Entity's discretion, one or a combination of the following two methods. The first alternative calls for the sale (or exchange with a non-PJM entity) of base load nuclear capacity through firm long-term sales contracts for terms that expire no later than 15 years following the merger. The second alternative is an auction of three-year firm entitlements of base load energy in 25 MW blocks to take place over a 15 year period.[53] Significantly, after 15 years, the nuclear base-load energy entitlement will revert completely to the Merged Entity.

It is undisputed that, absent the acceptance of virtual divestiture as an effective form of mitigation, the proposed merger produces extremely large increases in market concentration and, hence, significant failures in the competitive impact screens in the PJM Classic, PJM East, and PJM pre-2004 markets.[54] In both the PJM Classic and PJM East markets, there would be merger screen failures in all price/demand conditions, with HHI increases in the PJM Classic market of up to 800 points and in the PJM East Market of almost 1600 points. All markets in PJM East would be highly concentrated and the proposed merger would be presumed to create market power.[55]

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[53] Hieronymus FERC Direct Testimony at 7, 9; *see also* Joint Application of PECO Energy Company and Public Service Electric and Gas Company for Approval of the Merger of Public Service Enterprise Group Incorporated With And Into Exelon Corporation, Docket No. A-110550F0160, Main Brief of the PPL Companies at 38-39 (filed Oct. 14, 2005) ("PPL Main Brief").

[54] *See, e.g.*, Kalt Direct Testimony at 10, 23, & Exhibit JPK-5 (showing that, particularly during lower market price periods, the effectiveness of the dubious virtual divestitures are critical to ensuring that screening violations are eliminated, and that screen failures are severe when the virtual divesture of nuclear facilities is ineffective as merger mitigation). *See also id.* at 19 & Exhibit JPK-4 (also showing substantial screen failures in the PJM Classic market using the analysis Dr. Hieronymus provided in response to PPL's Interrogatory 9b); Kalt Surrebuttal Testimony at 5.

[55] Kalt Direct Testimony, Exhibit JPK-5; PPL Main Brief, Tables at 24-25.

Joint Petitioners' virtual divestiture proposal is not an effective cure for the Merged Entity's market power. First, as discussed in greater detail below,[56] virtual divestiture will leave the Merged Entity with the incentive and ability to exercise market power. However, like the fossil divestiture, the proposal leaves many questions unanswered, which should be resolved before the Commission approves the transaction. The identities of the buyers or swappers will not be known until after the merger has been consummated. Indeed, if the "virtually" divested nuclear generation is auctioned in the open market for the rolling three-year terms, the identities of the owners will not be known until many years after the merger. Moreover, nowhere do Joint Petitioners analyze the effect of the reversion of up to 2,600 MW of nuclear base load energy to the Merged Entity after the 15-year period expires.

Thus, the efficacy of the "virtual" divestitures will require continued regulatory oversight for years into the future – a result that undermines the principles and objectives upon which the Commonwealth deregulated electricity markets nine year ago. The Initial Decision completely ignores this fatal shortcoming.[57] Instead, it relies solely on Joint Petitioners' commitment to FERC to appoint an independent monitor and the creation a public website to help "oversee" their virtual divestiture proposal[58] – a commitment that even FERC admits will be necessary and difficult.[59] Neither Joint Petitioners nor the Initial Decision can point to any evidence that rebuts this fact.

The Commission has previously considered and rejected vague market power mitigation proposals in the past and has held that effective merger relief should be structural. In evaluating market mitigation proposals in *DQE*, the Commission stated:

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[56] *See infra* Section IV.F.

[57] Initial Decision at 45.

[58] *Id.* at 46, 48; FERC Merger Order at P 135.

[59] FERC Merger Order at PP 134-135 and Ordering Paragraph H.

> First, a proposal will not be in place at the time the merger is consummated nor does it specify exactly which facilities are affected. . . . The Applicants also failed to clearly demonstrate how their proposal would mitigate the specific competitive problem identified in their market power analysis. . . .[60]

Joint Petitioners' proposal in this proceeding suffers from these same deficiencies. Their proposed mitigation measures should be rejected, as they were in *DQE*. The Department of Justice agrees: "Structural remedies are preferred to conduct remedies in merger cases because they are relatively clean and certain, and generally avoid government entanglement."[61] In contrast, a conduct remedy (such as "virtual" divestiture) "typically is more difficult to craft, more cumbersome and costly to administer, and easier than a structural remedy to circumvent."[62]

In apparent response to the vagueness and uncertainties surrounding their proposed mitigation plan, Joint Petitioners propose to rely on market monitoring by PJM, FERC and the Commission as a cure for the deficiencies of their mitigation plan. In making this proposal, Joint Petitioners ignore the fact that the Commission has already expressed its opinion on such after-the-fact, post-merger measures. In *DQE*, the Commission stated:

> We do not intend to rely on post-merger review or on new remedies imposed after a merger is approved. We must find that a merger is consistent with the public interest before we approve the merger. . . .
>
> Post-merger review is disfavored because once a merger goes through, undoing the merger at a later date is almost always impossible to do. See, e.g., *Ronson Corp. v. Liquifin Aktiengesellschaft*, 483 F 2d 846, 851 (3d Cir. 1973) (injunctive relief is typically granted in a merger case before consummation so as to avoid having to 'unscramble the eggs' after the merger has occurred). Knowing this

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[60] *DQE*, 186 PUR 4th at 74-75.

[61] U.S. Dep't of Justice, *Antitrust Division Policy Guide to Merger Remedies* at 8 (Oct. 2004).

[62] *Id.*

> fact, the now merged entity always has less incentive to cooperate with enforcement officials and regulators to remove entry barriers or eliminate market power abuses that were not addressed before consummation of the merger.[63]

Further, as a rational business entity, it is logical that the Merged Entity – given the substantial range of discretion afforded under its vague mitigation proposal – would always exercise the option most favorable to itself and would not attempt voluntarily to curb its own market power. The Commission addressed this problem in *DQE*:

> Equally disturbing is the fact that the Applicants would retain authority over which option would be chosen to satisfy this requirement. . . . They could, for example, choose the option most favorable to them and least favorable to promoting competition. Although the applicants attempt to rebut this later concern in their Exceptions, it is not sufficiently addressed in the evidentiary record before us and we remain unpersuaded.[64]

In essence, Joint Petitioners ask the Commission to buy a "pig in a poke." Joint Petitioners improperly plan to sell unidentified fossil fuel generation and baseload nuclear energy to unknown buyers over a specified, but limited, term. Compounding these aforementioned flaws, the amount of nuclear capacity is subject to reduction on a megawatt-for-megawatt basis when units are retired or sold. This uncertainty, combined with similarly vague references to market monitoring after the merger is consummated and to unspecified further mitigation should market power concerns continue or arise, ensure that Joint Petitioners' proposal will be ineffective in resolving the substantial market power concerns arising from the proposed merger.

Given the vagueness of Joint Petitioners' proposal, it is impossible for anyone to perform HHI screen calculations with any degree of certainty to determine whether the proposed mitigation, even under their most optimistic of circumstances, will fully offset

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[63] *DQE*, 186 PUR 4th at 69-70.

[64] *Id.* at 62.

the Merged Entity's market power. Witnesses, such as Dr. Kalt, were required to make assumptions as to the nature of the units to be divested and the identity of the buyers in order to evaluate the merger's competitive impact. Recognizing that these variables could make a significant difference as to whether the relief proposed would address the market power concerns created by the proposed merger,[65] Dr. Kalt made assumptions favorable to Joint Petitioners, finding nonetheless that the threat of market power remained.[66] The Commission, however, should not be required to make such assumptions or to rely on vague promises in reaching its decision. Rather, it should be afforded sufficient information to base its decision on known facts.

2. Joint Petitioners' Virtual Divestiture Proposal Does Not Eliminate The Merged Entity's Incentive And Ability To Exercise Market Power.

Had the Initial Decision properly applied the burden of proof with respect to Joint Petitioners' virtual divestiture proposal – as opposed to relying solely on the FERC Merger Order – it would have been apparent that Joint Petitioners' mitigation scheme does not fully mitigate the Merged Entity's incentive and ability to exercise market power. By allowing Joint Petitioners to retain control of the operation of the nuclear baseload facilities, it effectively ensures that the Merged Entity will be able to use this control to influence the price of nuclear energy at the annual three-year virtual divestiture auctions. Joint Petitioners' own expert, Dr. Hieronymus, acknowledges that the purchasers of the virtually divested nuclear capacity will have no say in how the nuclear facilities are run, the scheduling of maintenance, or whether output will be increased or

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[65] Notably the PJM Market Monitor also found that a meaningful assessment is not possible absent more specific information. PJM Market Monitoring Unit, *Exelon/PSEG Merger Analysis Part Two*, at 20 (Oct. 14, 2005), *available at* http://www.pjm.com/markets/market-monitor/downloads/mmu-reports/merger-analysis-part-2-public.pdf.

[66] Kalt Direct Testimony at Table 1, Exhibit JPK-5.

decreased.[67] The Merged Entity's control of the nuclear facilities, combined with its knowledge of the plants' frequency of outages and need for maintenance, leaves open the possibility that the Merged Entity will manipulate outages and maintenance projects to signal higher going-forward prices, and thereby maximize its profits by increasing demand for, and the price of, the nuclear power being sold at the annual virtual divestiture auctions.[68]

Moreover, even if the Commission accepts Joint Petitioners' claims that withholding of nuclear capacity is difficult and too costly to be a technique for exercising market power, they cannot deny that their retained ownership of nuclear capacity would provide an incentive to withhold non-nuclear power outputs. Dr. Hieronymus himself admits that, even if the Merged Entity's ability to withhold its nuclear facilities were limited, the incentive and ability still exists for it to maximize profits by withholding output from its fossil plants.[69] The resulting increase in wholesale electricity prices would be factored into market expectations, and result in a concomitant increase in the price of the nuclear energy sold at the annual auctions.[70] Hence, the prospect of increased profitability from the nuclear plant output at the auctions provides a strong incentive for the Merged Entity to exert market power through other actions that will increase wholesale market prices.

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[67] Tr. 425:13-24. *See also* Kalt Direct Testimony at 22 (noting that the proposed virtual divestiture proposal "will not result in the transfer of control of the nuclear facilities to the owners of the contracts"); Kalt Surrebuttal Testimony, Exhibit JPK-13 at 12-13.

[68] Kalt Direct Testimony at 22 (noting that operational control of the nuclear facilities "combined with the expected repeated auctions for three-year forward sales of 'virtually' divested capacity, can create incentives for the Merged Entity to discover means for affecting near-term forward market electricity prices").

[69] Kalt Surrebuttal Testimony, Exhibit JPK-14 at 2 (Joint Petitioners' Response to Discovery Request OCA-V-6) (emphasis in original). *See id.*, Exhibit JPK-13 at 10-11; *see also* Kalt Surrebuttal Testimony at 6.

[70] Kalt Surrebuttal Testimony, Exhibit JPK-14 at 2; *see also* Kalt Surrebuttal Testimony at 6-8, Exhibit JPK-13 at 10-11.

The Initial Decision summarily rejects, without any meaningful discussion or analysis, the evidence establishing that Joint Petitioners' virtual divestiture scheme would be ineffective. Nowhere does the Initial Decision address, or even acknowledge, the pages upon pages of testimony and data submitted by the parties that expose its numerous flaws. In fact, the only alleged support for the Initial Decision's questionable holding is a brief quote from the FERC Merger Order – "We have recognized that operational control of generation resources is a key element of market power analysis and mitigation."[71] – which actually *supports* the PPL Companies' position (discussed above) that, if the Merged Entity is allowed to retain control over the virtually divested capacity, it will ensure that Joint Petitioners' mitigation plan will be ineffective in preventing the unlawful exercise of market power.

3. Joint Petitioners Should Not Be Allowed To Reduce Their Mitigation Obligation When Capacity Is Retired.

Further adding to the uncertainty of the "virtual" divestiture of nuclear capacity is Joint Petitioners' reservation of the right to reduce the amount of nuclear capacity to be divested, even "virtually," by amounts equal to base load capacity lost by the Merged Entity as a result of de-rating, retirement or sale. This proposal not only reduces the effectiveness of the virtual divestiture proposal, but could be anticompetitive as well.[72]

Here again, had the Initial Decision conducted even a cursory examination of the evidence, it would have been apparent that Joint Petitioners' claim that the retirement of capacity will reduce their market share is simply not true. As the unrebutted record evidence demonstrates, and Dr. Hieronymus himself admits, retirements can be a form of withholding that increase market prices in a manner that is profitable for the Merged Entity.[73] Hence, the Merged Entity is effectively able to eliminate competition for the

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[71] Initial Decision at 45 (citing FERC Merger Order at PP 134-140).

[72] *See id.* at 45-46.

[73] Tr. 426:17 - 427:1.

virtually divested assets, which would remain in the Merged Entity's control, as its divestiture obligation is reduced each time a unit is retired. Such a result would have a clear and undeniable impact on the competitiveness of electricity markets in Pennsylvania. Moreover, there is no limit on the one-for-one reduction of mitigation; and thus Joint Petitioners could reduce their obligation to divest even "virtual" base load energy by retiring largely uneconomic peaking facilities. In short, the Initial Decision should have rejected virtual divestiture and required physical divestiture. Such a result would eliminate the Merged Entity's ability to dictate if and when retirements occur.

D. The Initial Decision Erred In Failing To Consider The Impact Of The Proposed Merger On The PJM Classic Market.

The Initial Decision excused Joint Petitioners' failure to present evidence of the proposed merger's impact on the PJM Classic market based on a clear error by FERC. It then added its own error by failing to examine the well-developed evidentiary record on market definition, which demonstrates that even with the market power mitigation that Joint Petitioners proposed, there is still a threat that the Merged Entity could exercise market power in the PJM Classic market. This error alone requires Commission reversal of the Initial Decision. The citizens of the Commonwealth are entitled to have a decision on this issue based on the record evidence, not some other agency's erroneous decision.

Analysis of whether the proposed merger or, indeed, any merger, will lessen competition begins with the proper definition of a relevant market.[74] To properly demonstrate the competitive impacts of a proposed merger, Joint Petitioners were obligated to define the relevant geographic and product markets in which the merger

[74] DOJ/FTC Horizontal Merger Guidelines, 4 Trade Reg. Rep (CCH) at 20,571; *see also U.S. v. E.E. Du Pont De Nemours & Co.*, 353 U.S. 586, 593 (1957) ("Determination of the relevant market is a necessary predicate to a finding of a violation of the Clayton Act because the threatened monopoly must be one which will substantially lessen competition 'within the area of effective competition.'"); *Luria Brothers & Co., v. FTC*, 389, F.2d 847, 864 (3rd Cir. 1968) (stating that to determine if monopoly power exists, one must first determine the areas where monopoly power can be exercised).

could restrain competition and threaten the creation of market power.[75] In this proceeding, Joint Petitioners, for readily self-serving reasons, refused to assess the impact of the proposed merger on the PJM Classic Market, instead proffering the "Pre-2004" PJM market in order to include significant generation not controlled by Joint Petitioners. As demonstrated by the record evidence, by including the significant generation resources of Allegheny Power ("APS") in their market definition, Joint Petitioners hoped the Commission would ignore their significant market power in the PJM Classic market.[76] Significant price differentials and congestion that separate the PJM Classic market from APS' generation resources located on the far (lower price) side of the often constrained Western Interface. The Initial Decision considered none of this evidence, choosing instead to rely on Joint Petitioners' mischaracterization of the PJM MMU Report, rather than the an actual reading of the report itself.[77] As a result, the Initial Decision is inherently flawed and cannot be relied upon by the Commission to assure that the proposed merger will not raise market power concerns.

1. The FERC Merger Order Says Nothing About The PJM Classic Market.

To conclude that the FERC Merger Order provides no support for Joint Petitioners' efforts to dismiss the PJM Classic market, it is necessary to read two, but *only* two documents: The FERC Merger Decision and the PJM Market Monitoring Unit ("PJM MMU") Report. The Initial Decision instead relied on one sentence from the FERC Merger Order in rejecting the PJM Classic market: "We reject arguments that 'PJM Classic' should be considered a separate relevant geographic market within PJM Pre-2004."[78] However, the very next sentence of the FERC Merger Order demonstrates

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[75] DOJ/FTC Horizontal Merger Guidelines, 4 Trade Reg. Rep (CCH) at 20,572-73.

[76] Kalt Direct Testimony, Exhibits JPK-4 & JPK-11.

[77] Initial Decision at 45.

[78] *Id.* (quoting the FERC Merger Order at PP 68, 123).

that FERC never really considered the issue. FERC concluded that it need not assess whether the Merged Entity could exercise market power in the PJM Classic market because the PJM MMU Report did not analyze a separate PJM Classic market.[79] But the PJM MMU Report did not reject a PJM Classic market definition. In fact, the PJM MMU Report never mentioned the PJM Classic market or Joint Petitioners' preferred Pre-2004 PJM market. Instead, the PJM MMU Report focused its analysis entirely on interfaces and constraints. Thus, it cannot be read to endorse Joint Petitioners' proposed market definitions. Nor did FERC address the significant price differentials between the PJM Classic market and the rest of PJM – evidence that clearly establishes the existence of a separate PJM Classic market. Because FERC relied on no evidence in ignoring the PJM Classic Market, it follows that the Initial Decision did the same. Without any evidence or analysis, the Initial Decision failed to consider whether the Merged Entity could exercise market power in the PJM Classic market.

2. Joint Petitioners Failed To Meet Their Burden Of Proof That The PJM Classic Is Not A Relevant Market.

Joint Petitioners purport to rely on price differentials and transmission constraints to identify relevant markets that must be analyzed.[80] Yet, Joint Petitioners refuse to recognize the significant price differentials and congestion identified by Dr. Kalt, which separates PJM Classic as a distinct, relevant market. Dr. Kalt demonstrated in his Exhibit JPK-3 that the average yearly price differential between the APS and PEPCO zones in 2004 was $3.27 per MWh. Moreover, these price differentials, which reach averages of $15 per MWh in the winter and summer months, are readily traceable to specific congestion identified in the PJM 2004 State of the Market Report.[81]

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[79] FERC Merger Order at P 123.

[80] Joint Petitioners' Initial Brief at 25-26.

[81] Kalt Direct Testimony at 15, Exhibits JPK-2 & JPK-3.

Joint Petitioners responded that because of the integration of APS into PJM the congestion along the Western Interface that isolates APS from the PJM Classic zone is no longer significant and can be controlled by PJM through redispatch.[82] Redispatch, however, did nothing to prevent the moving weekly average price differentials between APS and the PJM Classic market from reaching $15 per MWh during the winter and summer months when congestion is at its peak.[83] Joint Petitioners' claims also demonstrate a clear misunderstanding of the effect of redispatch on market definition. Although redispatch may allow PJM to alleviate constraints, the fact that redispatch *occurs* is actually evidence of a separate market, because redispatch means that PJM is calling on more expensive units on the downstream side of the constraint to alleviate the congestion and allow the continued flow of power. Prices on the downstream side of the constraint are accordingly higher than prices on the upstream part of the constraint, thereby defining a separate relevant market in which market power could be exercised.[84]

Joint Petitioners next try to discredit the price differentials found in Dr. Kalt's Exhibit JPK-2 by comparing them to price differentials in other markets.[85] However, Joint Petitioners' expert Dr. Hieronymus admitted that the prices depicted in Exhibit JPK-2 are average prices; and thus could not dismiss the higher seasonal prices separating the PJM Classic market from his PJM Pre-2004 market.[86] Dr. Kalt explained that, when examined over a period of several months, a pattern emerges demonstrating

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[82] Joint Petitioners' Initial Brief at 28. *See also* Joint Application of PECO Energy Company and Public Service Electric and Gas Company for Approval of the Merger of Public Service Enterprise Group Incorporated With and Into Exelon Corporation, Docket No. A-110550F0160, PECO Statement No. 3-R, Rebuttal Testimony of William H. Hieronymus at 22-23, 25 (filed July 29, 2005).

[83] Kalt Direct Testimony, Exhibit JPK-3.

[84] PPL Main Brief at 28.

[85] Tr. 405:10-15 (discussing Exhibit WHH-3).

[86] Tr. 406:15-16; *see* Kalt Direct Testimony at 18 & Exhibit JPK-3.

sustained price differentials of $5-10/MWh during the summer and winter months.[87] Such seasonal price differentials further demonstrate congestion, which isolates the APS zone from the historical PJM Classic market.[88]

It is important to note that FERC, upon which the Initial Decision relies, did not have the full benefit of the PJM Classic market analysis before it when it reached its initial decision on the proposed merger. That analysis was developed in part through discovery from Joint Petitioners in this proceeding. FERC has not to date permitted discovery in its consideration of the proposed merger.[89] As such, FERC could not have been fully aware of the significant market power concerns raised by the proposed merger in the PJM Classic market. There is simply no plausible explanation for the Initial Decision's refusal to ignore the evidence that demonstrates that the PJM Classic market is a relevant market that must be considered in Joint Petitioners' merger analysis.

3. A Commission Decision That Does Not Address The Proposed Merger's Impact On All Relevant Markets Is Inherently Flawed.

By ignoring the impact of the PJM Classic market, the Initial Decision fails to address the proposed merger's impact on all of the relevant markets. A Commission decision that adopts this conclusion cannot be confident that the proposed merger does not raise market power concerns. The only way the Commission can be sure that the proposed merger does not raise market power concerns is if all relevant markets are analyzed and Joint Petitioners' divestiture proposal operates to remedy the market screen failures in all of them. This, Joint Petitioners have failed to do, because when the diluting

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[87] *Id.*

[88] Kalt Direct Testimony at 18.

[89] Although the PPL Companies presented the analysis to FERC on rehearing, the analysis was not received in time to be considered in the FERC Merger Order. The PPL Companies' request for rehearing is still pending before FERC.

effect of APS' generation supply is removed from their analysis, the Merged Entity's potential market power in PJM Classic is clear, as numerous screen failures occur.[90]

The proposed merger's effects on the PJM Classic market cannot be ignored. Yet the Initial Decision does just that. A Commission decision that relies on the Initial Decision's conclusion that the PJM Classic market is not relevant would be inherently flawed and cannot assure that the proposed merger is free from market power concerns.

E. The Initial Decision Erred In Rejecting The Use Of FTR Ownership In Assessing Market Shares In PJM East.

The PJM East market is where most of Joint Petitioners' generation is located,[91] and where millions of customers affected by the proposed merger live and work, including those in the City of Philadelphia.[92] Joint Petitioners admit that the proposed merger would create significant market power in the PJM East market. Thus, they have proposed significant divestiture in an attempt to mitigate that market power. However, Joint Petitioners' proposed mitigation is clearly inadequate because it ignores their significant share of FTRs, which allows them to hedge congestion by treating some of their generation west of the PJM Eastern Interface as if it were located in PJM East.[93] The use of FTRs to assess market shares provides a more accurate picture of Joint Petitioners' ability to exercise market power, even in a mitigated post-merger PJM East market.[94] The Initial Decision ignores this picture and instead relies on the FERC Merger Order to reject the use of FTR ownership when assessing market shares in PJM East.[95] The FERC Merger Order, however, makes no attempt to address the significantly

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[90] Kalt Direct Testimony, Exhibits JPK-4 & JPK-11 (demonstrating impact on the PJM Classic market).

[91] Hieronymus Direct Testimony at 4.

[92] Tr. 413.

[93] Tr. 414:21-23; Kalt Surrebuttal Testimony at 18.

[94] Kalt Direct Testimony, Exhibit JPK-7.

[95] Initial Decision at 45.

different outcome that results when imports are properly allocated based on FTR ownership. The Commission should not compound this mistake. Instead, the Commission must consider the impact of FTRs when assessing market shares in the PJM East market.

1. Joint Petitioners Failed To Meet Their Burden Of Proving That FTRs Have No Impact On The Incentive And Ability To Exercise Market Power.

FTRs are financial rights to offset congestion costs along a given transmission pathway and allow a holder to hedge against price increases in a given market.[96] Generators located in western PJM seeking to compete to sell power in the higher-priced PJM East market often face congestion which prevents them from realizing those higher prices. FTRs protect their owners from increased transmission costs that result from that congestion. When they sell power in PJM East they can realize the full difference between the PJM East price and their costs. Thus, entities, such as Joint Petitioners, that own generation resources located outside of PJM East can use their FTRs to compete in the PJM East market as if an equivalent amount of generation were located therein.[97] Under such circumstances, generation in the west will provide an incentive to exercise market power in PJM East.

Joint Petitioners own significant amounts of FTRs across the PJM East Interface. They acknowledge that FTRs provide an incentive to withhold generation in the PJM East market because withholding will increase the value of both their generation and their FTRs.[98] They thus concede that FTR ownership can provide an incentive to exercise market power.[99] However, rather than making the logical choice of using FTRs to allocate imports across the PJM Eastern Interface, Joint Petitioners, along with the Initial

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[96] Tr. 383:11-383:23. *See also* Kalt Surrebuttal Testimony, Exhibit JPK-13 at 4-5.

[97] Kalt Surrebuttal Testimony at 14.

[98] *Id.*, JPK-13 at 8-9.

[99] *Id.*

Decision, continue to rely on the hypothetical pro rata or "squeeze down" method for assigning shares of transmission imports. They attempt to justify their reliance on the squeeze down method by turning to the Merger Guidelines established by FERC in Order No. 642.[100] Neither Order No. 642 nor the Merger Guidelines dictate, let alone address, the manner in which FTRs should be factored into an Order No. 642 merger analysis. Both were adopted before FTRs came into widespread use as a means by which congestion costs could be hedged.[101]

Even more startling is the Initial Decision's reliance on the FERC Merger Order as support for rejecting the need to use FTRs in assessing market shares in PJM East.[102] A review of the passages of the FERC Merger Order cited by the Initial Decision reveals no analysis by FERC regarding why FTRs can be ignored. Nor did FERC even consider the fact that significantly different outcomes result when imports are properly allocated based on FTR ownership.[103] Rather, the passage quoted by the Initial Decision simply recites that the squeeze down method has been used in the past. It never references the use of FTRs, nor does any other part of the "Discussion" part of the FERC Merger Order.[104] It does not appear that FERC considered FTR ownership at all.

The Commission cannot afford to accept the Initial Decisions' invitation to make the same mistake as FERC. The pro rata or "squeeze down" method for assigning shares of transmission imports is an artifact of the early days of FERC merger analysis and was

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[100] *See* Joint Petitioners' Initial Brief at 30 (citing *Revised Filing Requirements Under Part 33 of the Commission's Regulations*, Order No. 642, 65 Fed. Reg. 70,983 (Nov. 28, 2000), FERC Stats. & Regs., Regulations Preambles (July 1996 – Dec. 2000) ¶ 31,111, at p. 31,894 (2000), *order on reh'g*, Order No. 642-A, 66 Fed. Reg. 16,121 (Mar. 23, 2001), 94 FERC ¶ 61,289 (2001)).

[101] *See, e.g.*, *PECO Energy Co.*, 81 FERC ¶ 61,257, at p. 62,260 (1997) (approving PJM's initial allocation of FTRs). FTRs were initially used in the PJM spot market in 1998.

[102] Initial Decision at 45.

[103] *See* Kalt Direct Testimony at 29, Exhibit JPK-7 (demonstrating screen failures in all but one of the season/load conditions, with five of the post-merger markets being "highly concentrated" and presumed as likely to permit the exercise of market power).

[104] FERC Merger Order at P 112.

devised before the existence of Regional Transmission Organization energy markets and FTRs. The Commission must recognize that because an FTR gives its holder the economic value of the price difference resulting from congestion, it provides Joint Petitioners with the incentive to withhold generation in PJM East. Such a strategy will not only drive up the price of electricity, but will increase the value of the FTRs themselves. In both instances, the Merged Entity will benefit.[105] Rejecting, as FERC and the Initial Decision did, the use of FTRs in favor of the squeeze down method for allocating imports is akin to rejecting "instant replay" to confirm if a referee's call was correct simply because it was not available prior to the advent of new technology.

2. A Commission Decision That Fails To Consider FTR Ownership In Assessing PJM East Market Shares And In Ordering Relief Will Fail To Address The Full Extent Of The Merged Entity's Market Power.

Joint Petitioners' reliance upon the "pro rata" method to allocate import capacity to market participants in PJM East significantly understates the Merged Entity's market share.[106] While the pro rata method assigns a very modest share of imports to Joint Petitioners, allocating transmission imports based upon FTR ownership more accurately assigns a much larger market share. As demonstrated by the table below, use of FTRs to allocate transmission import capacity increases the Merged Entity's post-merger, post-mitigation market share anywhere from 6.2 to 12 percentage points and assigns an additional 623 MW to 972 MW of the market's capacity to Joint Petitioners.

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[105] Kalt Surrebuttal Testimony at 18. The incentive to withhold is not disputed. *See* Tr. 414:21-23; Kalt Surrebuttal Testimony, Exhibit JPK-13 at 8-9.

[106] Tr. 386; Joint Petitioners' Initial Brief at p. 29.

Period	EEG Post Mitigation Market Share (FTR)	EEG Post Mitigation Market Share (Squeeze Down)	Increase In Market Share Using FTRs	Increase in EEG Import (MW)
S_SP1	37%	30.7%	6.3%	2,369
S_SP2	36%	29.8%	6.2%	2,008
S_P	38%	29.6%	8.4%	1,962
S_OP	45%	33.7%	11.3%	1,783
W_SP	37%	30.2%	6.8%	2,237
W_P	37%	28.8%	8.2%	1,983
W_OP	43%	30.8%	12.2%	2,349
SH_SP	35%	27.6%	7.4%	1,767
SH_P	41%	30.3%	10.7%	1,911
SH_OP	45%	32.4%	12.6%	1,787

When transmission import capability across the Eastern Interface is allocated based upon FTR ownership, the post-merger PJM East market produces significant market screen failures.[107] Even when Joint Petitioners' questionable virtual divestiture proposal is taken into account, the post-merger market remains highly concentrated.[108] Indeed, there are market screen failures in all but one of the season/load conditions, with HHI increases up to 300 points. Five of the post-merger markets are "highly concentrated," with HHI totals over 1800 points and thus presumed as likely to permit the exercise of market power.[109]

Joint Petitioners mounted two arguments against the use of FTR ownership to allocate PJM East import capacity for purposes of calculating market shares. First, they claim that FTRs have a life of only one year and do not provide the same certainty as

[107] Kalt Direct Testimony, Exhibit JPK-7.

[108] *Id.*

[109] *Id. See* PPL Main Brief at 31. A 100 point increase where markets are moderately concentrated (HHI's of 100-1800) constitutes a screen failure. A 50 point increase constitutes a screen failure in highly-concentrated markets (1800 HHI and above). A 100 point increase in a highly-concentrated market is presumptive evidence that the merger is likely to create or enhance market power. The Initial Decision describes how the HHI index under the DOJ/FTC Merger Guidelines is calculated. Initial Decision at 39.

ownership of generation.[110] It is true that ownership of grandfathered FTRs – those allocated by PJM rather than sold through the secondary market – generally follow load serving obligations in PJM.[111] However, Joint Petitioners can count on the continued receipt of a substantial amount of FTRs for the foreseeable future. Despite years of retail competition in Pennsylvania, PECO continues to serve more than 90% of the load in its service territory as a provider-of-last-resort. Thus, PECO can expect to continue to receive a significant amount of ARRs each year based upon this load.[112]

Joint Petitioners next claim that the incentive to withhold generation in PJM East to drive up the value of FTRs would be offset by the fact that such withholding would also drive up the cost to serve load there[113] and, hence, "the incentive effect is washed out."[114] However, as Dr. Kalt explains, "[w]hether the Merging Parties control 1 MW of generation within PJM East or hold a 1 MW FTR that sources from the western hub and sinks in PJM East, a price increase in PJM East benefits the Merging Parties equally in both cases."[115] Moreover, Joint Petitioners' contention ignores the fact that Dr. Kalt's FTR analysis is an "economic capacity" analysis.[116] Economic capacity is one of the two measures used by FERC to gauge the increase in concentration caused by the merger.[117] As Joint Petitioners are fully aware, load is not considered in an economic capacity analysis.[118] Even if Joint Petitioners' load were considered, however, the incentive to

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[110] Hieronymus Rebuttal Testimony at 20-21.

[111] Load Serving Entities are currently allocated "Auction Revenue Rights" (or "ARRs"), which can be converted to FTRs. If retained, they entitled the holder to a share of the FTR auction revenue. Kalt Surrebuttal Testimony at 14-15.

[112] Kalt Surrebuttal Testimony at 17.

[113] Tr. 384:4-14.

[114] *Id.* at 384:9-10.

[115] Kalt Surrebuttal Testimony at 18.

[116] Kalt Direct Testimony, Exhibit JPK-8.

[117] Hieronymus FERC Direct Testimony at 47.

[118] Hieronymus Rebuttal Testimony at 21-22.

withhold generation still exists. The record demonstrates that in all time periods both Exelon and PSEG have sufficient quantities of generation supply in PJM East to serve their native load obligations without imports.[119] Therefore, FTRs are not necessary to supply their load. Accordingly, and contrary to Joint Petitioners' claims, an increase in the cost of supplying load will not "wash out" the gains experienced by increasing the value of the FTRs.

When generation imports into PJM East are assigned based on FTR ownership, rather than the pro rata or "squeeze down" method used by Joint Petitioners, a different picture of the proposed merger's effect, even with the proposed divestiture, emerges. The decision to ignore FTRs has a significant effect on the Commission's ability to predict the proposed merger's impact on market concentration levels and ultimately its impact on Pennsylvania retail customers.[120]

F. Should The Commission Conclude That Joint Petitioners Have Not Demonstrated That The Proposed Merger Is Not Likely To Result In Anticompetitive Or Discriminatory Conduct, It Should Refer Its Findings As Provided In Section 2811(d) Of The Competition Act.

The Commission has a clear statutory obligation to consider the impact of the proposed merger on competition in retail electricity markets in Pennsylvania. Section 2811(e) of the Competition Act requires the Commission to consider the evidence before it and make appropriate findings on market power in this application proceeding. Based on the many reasons explained above, the Commission should conclude that Joint Petitioners have not demonstrated that the proposed merger is unlikely to result in anticompetitive or discriminatory conduct that would harm competitive markets for

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[119] *Joint Application of PECO Energy Company and Public Service Electric and Gas Company* for Approval of the Merger of Public Service Enterprise Group Incorporated With and Into Exelon Corporation, Docket No. A-110550F0160, Supplemental Testimony and Exhibits of William H. Hieronymus, Exhibit J-19 (filed May 27, 2005).

[120] Kalt Direct Testimony at 29. *See also id.*, Exhibit JPK-7 (demonstrating the effects of FTRs on the economic capacity analysis).

electricity in the Commonwealth. Thus, the Commission should deny Joint Petitioners' application. At a minimum, even if the Commission does not deny the application, it is required to refer its findings (and the evidentiary record underlying them) to several specifically-identified governmental agencies, including the Attorney General of Pennsylvania and the United States Department of Justice. The Commission should not hesitate to do so.

V. CONCLUSION.

For the foregoing reasons, the PPL Companies urge the Commission to find that the proposed merger will likely lessen competition in the PJM Classic and PJM East wholesale electricity markets and, as a result, the Pennsylvania retail electricity market. The PPL Companies also request that the Commission hold that the mitigation proposed by Joint Petitioners is insufficient to prevent such lessening of competition. Further, the PPL Companies urge that the Commission either: (1) deny the application; (2) condition its approval of the proposed merger on Joint Petitioners' agreement to effective relief, as set forth herein; or (3) certify its findings, along with the record of these proceedings, to the Attorney General of the Commonwealth, Antitrust Division of the United States Department of Justice, FERC, and the NJBPU.

Respectfully submitted.

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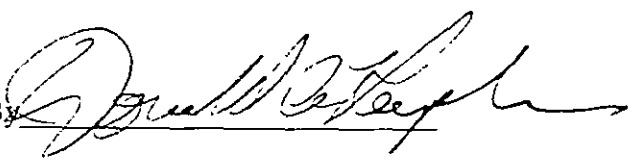
By: 

December 20, 2005

DATE: January 11, 2005

SUBJECT: A-110550 F0160

TO: Cheryl W. Davis, Director
Office of Special Assistants

FROM: James J. McNulty
Secretary
nvl

Joint Application of PECO Energy Company and Public Service Electric and Gas Company for Approval of the Merger of Public Service Enterprise Group Incorporated with and into Exelon Corporation

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Copies of the Initial Decision have been served upon all parties of interest.

Exceptions have been filed by:

PPL COMPANIES
CITY OF PHILADELPHIA

Reply Exceptions have been received from:

PECO ENERGY COMPANY
OFFICE OF SMALL BUSINESS ADVOCATE
OFFICE OF SMALL BUSINESS ADVOCATE

cc: Susan Hoffner