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October 13, 2005

James J. McNulty
Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street
P. O. Box 3265
Harrisburg, PA 17105-3265

*In re:* *Docket No. A-110550F0160*
Joint Application of PECO Energy and
Public Service Electric and Gas Company

DOCUMENT FOLDER

Dear Secretary McNulty:

We represent Philadelphia Gas Works and are enclosing for filing its Main Brief in the above referenced proceeding. Please note that there are two versions to the Main Brief: a Proprietary Version and a Public Version with proprietary material redacted. An original and nine (9) copies of each version of the Main Brief are enclosed for filing along with a disk containing an electronic copy of each version. Copies of the Main Brief are being served upon the persons and in the manner set forth on the Certificate of Service attached to it.

Very truly yours,

THOMAS, THOMAS, ARMSTRONG & NIESEN

By

Thomas T. Niesen

Encl.
cc: Certificate of Service
Steven P. Hershey, Esquire (w/encl.)
Denise Adamucci, Esquire (w/encl.)

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Before the
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Administrative Law Judge
Marlane R. Chestnut, Presiding

| | | |
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| 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 |

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SECRETARY'S BUREAU

# MAIN BRIEF
# OF
# PHILADELPHIA GAS WORKS

***PUBLIC VERSION***
***PROPRIETARY MATERIAL REDACTED***

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## I. STATEMENT OF THE CASE

This proceeding concerns the Joint Application of PECO Energy Company ("PECO") and Public Service Electric & Gas Company ("PSE&G"), filed February 4, 2005, seeking the approval of the Public Utility Commission ("Commission") under Chapters 11, 22 and 28 of the Public Utility Code, 66 Pa. C.S. Chapters 11, 22 and 28, for the merger of Public Service Enterprise Group, Inc. ("PSEG"), PSE&G's parent company, into Exelon Corporation ("Exelon"), PECO's parent company, or, in the alternative, an order declaring that Commission approvals are not required for the transaction.

On March 28, 2005, PGW filed a Petition to Intervene in the proceeding.[1] PGW is a natural gas distribution company and, as a collection of assets owned by the City of Philadelphia, a city natural gas distribution operation under the Natural Gas Choice and Competition Act. PGW provides natural gas distribution service within the City of Philadelphia to approximately 510,000 customers, including 420,000 residential heating customers. PGW is the largest natural gas distribution company in the Commonwealth of Pennsylvania.

The proceeding was assigned to Administrative Law Judge Marlane R. Chestnut and an Initial In-Person Prehearing Conference was held on March 29, 2005. A schedule for the litigation of the proceeding was established at the Prehearing Conference and confirmed by Judge Chestnut in Revised Prehearing Order #2 dated March 31, 2005. On July 15, 2005, the Commission presented five additional questions for the parties and Judge Chestnut to address during the proceeding.

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[1] Other Intervenors in the proceeding include the City of Philadelphia, the Office of Consumer Advocate, the Office of Trial Staff, the Office of Small Business Advocate, the Philadelphia Area Industrial Users Group, Citizens for Pennsylvania's Future, the Department of Environmental Protection, Exelon Utility Coordinated Council, the PPL Companies, FirstEnergy Companies, Action Alliance of Senior Citizens of Greater Philadelphia, the Reinvestment Fund and Pennsylvania State Senator Anthony H. Williams.

On September 12, 2005, the Applicants and several Intervenors filed a Joint Petition for Settlement ("Joint Settlement") with the Commission. PGW did not join in the Joint Settlement. Other Intervenors not joining in the settlement include the City of Philadelphia, the PPL Companies and the FirstEnergy Companies.

Evidentiary hearings were held before Judge Chestnut on September 22, 23 and 26, 2005. PGW presented PGW Statement No. 1, the prepared written direct testimony of Dr. Paul R. Carpenter,[2] PGW Statement No. 1-SR, the prepared written surrebuttal testimony of Dr. Carpenter[3] and PGW Statement No. 1-S, the supplemental testimony of Dr. Carpenter.[4] PGW also presented PGW Statement No. 2, the prepared written testimony of Mr. Craig E. White.[5]

PGW submits this Main Brief in accordance with the briefing schedule set forth in Prehearing Order #7 dated September 12, 2005, formatted in accordance with Paragraph 39 of Revised Prehearing Order #2.[6]

---

[2] PGW Statement No. 1 addresses the issue of market power and the merged entity's ability and incentive to use market power to adversely affect the public interest and competition in the electricity and natural gas markets. It also addresses the remedial measures the Commission should consider in connection with the proposed merger in order to ensure competition and consistency with the public interest.

[3] PGW Statement No. 1-SR responds to rebuttal testimony of Applicants' witnesses William Hieronymus and John Morris. It also addresses the Commission's Directed Questions Nos. 1 and 5.

[4] PGW Statement No. 1-S addresses the Joint Petition for Settlement filed September 12, 2005.

[5] PGW Statement No. 2 presents additional information concerning the Commission's Directed Question No. 5.

[6] The foregoing brief Statement of the Case is provided consistent with 52 Pa. Code §5.501(a). Consistent with the discussion at transcript page 598, PGW is not including a separate History of Proceeding with its Main Brief.

## II. SUMMARY OF ARGUMENT

Applicants must demonstrate by a "preponderance of the evidence" that this proposed merger will affirmatively promote the public interest. *City of York v. Pa. P.U.C.*, 449 Pa. 136, 295 A.2d 825 (1972). The benefits and detriments of the merger should be measured under the public interest test and, thus, as these benefits and detriments will impact on "all affected parties." *Middletown Township v. Pa. P.U.C.*, 482 A.2d 674, 682 (Pa. Commwlth. Ct. 1984).

Furthermore, the Commission must exercise its jurisdiction and authority under Section 2811 of the Electric Competition Act, 66 Pa. C.S. §2811, and Section 2210 of the Natural Gas Competition Act, 66 Pa. C.S. §2210, to investigate and determine whether the proposed merger will result in the unlawful exercise of market power. Most relevant to this proceeding, any merger that provides the opportunity for anticompetitive or discriminatory conduct, including the unlawful exercise of market power, shall not be approved except upon such terms and conditions as are necessary to preserve competitive retail markets.

The proposed merger, even as supplemented by the terms and conditions of the Joint Petition for Settlement, would not promote the public interest. The evidence of record demonstrates that the proposed merger would produce substantial detriments that far outweigh any benefit that might result from it or from the proposed partial settlement. The proposed merger would result in substantial market power for the merged entity in both the electric and gas markets. The Applicants have not provided sufficient remedies to protect the public from the improper abuse of market power. The mitigation measures proposed by Applicants are not substantial and they do not meaningfully address the vertical market power concerns that will result from the merger.

The testimony of PGW witness Carpenter is entitled to dispositive weight. The vertical market power concerns identified by Dr. Carpenter are substantial and demand remedy. The appropriate remedial measure to address these concerns is the divestiture of PECO Gas and PSE&G's gas operations as a condition precedent to the merger.

## III. DISCUSSION AND ARGUMENT

### A. In Order to Obtain Approval of the Commission in This Proceeding, Applicants, Which Bear the Burden of Proof, Must Establish the Facts to Support Adjudication in Their Favor by A Preponderance of the Evidence

Section 332(a) of the Public Utility Code, 66 Pa. C.S. §332(a), provides that the proponent of a rule or order has the burden of proof. As the proponent of a rule or order, Applicants have the burden of proof in this proceeding and, therefore, the duty to establish facts by a "preponderance of the evidence." *Se-Ling Hosiery, Inc. v. Margulies*, 364 Pa. 45, 70 A.2d 854 (1950); *Samuel J. Lansberry, Inc. v. Pa. P.U.C.*, 578 A.2d 600, 602, alloc. den., 602 A.2d 863 (Pa. Cmwlth. 1992).

Additionally, any finding of fact necessary to support the Commission's adjudication must be based upon substantial evidence. 2 Pa.C.S. §704; *Mill v. Pa. P.U.C.*, 447 A.2d 1100 (Pa. Cmwlth. 1982); *Edan Transportation Corp. v. Pa. P.U.C.*, 623 A.2d 6 (Pa. Cmwlth. 1993). More is required than a mere trace of evidence or a suspicion of the existence of a fact sought to be established. *Norfolk and Western Ry. v. Pa. P.U.C.*, 413 A.2d 1037 (Pa. 1980); *Erie Resistor Corp. v. Unemployment Compensation Bd. of Review*, 166 A.2d 96 (Pa. Super. 1960); *Murphy v. Commonwealth, Dept. of Public Welfare, White Haven Center*, 480 A.2d 382 (Pa. Cmwlth. 1984). Instead, Applicants must provide substantial evidence of the facts supporting the findings they have proposed.

### B. The Commission Has Jurisdiction and Authority, as Well as the Responsibility, to Address Significant Issues in Utility Merger Proceedings

The Commission addressed its jurisdiction and authority in utility merger proceedings in *Re DQE, Inc.*, 186 PUR 4th 39 (1998). There, Allegheny Power System, Inc., the parent holding company of West Penn Power Company, proposed the formation of a new subsidiary to be merged into DQE, Inc., the parent holding company

of Duquesne Light Company. The Commission explained that it has jurisdiction to review the merger under both Chapters 11 and 28 of the Public Utility Code. 66 Pa. C.S. §§§§1101-1104 and 2801-2812. Thus, the Commission has jurisdiction to review the merger proposed in this proceeding.

### 1. A Certificate of Public Convenience Is Required Under Chapter 11 and Applicants Must Demonstrate That the Merger Will Affirmatively Promote the Public Interest

In *DQE*, the Commissioned addressed its authority under Chapter 11 as follows (186 PUR 4th at 46):

> "The proposed merger of DQE with APS via a stock-for-stock transaction will constitute the transfer of a public utility's 'tangible and intangible property used or useful in the public service,' 66 Pa. C.S. §§ 1102(a)(3); and, accordingly, will require a certificate of public convenience from the Commission before the transaction can be lawful under the Public Utility Code. By law, the application for a certificate of public convenience may be granted by the Commission 'only if the commission shall find or determine that the granting of such certificate is necessary or proper for the service, accommodation, convenience, or safety of the public.' 66 Pa. C.S. §§ 1103(a). *See City of York v. Pa. Pub. Util. Comm'n*, 449 Pa. 136, 295 A.2d 825 (1972) (the Pennsylvania Supreme Court held that a proponent of a merger has the burden to show that the merger will affirmatively promote the public interest); *Middletown Township v. Pa. Pub. Util. Comm'n*, 482 A.2d 674, 682 (Pa. Commw. Ct. 1984)(the benefits and detriments of the merger will be measured under the public interest test as they impact on 'all affected parties'). In addition, the Public Utility Code also permits the Commission to 'impose such conditions as it may deem to be just and reasonable' in exercising our authority to grant the application for a certificate. 66 Pa. C.S. §§ 1103 (a).

Accordingly, the focus of the Commission's merger analysis should be the impact that this merger would have on the public. Applicants must affirmatively prove that the grant of a certificate of convenience is necessary or proper for the service, accommodation, convenience or safety of the public

2. **The Commission Must Also Examine Whether the Proposed Merger Is Likely to Result in Anticompetitive or Discriminatory Conduct, Including the Unlawful Exercise of Market Power And, If Such Market Power Exists, Attach the Terms and Conditions It Finds Necessary to Preserve the Benefits of Properly Functioning and Workable Competitive Retail Electricity and Gas Markets**

In a prior proceeding, the Commission acknowledged that it has the authority to investigate whether a proposed merger would result in anticompetitive or discriminatory conduct, including the unlawful exercise of market power. The Commission noted in *DQE* that the then recently enacted Electric Generation Customer Choice and Competition Act ("Electric Competition Act"), 66 Pa. C.S. Chapter 28, added an additional market power related "approval standard" to its jurisdictional review authority in electric merger proceedings (186 PUR 4th at 46):

> "The Electric Competition Act adds an additional approval standard which provides the Commission with authority to investigate and hold public evidentiary hearings on 'the effect of mergers, consolidations, acquisition or disposition of assets or securities of electricity suppliers ... [on] the retail distribution of electricity.' 66 Pa. C.S. §§ 2811(b). Section 2811(e)(1) gives the Commission the authority to approve or disapprove such mergers or acquisitions depending on whether:
>
> > [T]he proposed merger ... [or] acquisition is likely to result in anticompetitive or discriminatory conduct, including the unlawful exercise of market power, which will prevent retail electricity customers ... from obtaining the benefits of a properly functioning and workable competitive retail electricity market."

In addition to Section 2811(b) above, the Commission also quoted Section 2811(e)(2) of the Act, 66 Pa. C.S. §2811(e)(2), which specifically requires the Commission to attach appropriate terms and conditions to any merger that is likely to result in the unlawful exercise of market power (186 PUR 4th at 46):

> "... [S]ection 2811(e)(2) provides that:
>
> *[I]f the commission finds, after hearing, that a proposed* merger ... [or] acquisition ... is likely to result in anticompetitive or discriminatory conduct, including the

> unlawful exercise of market power ... [in] the retail electricity market, the commission shall not approve such proposed merger ... [or] acquisition ... except upon such terms and conditions as it finds necessary to preserve the benefits of a properly functioning and workable competitive retail electricity market."

In order to determine whether a proposed merger would create or enhance market power, the Commission should follow the analytical process delineated in the 1992 United States Department of Justice and Federal Trade Commission Horizontal Merger Guidelines as revised on April 8, 1997 ('Merger Guidelines'). 57 Fed. Reg. 41,552 (1992), *revised* 4 Trade Reg. Rep. (CCH) ¶¶ 13,104 (April 8, 1997). *See* 186 PUR 4th at 47. Indeed, numerous parties in this proceeding, including Applicants (*See* PECO St. No. 3), have identified this standard as directly applicable to this Commission's determination in this proceeding. The Commission addressed the Merger Guidelines as follows (186 PUR 4th at 47):

> The Merger Guidelines provide general enforcement standards for three ranges of market concentration. A [Herfindahl-Hirschman Index ("HHI") calculation] below 1,000 is considered unconcentrated and will have no adverse competitive effect. A HHI between 1,000 and 1,800 is moderately concentrated and if the HHI increases 100 or more points from the pre-merger level, there may be significant competitive concerns depending on other competitive factors. A HHI above 1,800 is considered highly concentrated, and the Merger Guidelines provide that mergers in this range producing an increase in the HHI of more than 50 points raises significant competitive concerns and further presumes that mergers producing an increase of more than 100 points are 'likely to create or enhance market power or facilitate its exercise.' 57 Fed. Reg. at 41,558.

Thus, utilizing this standard, a HHI above 1,800 points indicates a merger will likely result in an improper exercise of market power.

The *DQE* record demonstrated that the relevant markets in that proceeding were highly concentrated with HHIs above 1,800. In light of this concentration, the Commission presented a lengthy discussion of its authority to impose market power

remedies and examined which remedies are generally preferred. The Commission specifically noted, as part of its discussion, its authority to direct divestiture as a mitigation measure (186 PUR 4th at 60):

> 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 the merger 'except upon such terms and conditions *as it finds necessary* to preserve the benefits of a ... competitive retail electricity market.' (Emphasis added.)
>
> 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. §§ 824b(b), to approve electric utility mergers and to impose 'such terms and conditions as it finds necessary or appropriate ' to mitigate market power concerns.

In its continuing analysis, the Commission noted that FERC recommends mitigation measures that are not dependent on post merger review (186 PUR 4th at 60):

> FERC's approach, which dictates against post-merger review, is consistent with that of the federal enforcement agencies. See 15 U.S.C. §§ 18a (the Hart-Scott-Rodino Antitrust Improvements Act of 1976 establishes a premerger notification and waiting period procedure that provides the two federal antitrust enforcement agencies information about planned transactions and a prescribed time period in which to analyze those transactions prior to their consummation).

Continuing its examination of which remedies should be favored, the Commission acknowledges (186 PUR 4th at 60-61):

> 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 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.

Instead, the Commission states in *DQE* that structural remedies are more appropriate remedies because they are the cleanest and most effective means of addressing market power problems (186 PUR 4th at 61):

> In addition, structural remedies, such as ... divestiture of plants or other assets are preferred by the federal antitrust enforcement agencies (and accepted by FERC) because they are the cleanest and most effective way to deal with a market power problem. With structural remedies, there is no need for continuing oversight of the merged entity to ensure that it does not abuse its market power -- the unlawful market power has been effectively removed by the structural remedy. *See, e.g.* Testimony of Milton A. Marquis, Senior Counsel to the Assistant Attorney General, Antitrust Division, U.S. Department of Justice, before the National Association of Attorneys General Hearing on Electric Utility Deregulation, San Francisco, CA, at 4-5 (January 29, 1998); Mark W. Frankena & Bruce M. Owen, *Electric Utility Mergers Principles of Antitrust Analysis* 135-37, 140-42 (1994).

Most relevant to this proceeding, in *DQE*, the Commission recognized that asset divestiture is often utilized as an effective means of addressing market power concerns, and that the Commission has the authority to direct such a remedy. The Commission in *DQE* stated (186 PUR 4th at 61):

> Although we are not directing divestiture as a strategy in this case, it is important to note that remedy is within our authority under the Act. ... Indeed, section 2811(e)(2) specifically provides the Commission with broad authority to fashion 'terms and conditions' it finds necessary to preserve a competitive retail electric market. As divestiture of assets has long been accepted by the courts and enforcement agencies as an effective means to address market power concerns in merger cases, this Commission may utilize this remedy (and other structural remedies as well) whenever it deems appropriate pursuant to its authority under section 2811 of the Electric Competition Act.
>
> In contrast to structural remedies, conduct restriction remedies are generally considered inferior to the protection of competition that would result from the imposition of a structural remedy such as membership in an approved, functioning ISO. Mark W. Frankena & Bruce M. Owen, *Electric Utility Mergers Principles of Antitrust Analysis* 141 (1994). The creation of new competition through structural remedies is likely to be better for electric customers than the creation of additional oversight requirements. Regulatory conditions that require continuing oversight by

a regulatory body to ensure compliance generally are less effective in preventing the exercise of market power and more costly to enforce.[7]

The Natural Gas Choice and Competition Act ("Natural Gas Competition Act"), 66 Pa. C.S. Chapter 22, contains provisions virtually identical to those found in the Electric Competition Act and discussed in *DQE, supra*. Section 2210(a) of the Natural Gas Act gives the Commission the authority to approve or disapprove natural gas mergers or acquisitions depending on whether the proposed merger or acquisition "is likely to result in anticompetitive or discriminatory conduct, including the unlawful exercise of market power, which will prevent retail gas customers from obtaining the benefits of a properly functioning and effectively competitive retail gas market." Section 2210(b) specifically requires the Commission to attach appropriate terms and conditions to any natural gas merger that is likely to result in the unlawful exercise of market power. *See Application of PECO Energy Company*, 2000 WL 33963140, PaPUC, June 22, 2000, (PaPUC Docket No. A-00110550F0147).

### 3. In Conclusion, Applicants Must Demonstrate That the Merger Will Not Be Detrimental and Will Affirmatively Promote the Public Interest and The Commission Must Investigate and Determine Whether the Merger Will Result in the Unlawful Exercise of Market Power

In conclusion, the applicable legal principles are clear. Applicants must demonstrate by a preponderance of the evidence that the proposed merger will affirmatively promote the public interest. *City of York v. Pa. P.U.C.*, 449 Pa. 136, 295 A.2d 825 (1972). Instead of focusing on the interest of one or two entities or groups, the benefits and detriments of the merger should be measured under the public interest

---

[7] The Commission in *DQE* also discussed mitigation proposals that ***do not*** adequately deal with market power. Significant in this regard is its discussion of rate caps which the Commission rejected as a mitigation tool in *DQE* and characterized as inadequate to deal with market power. 186 PUR 4th at 61. Based on their cross examination of Dr. Carpenter at transcript pages 475-476, Applicants will apparently argue that electric rate caps may mitigate their market power. That argument, if made, should be rejected as it was rejected in *DQE*.

test as they impact on "all affected parties." *Middletown Township v. Pa. P.U.C.*, 482 A.2d 674, 682 (Pa. Commwlth. Ct. 1984). The Commission, moreover, must exercise its jurisdiction and authority under Section 2811 of the Electric Competition Act and Section 2210 of the Natural Gas Competition Act to investigate and determine whether the proposed merger will result in the unlawful exercise of market power. *DQE*, 186 PUR 4th at 47. A merger that provides the opportunity for anticompetitive or discriminatory conduct, including the unlawful exercise of market power, shall not be approved except upon such terms and conditions as are necessary to preserve competitive retail markets, particularly when that merger might also provide the incentive for such conduct. Necessary terms and conditions include, but are not limited to, requiring divestiture of assets as a precondition for approval.

The merger proposed in this proceeding would not promote the public interest. Indeed, as detailed herein, the evidence of record demonstrates that the proposed merger will produce substantial market power and other detriments that far outweigh any benefit that might result from it or from the proposed partial settlement. The proposed merger, moreover, would result in substantial market power for the merged entity in both the electric and gas markets. In addressing electric market power concerns, Applicants proposed the actual and virtual divestiture of generating plants. Under the heading "Competitive Electric Markets" in the Joint Petition for Settlement, PECO also agrees to provide the Commission with a report of wholesale market prices and price trends for each of the next six years. These measures are inadequate and they do not address effectively the vertical market power concerns that will result from the merger. The vertical market power concerns identified by PGW witness Carpenter and discussed below are substantial and require remedy. The appropriate remedial

measure to address them is the divestiture of PECO Gas and PSE&G's gas operations as a condition precedent to the merger.

## C. The Proposed Merger Raises Significant Vertical Market Power Concerns Which Are Not Adequately Addressed By the Proposed Partial Settlement

### 1. The Proposed Transaction Is A Vertical Merger, Which By Combining Exelon's Gas and Electricity Assets With the Gas and Electricity Assets of PSEG, Would Create A Market Power Risk

A vertical merger is one that involves entities that have positions in two product markets where one product (e.g., natural gas) supplies or is an important input to the production of the second product (e.g., electricity). Applicants' proposed merger is a vertical merger since it would combine Exelon's gas and electricity assets with PSEG's gas and electricity assets. It would create a merged entity that has a substantial position in both the gas and electricity markets in the PJM East region. The principal risk presented by this vertical merger is that the merged entity would have the ability to use its market power in the first (input) product market to harm competition and raise prices in the second (output) product market. PGW St. No. 1 at 8.

### 2. PGW Witness Paul R. Carpenter, Who Is a Nationally Known Expert, Has Presented Testimony Concerning Vertical Market Power Which Should Be Given Dispositive Weight in this Proceeding

PGW witness Paul R. Carpenter evaluated the proposed merger to determine whether it raises vertical market power concerns. Dr. Carpenter holds a Ph.D. in applied economics and an M.S. in management from the Massachusetts Institute of Technology. He co-founded Incentives Research, Inc. and, prior to doing so, was employed by the NASA/Caltech Jet Propulsion Laboratory. He was a post-doctoral fellow at the MIT Center for Energy Policy Research and is currently a Principal and Vice Chairman of *The Brattle Group*. His areas of expertise, in which he is nationally known, include the fields of energy economics, regulation, corporate planning, pricing

policy, and antitrust. He frequently performs market power analyses for merger evaluations and in antitrust lawsuits. He testified before the FERC and the California Public Utilities Commission on the merger of Enova and Pacific Enterprises (now Sempra Energy) regarding vertical market power issues. He testified before those same bodies on the exercise of market power in western natural gas markets during the California Energy Crisis of 2000-2001 and its effects on the electricity market during the Crisis. PGW St. No. 1 at 2-3 and Appendix A. His testimony in this proceeding should be given dispositive weight.

### 3. The Post-Merger Market for Delivered Natural Gas in PJM East Would Be Highly Concentrated and, Thus, Requires Mitigation Before the Merger Is Approved

Dr. Carpenter presented a HHI analysis of the gas market created by the proposed merger with delivered natural gas as the relevant upstream market and PJM East as the appropriate geographic market. As shown in Table 1 below, the HHI in the PJM East delivered gas market in 2006 will exceed 1,800 if PSEG and Exelon merge.

Dr. Carpenter's conclusion differs from that presented by Applicants' witness Hieronymus, who argues that the post-merger delivered gas market will be only moderately concentrated and not highly concentrated.[8] Dr. Carpenter used Dr. Hieronymus' analysis as a starting point, but then made several corrections to what are clear errors in his analysis. The corrections are as follows (PGW St. No. 1 at 17-18):

- Dr. Carpenter excluded contracts that deliver into the Algonquin pipeline (largely held by New York and New England LDC's) for ultimate delivery outside of PJM East;
- Dr. Carpenter included contracts that appear to have been excluded from Dr. Hieronymus' analysis, even though they are in his relevant market and are in effect in 2006; and
- Dr. Carpenter excluded contracts that Dr. Hieronymus included that have receipt rights *only* in PJM East, and therefore cannot represent alternatives to capacity held by the Exelon and PSEG into PJM East.

Some of these corrections to Dr. Hieronymus' work increase the post-merger HHI while others decrease the statistic. PGW St. No. 1 at 17-18. The end result of this analysis shows that this merger requires the application of vertical market power remedies as a condition for approval.

### 4. The Merged Entity Would Have the Ability to Affect the Level and Volatility of the Price of Gas

Exelon and PSEG have substantial gas transportation and LPG/LNG assets (*See* PGW St. No. 1 at 10-14) and flexibility to draw on those substantial assets to meet the demands of their retail customers. Over 1.9 Bcf/d of their combined 2.51 Bcf/d of delivery capability into the natural gas market is held by PSE&G's unregulated affiliate PSEG ER&T. PGW St. No. 1 at 22 and Tr. 468.

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[8] Under the FTC and DOJ merger guidelines, markets with post-merger HHIs of between 1,000 and 1,800 points are considered to be "moderately concentrated." *See* PECO Exhibit WHH-1, page 24 of 75, footnote 10. Dr. Hieronymus found that the post-merger delivered gas market would have an HHI of 1,572, so that the market would be moderately concentrated. *See* Exhibit J-16 of PECO Exhibit WHH-1 and Tr. 482.

On most days of the year, the Exelon/PSEG delivery capability greatly exceeds the retail gas demands that the merged entity will be required to meet, including storage injection requirements. The merged entity will have the discretion to make third-party sales, or release transportation capacity into the wholesale market, or not make such sales and releases, on any given day. PGW St. No. 1 at 22.

When demand conditions are such that pipeline transportation capacity in the region becomes heavily utilized, the merged entity operating in a highly concentrated market will potentially have a pivotal supplier role in the gas market. Its decisions concerning the use, or lack of use, of the gas assets it controls would affect the level and volatility of the price of gas. PGW St. No. 1 at 22.[9] The merged entity's ability to raise the price of natural gas derives from its control of substantial gas transportation rights, and its discretion and flexibility to draw on those rights depending on demand conditions in the market during particular days. PGW St. No. 1 at 4. The merged entity would have the discretion to inject or withdraw from storage, to transport gas on its baseload contracts, or to purchase gas at the citygate. This discretion would allow it to create congestion in the market. Tr. 480-481.

The merged entity, operating in a highly concentrated market, would also have the ability to increase the volatility of the price of gas through the discretionary use of selected storage (and LPG/LNG) injection and withdrawal strategies at particular locations. Decisions to accelerate or decelerate withdrawals during the winter, for example, in lieu of using the merged entity's pipeline transportation capacity to meet

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[9] In theory, existing federal and state regulations prohibit the kind of market manipulation that would affect the level and volatility of the price of gas. Market manipulation, however, is very difficult for regulators to detect after the fact unless the regulators are collecting the right data, are carefully monitoring the entity's actions, and are able to distinguish between price movements caused by actions of the entity and price movements that are the result of the complexities of market forces. PGW St. No. 1 at 23; *See DQE, supra* at 60-61. In short, the market could be manipulated without regulators ever being aware of it.

retail requirements or make off-system sales could cause rapid movements in prices (both upward and downward). Such volatility would be financially beneficial to Exelon/PSEG's unregulated power and gas trading arm that has physical and financial positions that profit from increased price volatility. PGW St. No. 1 at 23.

### 5. In Addition to the Ability to Affect the Level and Volatility of the Price of Gas, the Merged Entity Will Have the Incentive to Increase PJM Gas Prices In Order to Increase Prices and Its Profits from Its Electric Baseload Capacity

Exelon and PSEG have generating capacity in PJM of 26,164 MW and 13,963 MW, respectively. The proposed merger would produce an entity with combined generating capacity in PJM of 40,127 MW. Giving full effect to the actual and virtual divestiture of generating assets proposed by Applicants would still leave the merged entity with 33,727 MW of generating capacity in PJM.[10] PGW St. No. 1 at 24-25.

Gas was on the margin during almost 40% of all hours in 2004 in PJM East, and during 60% of peak hours. When gas is on the margin in PJM East, an increase in the PJM East gas price increases the price for PJM East electricity. Thus, there is a direct relationship between the price of natural gas and the price of electricity in PJM East. *See* PGW St. No. 1-S at 3. With the ability to increase gas prices (*See* Section 4, *supra*) and 33,727 MW of generating capacity, the merged entity will have a strong incentive to increase gas prices and benefit from higher electric prices and increased profits on its baseload electric capacity. PGW St. No. 1 at 24-25.

In his original testimony filed with the Joint Application, Dr. Hieronymus claimed that the following factors prevent, or make it more difficult for, the merged entity to exercise vertical market power: (1) PECO and PSE&G's distribution systems serve a relatively small amount of unaffiliated electric generation; (2) Pennsylvania and New

[10] Calculated as 40,127 MW minus 4,000 MW of actual divestiture and 2,400 MW of "virtual" divestiture.

Jersey regulate PECO and PSE&G's distribution tariffs, and have imposed open access requirements on PECO and PSE&G; (3) new generation in PJM East could bypass PECO and PSE&G's distribution systems and connect directly to an interstate pipeline; (4) PECO's gas transportation assets are committed to meeting its retail customer load; (5) the merged entity could not withhold its firm transportation rights because this would simply increase the amount of non-firm capacity available to the market; and (6) the merged entity must comply with affiliate conduct codes in Pennsylvania and New Jersey, and FERC Order No. 2004. Dr. Carpenter countered each point and detailed the abilities and incentives the merged entity would possess, demonstrating that the factors cited by Dr. Hieronymus would not have the protective effect that Dr. Hieronymus claims they would have (PGW St. No. 1 at 28-29):

- The amount of unaffiliated generation served by the distribution systems of PECO and PSE&G minimizes only one form of potential anticompetitive behavior, and not the potential behavior that is the focus of Dr. Carpenter's analysis. That is, the ability and incentive of the merged entity to raise rival generator's costs in this case derives from its ability to raise the wholesale price of gas generally in PJM East, which differentially benefits its baseload generation relative to competitors' gas-fired units (including those units that are divested).

- The regulation of the tariffs and open access requirements placed on PECO and PSE&G as distributors is irrelevant to the vertical market power. This market power derives from the upstream contractual position held by the combined entities, and not their regulated distribution systems.

- Whether or not new generation in PJM East could bypass PECO and PSE&G's distribution systems is irrelevant, because the combined entity has the ability and incentive to raise gas prices for all gas-fired plants in PJM East.

- While PECO's gas transportation assets may be committed (in a regulatory sense) to meeting its retail customer load, on most days it holds substantially more capacity (including storage and LNG/LPG) than is required to meet that load. Thus, and particularly when combined with the assets held by PSEG ER&T, the combined entity will have substantial discretion in how it uses those assets.

- Non-firm or interruptible capacity that might be made available as a result of episodic capacity withholding is not a substitute for firm gas supply that a gas-fired plant requires to meet its generation commitments. This is a lesson that was learned painfully during the summer of 2000 in California, when interruptible transportation failed to substitute for the firm capacity that was withheld from the market on the El Paso Natural Gas pipeline.

- The affiliate conduct codes Dr. Hieronymus refers to would not in any way diminish the vertical market power of the merged entity. Even assuming that these codes apply to communications between unregulated affiliates such as PSEG ER&T and Exelon's gas and power trading arm, violations of these rules are difficult to detect and enforce after the fact.

In summary, the risks of the proposed merger are substantial. The merged entity would not only have the ability to affect the level and volatility of the price of gas, but would have strong incentive to raise gas prices throughout PJM East. There is nothing in the proposed settlement that would provide effective protection against such market power or effectively mitigate the impact of its use. *See* Section F, *infra*.

### 6. Divestiture Is the Cleanest, Easiest and Most Effective Remedy for the Vertical Market Power That Would Be Created by the Proposed Merger

The vertical market power problems at issue in the proposed merger mandate that approval of this merger not occur before effective remedies are in place. As set forth above, the entity created by the merger would have market power in the highly concentrated mid-Atlantic gas markets and the ability and incentive to use that market power to adversely affect competition in electricity and gas markets. There are two basic classes of potential remedies available to eliminate the resulting vertical market risk: 1) remedies that eliminate the *incentive* to exercise vertical market power created by the merger, and 2) remedies that eliminate the *ability* of the merged entity to exercise that power. The second of these two alternatives is generally preferable and is preferable in this case. PGW St. No. 1 at 29-30. *See DQE*, 186 PUR 4th at 60-61.

Both structural and conduct remedies are available to eliminate the ability to exercise vertical market power. Structural remedies involve the transfer or divestiture of natural gas assets that are the source of the market power. Conduct remedies include enhanced regulatory rules and codes of conduct that would help prevent the exercise of market power. Structural remedies are to be preferred, when available, because conduct remedies are difficult and costly to enforce by the relevant regulators. *See DQE*, 186 PUR 4th at 60-61. This is of specific concern in the proposed merger since there are multiple regulatory authorities involved. PGW St. No. 1 at 29-30; *See Re DQE, Inc,* 186 PUR 4th at 60-61.

The cleanest, easiest and most effective remedy for the market power problem in this proceeding is to require, as a condition for approval of the merger, the divestiture of PECO Gas and PSE&G's gas distribution company (including the gas assets held and managed by PSEG ER&T). In *DQE*, the Commission held that divestiture is a remedy within its authority under the Public Utility Code. 186 PUR 4th at 61. Requiring divestiture in this case would, by definition, eliminate the vertical problem.[11]

### 7. Summary of Dr. Carpenter's Vertical Market Power Analysis

Dr. Carpenter summarized his testimony as follows (PGW St No. 1 at 4-5):

- The proposed merger of Exelon and PSEG raises significant vertical market power concerns. The merged entity would possess market power in the downstream electricity market represented by PJM East, and it would possess market power in the upstream market for delivered natural gas in the same geographic area. The degree of market power in the upstream gas market, as measured by the level and change in the HHI

[11] A second, more targeted remedy is also one that would require greater regulatory supervision going forward. This remedy would require that the gas assets (upstream transportation contracts and storage rights) held by PECO and PSEG be placed in the hands of third parties that are independent of the merged entity and subject to oversight by Pennsylvania and New Jersey regulators, respectively. In the case of the assets currently managed by its unregulated subsidiary PSEG ER&T, putting these assets in independent third party hands with regulatory oversight would ensure that the ability to exercise market power is mitigated and separated from the incentive to exercise that power. PGW St. No. 1 at 31.

statistic, is sufficient to establish a presumption that the merger is "likely to create or enhance market power."

- Applicants' vertical market power analysis contains several errors. When corrected, Applicants' own analysis establishes that the merger fails the tests for lack of vertical market power. Conservatively, the HHI in the PJM East delivered gas market rises from 1,469 to 1,942 with the merger – a change of over 470 points.

- The merged entity will have the ability and incentive to raise the level and volatility of natural gas prices, and thus electricity prices, in PJM East. Its ability to raise the price of natural gas derives from the merged entity's control of substantial gas transportation rights, and its discretion and flexibility to draw on those rights depending on demand conditions in the market during particular days. The merged entity would control 2.51 billion cubic feet (Bcf) per day of delivery capability into the market, over 1.9 Bcf per day of which is held currently by PSE&G's unregulated affiliate PSEG ER&T. When demand conditions are such that pipeline transportation capacity in the region becomes heavily utilized, the merged entity will potentially have a pivotal supplier role in the gas market.

- The incentive of the merged entity to raise the price of gas derives from its substantial baseload power generation capacity that will remain in its possession after the proposed divestitures. Since natural gas fired generation is "on the margin" during more than 50 percent of the peak hours in PJM East, an increase in the price of gas during those hours would directly translate into the market price of electricity to the benefit of the merged entity's baseload generation.

- Existing regulations are not sufficient to protect against the potential for the exercise of market power by the merged entity, particularly since such a large proportion of its upstream holdings will be in the possession of an unregulated affiliate. There is no equivalent to the PJM Market Monitoring Unit for the gas markets relied on for power generation in PJM.

- The vertical market power concerns raised by this merger are best remedied by eliminating the source of the market power in natural gas. This could be accomplished cleanly by requiring the divestiture of the regulated gas operations of PECO and PSE&G (including the contracts held by PSEG ER&T).

## D. The Testimony of Applicants' Witnesses Hieronymus and Morris Regarding Vertical Market Power Is Incorrect and/or Irrelevant

Rebuttal to Dr. Carpenter's vertical market power analysis was submitted by Applicants' witnesses Hieronymus and Morris. Dr. Carpenter responded to the

Hieronymus and Morris testimonies in PGW Statement No. 1-SR.[12] A summary of Dr. Carpenter's surrebuttal points follows (PGW St. No. 1-SR at 3-4):

- In rebuttal, Dr. Hieronymus presents an entirely new gas market concentration analysis that corrects some of the errors in his original analysis but perpetuates the fundamental problem with his methodology – a geographic market that is too broad to correctly reflect competitive alternatives to the Applicants' natural gas capacity during peak periods in PJM East.

- Instead of performing his own analysis to justify this expanded geographic market, Dr. Hieronymus relies on the testimony of Dr. Morris for his conclusion that "the value of gas flowing through PJM East and its value downstream rarely diverge by more than a trivial amount." Dr. Carpenter demonstrates that no such conclusion can be reached from Dr. Morris' work.

- A more detailed and expanded analysis of prices than was performed by Dr. Morris indicates that there is nothing "trivial" about the frequency and magnitude of the price separation between the PJM East and New York/New England natural gas markets during peak demand periods. Thus, pipeline capacity serving the New York/New England region should not be included in the same geographic market as the capacity serving PJM East for purposes of a gas market concentration analysis.

- Dr. Morris claims that additional factors eliminate the ability of the merged entity to exercise market power in the PJM East gas market, including: the use of interruptible transportation ("IT") capacity as a substitute for firm capacity, the fact that the utilities hedge their gas positions, that the merged entity could not create or benefit from increased price volatility, the entry of new LNG facilities on the East Coast, and pervasive regulatory oversight of PSEG ER&T by the New Jersey Board of Public Utilities ("New Jersey BPU"). Dr. Carpenter demonstrates that:

    - Dr. Morris' claim that IT is an economic substitute for firm transportation during peak periods is incorrect.

    - Whether the utilities hedge their gas position is irrelevant to whether they have the discretion to use their gas assets to create

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[12] There are two versions to PGW Statement No. 1-SR, a Proprietary version (PGW Statement No. 1-SR (Proprietary)) and a Public version (PGW Statement No. 1-SR (Public)). Proprietary material is redacted in the presentation of the Public version at pages 17 through 19. The pagination, however, is the same in both the Proprietary and Public versions of the testimony. Since the pagination is the same in both versions, the citations hereinafter are stately as PGW Statement No. 1-SR without distinction between Proprietary or Public versions except in Section D.3. where proprietary material is cited and the reference then is specifically to the Proprietary version of the testimony.

volatility and profit from that volatility. The evidence demonstrates that the merged entity will have substantial discretion in the use of its transportation and storage assets to move prices during peak periods while simultaneously serving their peak loads.

- The potential entry of new LNG facilities on the East Coast is too speculative to rely on to mitigate the market power of the merged entity. Indeed, the more likely scenario is the construction of additional LNG capacity on the Gulf Coast, leading to further potential congestion on the pipelines serving PJM East.

- The New Jersey BPU's regulatory authority over PSEG ER&T is not as all-pervasive as implied by Dr. Morris.

- Dr. Hieronymus did not respond in any way to Dr. Carpenter's proposed remedies. Dr. Morris's response was simply to assert without support that a divestiture remedy "has no nexus to the alleged problem." He ignores completely the second, more targeted, remedy, but which would require greater regulatory oversight.

As detailed below, the analysis of concentration in the PJM East natural gas market contained in Dr. Carpenter's direct testimony is the best evidence as to the effect of the merger on concentration in the upstream gas market during peak demand periods. The new measures of concentration provided by Drs. Hieronymus and Morris and the pricing analysis provided by Dr. Morris and relied on by Dr. Hieronymus do not provide an economic basis for employing an expanded geographic market in this proceeding. PGW St. No. 1 at 22.

### 1. The New Market Concentration Analysis Presented by Dr. Hieronymus in His Rebuttal Testimony Overstates the Size of the Relevant Geographic Market and the Amount of Pipeline Capacity Available to Serve It During Peak Periods

In response to the vertical market power analysis presented by Dr. Carpenter, Dr. Hieronymus directed his staff to recheck all of the data he used in his initial study. As a result of the rechecking, he accepted some of the corrections identified by Dr.

Carpenter.[13] He also made two additional and material changes to his PJM East gas market concentration analysis: (1) he increased his measure of the total size of the PJM East gas market by including 885 MMcf/d of capacity on Transco's Leidy Line in the PJM East market,[14] and (2) he changed his methodology for allocating pipeline capacity to capacity holders to include holders of firm transportation into PJM East ***and*** *markets downstream of PJM East, namely Eastern New York. In doing so, he included* entities that hold capacity downstream of PJM East as PJM East market participants. PGW St. No. 1-SR at 6-8.

The bottom line result of Dr. Hieronymus' rebuttal analysis is a 15% increase in the size of the PJM East Gas Market from 5,934 MMcf/d to 6,831 MMcf/d and a 7% reduction in the measure of the Exelon/PSEG capacity from 2,115 MMcf/d to 1,974 MMcf/d. With these revisions, his HHI calculation decreases from 1,572 in his original analysis to 1,292. All of the foregoing is claimed, erroneously, to support the proposed merger. PGW St. No. 1-SR at 9 and Table 1.

Dr. Hieronymus' rebuttal analysis improperly supports the merger by overstating the size of the relevant geographic market and the amount of pipeline capacity that is available to serve that market during peak periods. The essential error is the inclusion of interstate capacity with delivery rights downstream of PJM East (in New England and New York) in the PJM East gas market. Dr. Carpenter properly excluded this

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[13] Specifically, Dr. Hieronymus added three contracts held by PECO and PSEG with capacity of approximately 117 MMcf/d that have delivery rights in PJM East that he improperly excluded in his initial concentration analysis, apparently because he was treating them as if they expire in 2005 when in fact they do not. He added a number of contracts that he had improperly excluded in his initial concentration analysis, apparently because he was treating them as if they did not have delivery rights in the PJM East market when in fact they do have firm delivery rights in PJM East. He excluded a contract held by PSEG totaling approximately 187 MMcf/d that has receipt rights solely within PJM East and thus could not be used to counter withholding into PJM East. PGW St. No. 1-SR at 6-7.

[14] Dr. Hieronymus' revised analysis increased the size of the PJM East market by a total of 897 Mmcf/d. The remaining 12 Mmcf/d (*i.e.*, 897 Mmcf/d minus 885 Mmcf/d) is the result of his use of more recent EIA pipeline capacity data. PGW St. No. 1-SR, footnote 7.

downstream capacity from his analysis since this capacity will not be available to deliver to PJM East in time periods when those two markets are distinctly separate due to pipeline capacity constraints between them. PGW St. No. 1-SR at 10; Tr. 486.

Dr. Hieronymus performed no additional analysis in his rebuttal testimony to justify using a broader geographic market that includes interstate capacity with delivery rights downstream of PJM East (in New England and New York). Instead, he relies on testimony submitted by Dr. Morris to support his argument that delivery rights in New England and New York should be included in the PJM East gas market. PGW St. No. 1-SR at 10-11.

### 2. Dr. Morris' Analysis of Market Prices Is Not Entitled to Any Weight

Dr. Morris compares the price of natural gas delivered in PJM East to the prices of natural gas delivered in New York and New England and states that New York and New England prices were less than 5 percent greater than the PJM East price for 90 percent of the days during July 2003 to July 2005. Based on this price comparison, he concludes that pipeline capacity delivering to New York and New England is in the same geographic market as pipeline capacity delivering to PJM East and, thus, New England and New York are in the same geographic market as PJM East. Dr. Morris claims that the Department of Justice/FTC *Horizontal Merger Guidelines* use this "5 percent test" to define relevant geographic markets. PGW St. No. 1-SR at 11.

#### a. Under the *Horizontal Merger Guidelines* the Product Market Is Dependent upon Demand Condition, Not Price Differentials

Dr. Morris distorts the market definition framework outlined in the *Guidelines*. Under the *Guidelines,* the product market is dependent upon the demand conditions prevailing at the time a hypothetical increase in price is considered to be imposed by a monopolist. Seasonal fluctuations in demand, such as are seen in natural gas markets

in the Northeast United States, where demand peaks in the winter heating season, should be considered in defining the relevant market, a factor that Dr. Morris does not consider. The *Horizontal Merger Guidelines* do not contemplate the simplistic price comparison test utilized by Dr. Morris. PGW St. No. 1 at 11-12.

The Federal Trade Commission supports defining multiple product markets for merger analyses that depend upon demand levels. The FTC's experience with electricity mergers has led it to conclude that there are multiple, different product markets for electricity depending upon the prevailing demand level. The demand characteristics for natural gas also differ by day and season.[15] PGW St. No. 1-SR at 13.

A proper merger analysis must look at the *demand conditions* in determining the relevant product and geographic markets. Dr. Morris' simple price comparison analysis is flawed because it does not consider seasonal changes in demand. As explained in the following section, the very large separations in prices between the two regions that are observed during peak winter month demand conditions support the conclusion that

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[15] The FTC Staff's comments on how to define the relevant geographic market when there are temporal changes in demand conditions that cause multiple relevant product markets are presented at page 13 of PGW St. No. 1-SR as follows:

> Perhaps the most critical element in an analysis of electricity mergers is the extent of the relevant geographic market. Defining the geographic market may be difficult because it may involve many factors and factor interactions. The hypothetical monopolist in a particular hypothesized geographic market may face very different degrees of constraint from more distant alternative supply sources at different times of the day, different times of the year, different points in the business cycle, etc., leading to the conclusion that the geographic market differs for different product markets related to the same acquisition. Differences in the degree and sources of geographic competition may arise because the temporal distinctions between product markets may well be associated with variations in transmission conditions, generating conditions, and existing transmission and generating obligations. For example, supply from generator X that is currently contractually obligated to supply local load is unlikely to be part of the market for short-term capacity to serve distant area Y. However, supply from generator X might well be in the market for intermediate-term capacity to serve area Y, if the local contract of generator X expires before the intermediate term.

pipeline capacity serving New York and New England is in a separate market from pipeline capacity serving PJM East. PGW St. No. 1-SR at 13.

**b. Large Separations in Natural Gas Prices Between New England/New York and PJM East Confirm That New England and New York Are Not in the Same Geographic Market as PJM East**

Demand for natural gas peaks during the winter months in the northeast United States because of heating requirements. The differential in demand conditions is extreme. Demand by local distribution companies in the New York and New England areas increase by 300% in the winter months compared to summer months, *i.e.*, from less than 2 Bcf/d in the summer months to approximately 6 Bcf/d, or more, in the winter months. This increase in demand causes flows on the interstate pipelines to increase dramatically and often causes constraints on the pipeline system to occur between locations. PGW St. No. 1-SR at 13-14.

When constraints occur, prices between locations separate because arbitrage between locations is not possible. During the two winters considered by Dr. Morris (November 2003 to March 2004 and November 2004 to March 2005), prices between New York/New England and PJM East were clearly separated. The average daily price in New York *exceeded* the average daily price in PJM East by $0.75/MMBtu. The average daily price in New England *exceeded* the average daily price in PJM East by $0.63/MMBtu. PGW St. No. 1-SR at 14-15.

The following Table presents average daily prices in winter months for the previous four winters, a longer time period than the period considered by Dr. Morris, for New York, New England, PJM East, and the Henry Hub. The Table confirms the separation of prices between New England/New York and PJM East, particularly during

the previous two winters considered by Dr. Morris (PGW St. No. 1-SR at 14-15 and Table 2):

**Table 2**
**Average Daily Gas Prices in Winter Months**

| | Average Daily Gas Price ($/MMBtu) | | | | Difference btw Avg Price in New York and PJM East | Difference btw Avg Price in New England and PJM East |
|---|---|---|---|---|---|---|
| | New York | New England | PJM East | Henry Hub | | |
| During 11/1/01 - 3/31/02 | $ 2.94 | $ 2.92 | $ 2.84 | $ 2.47 | $ 0.10 | $ 0.08 |
| During 11/1/02 - 3/31/03 | $ 7.34 | $ 7.50 | $ 7.14 | $ 5.49 | $ 0.20 | $ 0.36 |
| During 11/1/03 - 3/31/04 | $ 7.10 | $ 7.30 | $ 6.53 | $ 5.49 | $ 0.56 | $ 0.77 |
| During 11/1/04 - 3/31/05 | $ 8.31 | $ 7.84 | $ 7.36 | $ 6.35 | $ 0.95 | $ 0.48 |

Source: *Gas Daily*. New York daily price is Transco New York price. New England daily price is Algonquin Citygates price. PJM East daily price is Transco non-New York price.

Additionally, during the period considered by Dr. Morris, almost all of the days that fail his 5% test are in the winter. During 2003 to 2005, the New York price exceeds 105% of the PJM East price on 23% of winter days, and the New England price exceeds the PJM East price on 24% of winter days. On these days, the New York and New England prices exceed the PJM East price by a significant amount in absolute terms. During the 23% of winter days during 2003 – 2005 when the New York price exceeds 105% of the PJM East price, the New York price exceeds the PJM East price by $3.00/MMBtu on average. During the 24% of winter days during 2003 – 2005 when the New England price exceeds 105% of the PJM East price, the New England price exceeds the PJM East price by $2.20/MMBtu on average.[16] Prior to the 2003 – 2005 period considered by Dr. Morris, his 5% test also fails for the New York and PJM East

[16] Dr. Morris' use of a strict 5 percent price difference also ignores the volatility of gas prices. Daily gas prices in PJM East during November 2003 to March 2004 varied between $4.17/MMBtu and $29.64/MMBtu. *Thus, 5% of the PJM East price varied between $0.21/MMBtu and $1.49/MMBtu.* Since daily prices are volatile and Dr. Morris uses a test based on a percentage threshold, his test passes on a number of days where the price difference between PJM East and New York is still quite high in absolute terms. During November 2003 to March 2004, Dr. Morris' five percent test passes on three days when the New York price exceeds the PJM East price by more than $0.30/MMBtu, and on eleven days when the New York price exceeds the PJM East price by more than $0.20/MMBtu. Similarly, during November 2004 to March 2005, Dr. Morris' five percent test passes on twelve days when the New York price exceeds the PJM East price by more than $0.20/MMBtu. PGW St. No. 1-SR at 16-17 and footnote 29.

markets during some summer periods, particularly in the summer of 2002.[17] PGW St. No. 1-SR at 15.

Dr. Hieronymus characterizes the price differences between New England/New York and PJM East as "trivial." *See* PECO St. No. 3-R at 52. Clearly, they are not. The price differences between New England/New York and PJM East are consistently substantial and significant on percentage and absolute bases during peak winter demand conditions. Dr. Morris' analysis of natural gas prices between New England/New York is incomplete and flawed. Dr. Hieronymus' reliance on Dr. Morris' analysis to support his conclusion that the relevant market includes downstream capacity to New England and New York is, likewise, flawed and inappropriate. The large separation of prices demonstrated by the evidence of record summarized above supports the conclusion of Dr. Carpenter that downstream capacity should not be included in the relevant geographic market.

Dr. Morris uses his five percent test in an attempt to make it seem that the potential exercise of market power by Exelon/PSEG in the PJM East gas market should not concern this Commission. He implies that if the merged entity could exercise market power, then at least it could only do so on a limited number of days. This argument should be seen for what it is – an attempt to mask a serious problem. According to Dr. Morris' own five percent test, over the previous two years, New York prices have separated from PJM East prices on 23% of winter days and New England prices have separated from PJM East on 24% of winter days. Therefore, the days that Dr. Morris attempts to dismiss in fact represent a significant portion of the winter.

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[17] Dr. Morris' 5% test fails for the New York and PJM East markets on 9 days during the summer of 2001 (June 27-July 2 and August 8-10) and 31 days during the summer of 2002 (June 26-27, July 2-9, July 17-19, July 23, July 30-August 5, and August 10-August 19). PGW St. No. 1-SR, footnote 27.

Moreover, the days Dr. Morris attempts to dismiss occur when PJM East gas prices are typically their highest. PECO St. No. 11-R, Figure 2, at 19. Even if Dr. Morris' test is accepted, it shows that Exelon/PSEG can exercise market power during a significant portion of the season when gas prices in PJM East are highest.

### c. Dr. Morris' Analysis of Gas Market Concentration, Like the Two Analyses Submitted by Dr. Hieronymus, Inappropriately Includes Downstream Capacity That Will Not Be Available in PJM East During Peak Demand Conditions

Having submitted an original and revised measure of gas market concentration through their witness Hieronymus, Applicants submitted yet a third measure of PJM East gas market concentration through Dr. Morris. While different still from Dr. Hieronymus' analysis, Dr. Morris' analysis fails for the same reason - it includes downstream capacity that will not be available in PJM East during peak demand periods. PGW St. No. 1-SR at 19.

In fact, Dr. Morris includes significantly more downstream (New York and New England) capacity in his PJM East market concentration analysis than does Dr. Hieronymus, thus compounding the prior error. Dr. Morris includes capacity on three pipelines, Maritimes & Northeast, Portland Natural Gas Transmission, and Iroquois Gas Transmission, which do not physically serve PJM East. These pipelines physically serve only the New York and New England markets[18] and, thus, are inappropriately included by Dr. Morris in his market analysis. Even Dr. Hieronymus does not include capacity on these pipelines in his PJM East market concentration analysis. PGW St. No. 1-SR at 19.

[18] PECO Cross Examination Exhibit 3 which purports to depict the pipelines passing through PJM does not include even one of the additional pipelines included by Dr. Morris in his market concentration analysis.

### 3. Dr. Hieronymus' Further Argument Concerning the Exclusion of PSEG's Transco Capacity With New York Deliverability Should Be Given No Weight

***CONTAINING REFERENCES TO PROPRIETARY MATERIAL***

In further rebuttal to Dr. Carpenter, Dr. Hieronymus argues that, if capacity with delivery rights in New England and New York is excluded from the PJM East market as Dr. Carpenter proposes, then 794 MMcf/d of PSEG's Transco capacity with firm delivery rights to New York should also be excluded from the PJM market analysis. PGW St. No. 1-SR at 17. The effect of this is to reduce the PJM East HHI calculated by Dr. Carpenter from 1,942 to 1,335. *See* PECO St. No. 3-R at 51-52.

However, Dr. Hieronymus' argument ignores the fact that the excluded 794 MMcf/d of PSEG's Transco capacity represents almost half (794 MMcf/d out of 1,663 MMcf/d, or 48%) of PSEG's total interstate capacity into PJM East. A significant portion of PSEG's Transco capacity is needed to meet PSE&G's BGSS requirements in PJM East during winter months. Thus, a significant portion cannot be sold into the spot market downstream of PJM East at New York prices. The portion of PSEG's Transco capacity that is needed to meet PSE&G's BGSS load should be included in PJM East. PGW St. No. 1 at 17.

***PROPRIETARY MATERIAL REDACTED***

***PROPRIETARY MATERIAL REDACTED***

4. **Dr. Morris Fails to Show That Applicants Lack the Ability to Exercise Market Power Fail**

Dr. Morris claims that the following factors eliminate the merged entity's ability to exercise market power: (1) use of interruptible transportation as a substitute for firm capacity; (2) the fact that the utilities hedge their gas positions; (3) that the merged entity could not create or benefit from increased price volatility; (4) the entry of new East Coast LNG facilities; and (5) pervasive regulatory oversight of PSEG ER&T by the New Jersey BPU. As explained by Dr. Carpenter at pages 22 through 30 of PGW Statement No. 1-SR, the foregoing factors do not eliminate the merged entity's ability to exercise market power. Dr. Morris' claims concerning interruptible transportation are discussed further below.

### a. Interruptible Transportation Is Not a Substitute for Firm Transportation

Dr. Morris erroneously claims that interruptible transportation is an economically viable substitute for firm transportation to PJM East (even during peak demand periods) which will be available to mitigate the merged entity's market power. Dr. Morris further claims that interruptible transportation becomes attractive when the price of natural gas delivered in PJM East exceeds the price in the producing basin by more than the maximum tariff rates on the interstate pipelines transporting to PJM East. PGW St. No. 1-SR at 22-23.

Interruptible transportation is a poor substitute for firm transportation because it is inherently unreliable, particularly in times of peak demand. Interruptible transportation is the first type of scheduled volumes to be curtailed due to operational constraints on a pipeline that occur for a number of reasons. Interruptible transportation is also subject to being curtailed ("bumped") by firm transportation rights. PGW St. No. 1-SR at 23.

The availability of back-up sales services does not transform interruptible transportation into a good substitute for firm transportation as further claimed by Dr. Morris. PGW St. No. 1-SR at 23-24. Most notably, PSE&G does not offer a firm back-up sales service. While PECO and several other LDCs in PJM East do offer firm back-up sales services, a generator would incur significant costs for subscribing to these services which shows that interruptible capacity is an unacceptable substitute for firm capacity in PJM East. PGW St. No. 1-SR at 23-24.

Contrary to the testimony of Dr. Morris, shippers do not use interruptible transportation as a substitute for purchasing delivered gas in a destination area such as PJM East whenever there is slack capacity on a pipeline. Because interruptible transportation is subject to being curtailed by firm transportation rights or for operational

reasons, consumers, which value and require reliability of supply, will choose to purchase delivered gas in the destination area, instead of purchasing gas in the producing basin and attempting to transport the gas via interruptible transportation to the destination area. PGW St. No. 1-SR at 24-25.

Finally, available data on the use of interruptible capacity on the El Paso Natural Gas Pipeline ("EPNG") demonstrates that interruptible transportation will not counteract capacity withholding. During the summer of 2000, there was slack capacity on EPNG. EPNG's marketing affiliate, El Paso Merchant Energy ("EPME"), was still able to withhold a portion of its firm EPNG capacity from the market. While some interruptible transportation flowed on EPNG, EPME was able to sell significant volumes of gas at prices that ***exceeded*** the cost of using interruptible transportation. In that well-documented case, interruptible transportation was not an economic alternative for customers purchasing gas from EPME. Gas buyers chose to buy from EPME at prices that exceeded the cost of using interruptible transportation, instead of using interruptible transportation. Therefore, interruptible transportation did not undercut capacity withholding by EPME. Conditions in PJM East are not so different that one would draw a different conclusion here. PGW St. No. 1-SR at 25.

### 5. Applicants Have Not Substantively Addressed the Problem of Market Power Presented By the Proposed Merger and, Thus, Have Not Provided the Commission With Remedies Which Would Resolve This Problem

Dr. Hieronymus did not address vertical market power remedies. Dr. Morris addresses the remedy of divestiture of PECO and PSE&G's gas operations and states that it "has no nexus to the alleged problem." He suggests "less intrusive" remedies are available but does not identify any. He wholly ignores Dr. Carpenter's alternative remedy which involves the transfer to an independent third party of the upstream

capacity rights held by PSEG ER&T and PECO gas, with significant regulatory oversight of the use of those rights. PGW St. No. 1-SR at 30-31.

Divestiture of the gas operations of PECO and PSE&G would separate the *ability* of the merged entity to exercise market power from its *incentive* to do so. It is the cleanest approach to solving the vertical market problem with the least regulatory oversight required, and it is the method traditionally favored by enforcement agencies such as the U.S. Department of Justice and the FTC. PGW St. No. 1-SR at 31.

## E. Applying the Legal Principles Applicable to This Proposed Merger and Upon Review of the Evidence of Record, The Commission Should Adopt the Analysis of Dr. Carpenter and Conclude That Applicants Have Failed to Prove Public Benefits from the Merger

The Commission has before it the largest utility merger ever proposed in the United States. If approved, the resulting merged entity will stretch from Chicago to the Hudson River and result in the combination of electric generating and gas pipeline capacity. The new entity would include not only regulated gas and electric utilities but also numerous unregulated subsidiaries. Applicants own HHI screen calculations demonstrate significant market power will exist. Applicants propose nothing to mitigate market power but divestiture of electric generation. In essence, Applicants have dismissed the serious vertical market power issues relevant to the proposed merger.

Statutory language (66 Pa. C.S. §1103) and long standing precedent (*City of York v. Pa. P.U.C.*, 449 Pa. 136 (1972)), require Applicants to demonstrate that the merger will promote the public interest. When the public interest is considered, it is contemplated that the benefits and detriments must be measured as they impact on all affected parties. *Middletown Township v. Pa. P.U.C.*, 85 Pa. Commonwealth Ct. 191 (1984). Here, the evidence of record demonstrates substantial detriment to the public

as a result of concentration of market power in the natural gas and electric markets. This significant detriment outweighs any possible benefit from the merger.

The General Assembly has also charged the Commission under both the Electric and Natural Gas Competition Acts to conduct careful and close investigations of electric and gas mergers. If a proposed merger is likely to result in anticompetitive or discriminatory conduct, including the unlawful exercise of market power in the retail electricity and natural gas markets, the Commission ***"shall not"*** approve the merger ***"except"*** upon such terms and conditions as it finds necessary to preserve the benefits of a properly functioning and workable competitive retail market.

Here, there is no question that the merger concentrates market power to a level that requires the application of mitigating terms and conditions. Applicants acknowledge as much when they propose actual and virtual divestiture of electric generation. However, the mitigating terms and conditions are insufficient and do not address vertical market power concerns, in particular market power in the gas market. The testimony of Dr. Carpenter demonstrates that the merged entity will have vertical market power and the ability and incentive to exercise it. In an attempt to disprove Dr. Carpenter's conclusions, Applicants present not one, not two, but three analyses of the natural gas market and a "five percent" pricing rule, none of which should be given any weight.

Even though FERC has allowed the merger without hearing, there is no indication in the FERC decision that any of Dr. Carpenter's testimony was considered. *See* PGW St. No. 1-SR at 5. Regardless of what occurred at FERC, the Applicants must meet the requirements of Pennsylvania law, including the Public Utility Code. An exercise of vertical market power would deny Pennsylvania customers the benefits of retail competition in both gas and electricity markets. Such a result is impermissible under the Competition Acts. To assure compliance with the Acts, the Commission

should require divestiture of PECO Gas and PSE&G's gas operations as a condition precedent to the merger.

## F. The Joint Settlement Does Not Adequately Protect the Public and the Commission Should Not Approve It

The Applicants and several Intervenors have filed a Joint Petition for Settlement ("Joint Settlement") with the Commission. PGW opposes the Joint Settlement for multiple reasons (PGW St. No. 1-S at 3-7):

- The Joint Settlement Neither Mitigates the Merged Entity's Market Power in the PJM East Natural Gas Market Nor Protects Customers from the Exercise of Market Power by the Merged Entity in the PJM East Gas Market.
  - The Joint Settlement contains no term or provision designed to protect the electricity market from potential market power abuses in the ***natural gas*** market.[19] There is a direct linkage between the price of natural gas and the price of electricity during many hours of the year. It is not possible to ensure that the wholesale and retail electricity markets are competitive without ensuring that the natural gas market is also competitive.
  - The provisions of Section F of the Joint Settlement concerning *Affiliate Risk and Cross-Subsidization are very limited and do not* give the Commission the ability to monitor the gas market activities of the merged entity's unregulated gas market affiliates. The Settlement, moreover, does not *require* the Applicants to maintain separate gas procurement operations for PECO and PSE&G.
- Section I - Competitive Electric Markets - of the Joint Settlement Provides No Additional Protection to Customers from the Exercise of Market Power by the Merged Entity in the PJM East Electricity Markets.[20]
  - The electricity price reporting requirement created in Section I does not give the Commission any information it does not already

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[19] Section I of the Joint Settlement concerns the electric market, not the natural gas market.

[20] For example, the Joint Settlement requires PECO to file an annual report with this Commission in 2007 – 2012 "addressing wholesale market prices and price trends in the Pennsylvania-New Jersey-Maryland Interconnection ("PJM") markets." The report is to contain "information regarding price differentials between PJM East and other PJM regions and other information necessary to assess price and price trends in the PJM markets." All of the information referred to in this section involves the prices for electricity as opposed to natural gas. PGW St. No. 1-S at 4.

have access to on the PJM website. More importantly, it does not give the Commission access to any additional information that would be useful in determining whether Exelon's affiliates were exercising market power in the PJM East electricity market.

- The "other information necessary to assess price trends in the PJM markets" to be included in the Section I report is so vague as to be meaningless. The Commission currently has access to an annual report on PJM electricity markets prepared by the PJM Market Monitor that is more comprehensive than the report required of PECO in the Joint Settlement.

- Even if the information for the report were better specified, it is extremely difficult to detect the exercise of market power after the fact by simply looking at price differential data, because it is very difficult to distinguish between high price levels and differentials that are the result of an exercise of market power and those that are the result of naturally tight supply and demand conditions in particular locations. *See DQE, supra.*

- The ability of a party to ask the Commission to initiate an investigation is already available to a party and the threshold level or type of information necessary to initiate the request is unclear. Again, if a merger creates a risk that market power could be exercised, it is best to mitigate it through structural remedies prior to approving the merger than to rely on the possibility of after-the-fact investigation to deter its exercise. *See DQE, supra.*

- <u>There Are Significant Risks from Not Addressing the Merged Entity's Gas and Electricity Market Power</u>

  - The Settlement offers the typical residential customer a rate reduction of $1.26 per month for two years, and $0.63 per month for an additional two years. The risks to customers from an exercise of market power are potentially much greater than the rate reductions offered by the Settlement. These risks are in the form of higher price levels for natural gas and electricity than would otherwise be the case, and greater price volatility which increases costs for gas and electricity ratepayers in ways that are difficult to quantify in advance but potentially significant.

  - The Settlement benefits are short-term in duration. The merged entity itself will likely be around for a very long time. Because it is very difficult to undo a merger once it has been completed, the Commission should not approve the merger unless there is adequate mitigation to resolve the vertical market power problem it presents.

The Joint Settlement does not adequately protect the public. Notably, it provides no remedy for the vertical market power that will occur as a result of the merger. The Commission, accordingly, should reject the Joint Settlement.[21]

## G. PGW's Responses to Directed Questions

By Memorandum and accompanying letter dated July 15, 2005, the Commission posed five questions for the parties and Judge Chestnut to address during this proceeding. PGW addressed Directed Question 1 and Directed Question 5.

### 1. PGW's Response to Directed Question 1 - The Merger Could Substantially Weaken Pennsylvania's Ability to Enhance its Competitiveness

Directed Question 1 is as follows

> "Neighboring states have availed themselves of opportunities to enhance their economic competitiveness through access to economical energy resources. What opportunities exist from this proposed merger in terms of economic development for Pennsylvania? Specifically, does this proposed merger present us with an opportunity to strengthen the State's ability to remain competitive during periods of economic recession and volatile energy pricing?"

While the Question suggests that the merger may present opportunities to enhance and strengthen economic development, the merger and resulting concentration of market power, if left unremedied, is likely to substantially ***weaken*** Pennsylvania's ability to enhance its competitiveness with respect to access to economical energy resources while increasing the level and volatility of natural gas and power prices. PGW St. No. 1-SR at 32.

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[21] Section J of the Joint Settlement - Consolidation of Natural Gas Operations provides that the Commission "may" initiate a separate fact-finding investigation following 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 the new Exelon Electric & Gas Corporation. PGW does not support Section J. PGW addresses the concept of combination of PGW and PECO Gas Division in its response to Directed Question 5 in Section G.2.b *infra*. In contrast to a fact-finding investigation that the Commission "may" initiate, PGW believes that existing publicly available data warrant a full due diligence type study of the combination concept. *Also see* Proposed Finding of Fact No. 39.

The merger would create an entity that has market power in the natural gas markets that serve important regions of Pennsylvania and create powerful incentives for the merged entity to leverage that power into the PJM East electricity market. The creation of an entity with such a dominant position in Pennsylvania's gas and power markets will make it even more difficult for the state to successfully create and sustain a competitive retail market in electricity. PGW St. No. 1-SR at 32.

### 2. PGW's Response to Directed Question 5

Directed Question 5 is as follows

> "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?"

PGW addressed the Question through both Dr. Carpenter and Craig E. White.

#### a. Testimony of Dr. Carpenter - A Combination of PECO Gas with PGW Would Mitigate Vertical Market Power Problems and Not Likely Create Horizontal Market Power Problems in Natural Gas

Dr. Carpenter addressed Directed Question 5 in the context of whether a potential combination might occur to remedy vertical market power concerns. A remedy that involves the divestiture of the PSE&G and PECO gas divisions into separate entities (unrelated to either Exelon or PSEG), and the combination of PECO Gas with PGW, would not likely create any horizontal market power problems in the natural gas market (assuming continued regulation of that entity by the Commission) and would certainly mitigate any vertical market power problems created by the proposed merger of Exelon and PSEG. PGW St. No. 1-SR at 33.

A combination of PECO and PSE&G's gas divisions (with or without PGW) should not be considered without fully assessing whether such a merger would create

horizontal market power problems in the natural gas market. Such a combination would also likely create some challenges for the coordination of state regulatory jurisdictions of the combined entity that would need to be resolved in advance. PGW St. No. 1-SR at 33.

**b. Testimony of Craig E. White - A Combination of PGW with the PECO Gas Division Could Result in a Viable, Profitable Gas Utility and There Is Sufficient Data Supporting the Concept to Warrant a More Detailed Due Diligence Type Study**

Craig E. White is the Acting Chief Operating Officer of PGW. He has been employed by PGW for more than 25 years in various positions of ascending responsibility. Mr. White provided additional information for the Commission's consideration in response to Directed Question 5 - specifically whether a combination of the PECO Gas Division and PGW would provide for a profitable utility under the stated assumptions in the Question. PGW St. No. 2 at 1; Tr. 525.

Mr. White's testimony should not be misinterpreted. It is not intended to serve as the final and dispositive answer to Directed Question 5. It is intended to provide some evidence that a combination of PGW and PECO Gas is worth further study if full information is available to inform the study. Mr. White also makes clear that his testimony, while not providing a full answer to the Question, is intended as a response that merits a more detailed analysis. *See* PGW St. No. 2 at 5.

Utilizing a preliminary analysis of publicly available information concerning PECO revenue, cash flow and debt, Mr. White testified that a combination of PGW with the PECO Gas Division could result in a viable, profitable gas utility and that there is sufficient data supporting the concept to warrant a more detailed due diligence type

study.[22] While the term "profitable" in the Question implies investor ownership, one other alternative to house the combined entity would be a not for profit entity such as an authority structure. PGW St. No. 2 at 3-5.

A complete study has not been done and must include a thorough evaluation of data currently not publicly available, such as data related to common plant facilities of the combined PECO electric and gas utility operation, including how corporate costs and current tax obligations are allocated between the two divisions. Under one alternative, the acquisition of PGW and the PECO Gas division through a taxable bond offering by a public enterprise could be supported by the cash flow generated sufficient to pay the debt service and provide liquidity for working capital and capital improvements. Once the new entity begins functioning, it could utilize tax exempt debt to refinance existing debt or to provide for on-going capital expenditures.

With respect to the benefits resulting from such a combined entity, PECO ratepayers would benefit through a lower cost of capital and security of supply and operations. Additional benefits in the form of reduced corporate related tax payments could result from tax-exempt status. PECO ratepayers would further benefit from improved cash flow with the elimination of dividend payments and a possible rate freeze for an undetermined period for current PECO and PGW customers. PGW St. No. 2 at 4.

PGW ratepayers could benefit from the economic growth and commercial/industrial component of the PECO Gas service territory, while both sets of ratepayers could benefit from streamlining operations and eliminating duplicative

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[22] An analysis of PSE&G data was not done for the several reasons explained by Mr. White at pages 2 and 3 of PGW Statement No. 2. Assuming that market power issues could be resolved, PGW would have no objection to including three gas systems in a combined entity and would review any information that might indicate that the concerns articulated at pages 2 and 3 of PGW Statement No. 2 can be overcome. PGW St. No. 2 at 3.

services of the merged entity. The combined enterprise could have a more stable liquidity base. PGW St. No. 2 at 4.

Combining PGW and PECO Gas would provide benefits with regard to gas supply. A combined entity would likely have the ability to negotiate more favorable commodity, storage and deliverability contracts without being so large as to raise market power issues. The interconnection of the two systems would enhance security of delivery to all customers while also enhancing efficiency. PGW St. No. 2 at 4.

Furthermore, there is potential for efficiency improvement for both utilities that could result from combining certain operational components. While some of those efficiencies, such as a single call center, centralized fleet management, and centralized meter reading, billing and collections, may now exist between PECO Electric and PECO Gas, there are greater efficiencies that could be realized from a combined PGW/PECO Gas operation particularly in the areas of centralized gas field services and distribution operations, gas management, centralized management of LNG facilities, and centralized gas procurement. Providing PECO Gas customers with direct access to PGW's LNG facilities should provide significant benefit to them. PGW St. No. 2 at 4-5.

In summary, there is publicly available evidence supporting the conclusion that a combination of PGW and PECO Gas is worth further study, if full information is available to inform the study.

## IV. PROPOSED FINDINGS OF FACT

**The Parties**

1. PECO is a corporation organized and existing under the laws of the Commonwealth of Pennsylvania and is engaged in the business of supplying, transmitting and distributing electricity and natural gas. It furnishes retail electric service in all or substantially all of Bucks, Chester, Delaware, Montgomery and Philadelphia Counties and portions of York County and retail natural gas service in substantial portions of Bucks, Chester, Delaware and Montgomery Counties and a small section of Lancaster County. Joint Application of PECO and PSE&G at 2.

2. PSE&G is a corporation organized and existing under the laws of the State of New Jersey and is engaged in the business of supplying transmitting and distributing electricity and natural gas. PSE&G's service territory comprises a corridor running diagonally across New Jersey from the southwest to the northeast and encompasses most of New Jersey's largest municipalities, including its six largest cities. Joint Application of PECO and PSE&G at 5.

3. PGW is a natural gas distribution company and, as a collection of assets owned by the City of Philadelphia, a city natural gas distribution operation. PGW is the largest municipally owned gas utility in the United States, serving nearly one half million customers in the City of Philadelphia and the largest natural gas distribution operation in the Commonwealth of Pennsylvania. PGW St. No. 1 at 6.

**PGW'S Interest in This Proceeding**

4. PGW is an electricity customer of PECO. Over the past four years, PGW's annual electricity expense has averaged over $2 million. PGW St. No. 1 at 6.

5. PGW has more than $1 billion of debt outstanding and a very weak liquidity position, with unrestricted cash reserves representing less than one day's cash

at particular times. Short term borrowing is utilized to the maximum, leaving almost no flexibility to meet increased operating expenses should those costs increase. PGW St. No. 1 at 6.

6. Residential customers make up approximately 95% of PGW's customers and 67% of gas sales. PGW's customers generally have below average wealth levels and higher than average unemployment levels. PGW customers generally have difficulty absorbing any substantial cost increases in their budgets, so even if only electric bills increase, customers will still be stretched, will find it difficult to make ends meet, and will have more difficulty paying their PGW bills. PGW St. No. 1 at 7.

7. No competitive suppliers are currently in operation in Philadelphia – perhaps in part due to the demographics of the customer base. Anything that increases the price and/or the volatility of the price of natural gas in the wholesale market will make it even more difficult for competitive suppliers to gain a foothold. PGW St. No. 1 at 7.

**The Proposed Merger Is a Vertical Merger Involving Two Product Markets**

8. A vertical merger involves entities that have positions in two product markets where one product (natural gas) supplies or is an important input to the production of the second product (electricity). PGW St. No. 1 at 8.

9. Applicants' proposed merger is a vertical merger since it would combine the gas and electricity assets of Exelon and PSEG. It would create a merged entity that has a substantial position in both the gas and electricity markets in the PJM East region. PGW St. No. 1 at 8.

10. The principal concern presented by a vertical merger is that the merged entity will use its market power in the first (input) product market to harm competition and raise prices in the second (output) product market. PGW St. No. 1 at 8.

11. There are three ways in which vertical market power may be exercised to adversely affect prices and output in electricity markets: (1) through foreclosure or raising rivals' costs, (2) by facilitating coordination, and (3) through regulatory evasion. PGW St. No. 1 at 8.

12. The primary concern with this merger is its potential impact on wholesale electric and gas markets, including vertical issues - the merged entity's ability and incentive to raise prices in order to benefit in the electricity market. An exercise of vertical market power would deny the public the benefits of retail competition in both gas and electricity markets. PGW St. No. 1 at 9.

**The Post-Merger Market for Delivered Natural Gas in PJM East Would Be Highly Concentrated**

13. There is a two-prong test to determine whether a vertical merger creates a combined entity with the incentive and ability to raise its rivals' costs. PGW St. No. 1 at 14.

14. The first prong requires a calculation of a Herfindahl-Hirschman Index ("HHI") for relevant downstream markets with electric generators assigned to their upstream suppliers. Downstream markets that are highly concentrated (with HHIs greater than 1,800) are "conducive to the exercise of market power." PGW St. No. 1 at 14-15.

15. The second prong requires a calculation of an HHI for relevant upstream markets. Upstream markets that are highly concentrated (with HHIs greater than 1,800) are vulnerable to market power exercise. PGW St. No. 1 at 15.

16. If both upstream and downstream markets are highly concentrated, Applicants should either provide additional information regarding their ability and incentive to raise rivals' costs, or propose specific mitigation measures that would eliminate their vertical market power. PGW St. No. 1 at 15.

17. Applicants concede and the evidence of record demonstrates that, even with Exelon and PSEG's proposed electricity market mitigation, relevant downstream (electricity) markets would be highly concentrated after the merger. PGW St. No. 1 at 15; PECO Exhibit WHH-1 at 72.

18. Delivered natural gas is the relevant upstream product market for evaluating potential vertical structural problems created by the proposed merger. PJM East, where there is the most overlap in Exelon and PSEG's electricity and natural gas assets, is an appropriate geographic market. It is also the geographic market the Applicants adopt for the vertical analysis they submitted. PGW St. No. 1 at 16.

19. The market for delivered natural gas in PJM East will be highly concentrated if PSEG and Exelon merge. The HHI in the PJM East delivered gas market in 2006 will exceed 1,800. The proposed Exelon/PSEG merger would increase the HHI in this market by over 470. PGW St. No. 1 at 16-17 and Table 1.

20. With a post-merger HHI exceeding 1,800 and the change in the HHI exceeding 470, it is "presumed that the merger is likely to create or enhance market power." PGW St. No. 1 at 17.

**The Merged Entity Will Have the Ability to Affect the Level and Volatility of the Price of Gas**

21. Exelon and PSEG have substantial gas transportation and LPG/LNG assets (*See* PGW St. No. 1 at 10-14) and flexibility to draw on those substantial assets to meet the demands of their retail customers. Over 1.9 Bcf/d of their combined 2.51 Bcf/d of delivery capability into the natural gas market is held by PSE&G's unregulated affiliate PSEG ER&T. PGW St. No. 1 at 22 and Tr. 468.

22. On most days of the year, the Exelon/PSEG delivery capability greatly exceeds the retail gas demands that the merged entity will be required to meet, including storage injection requirements. The merged entity will have the discretion to

make third-party sales, or release transportation capacity into the wholesale market, or not make such sales and releases, on any given day. PGW St. No. 1 at 22.

23. When demand conditions are such that pipeline transportation capacity in the region becomes heavily utilized, the merged entity operating in a highly concentrated market will potentially have a pivotal supplier role in the gas market. Its decisions concerning the use, or lack of use, of the gas assets it controls would affect the level and volatility of the price of gas. PGW St. No. 1 at 22

**The Merged Entity Will Have the Incentive to Increase PJM Gas Prices Because Doing So Would Increase Prices and Profits from its Baseload Capacity**

24. Exelon and PSEG have generating capacity in PJM of 26,164 MW and 13,963 MW, respectively. The proposed merger would produce an entity with combined generating capacity in PJM of 40,127 MW. Giving full effect to the actual and virtual divestiture of generating assets proposed by Applicants would still leave the merged entity with 33,727 MW of generating capacity in PJM (Calculated as 40,127 MW minus 4,000 MW of actual divestiture and 2,400 MW of "virtual" divestiture). PGW St. No. 1 at 24-25.

25. Gas was on the margin during almost 40% of all hours in 2004 in PJM East, and during 60% of peak hours. When gas is on the margin in PJM East, an increase in the PJM East gas price increases the price for PJM East electricity. There is, thus, a direct relationship between the price of natural gas and the price of electricity in PJM East. PGW St. No. 1 at 25; *Also see* PGW St. No. 1-S at 3.

26. With the ability to increase gas prices and 33,727 MW of generating capacity, the merged entity will have an incentive to increase gas prices and benefit from higher electric prices and increased profits on its baseload electric capacity. PGW St. No. 1 at 24-25.

**The Cleanest and Easiest to Enforce Remedy for the Vertical Market Power That Would Be Created by the Proposed Merger Is A Structural One - Divestiture of PECO Gas and PSE&G's Gas Distribution Company**

27. There are two basic classes of potential remedies available to eliminate the vertical market risk that would result from the merger: 1) remedies that eliminate the *incentive* to exercise vertical market power created by the merger, and 2) remedies that eliminate the *ability* of the merged entity to exercise that power. The second of these two alternatives is preferable in this case. PGW St. No. 1 at 29-30.

28. Both structural and conduct remedies are available to eliminate the ability to exercise vertical market power. Structural remedies involve the transfer or divestiture of natural gas assets that are the source of the market power. Conduct remedies would include enhanced regulatory rules and codes of conduct that would help prevent the exercise of market power. Structural remedies are preferred because conduct remedies are frequently difficult and costly to enforce. PGW St. No. 1 at 29-30.

29. The cleanest and easiest to enforce structural remedy would be to require, as a condition for approval of the merger, the divestiture of PECO Gas and PSE&G's gas distribution company (including the gas assets held and managed by PSEG ER&T). This remedy would, by definition, eliminate the vertical problem. PGW St. No. 1 at 30-31.

**Applicants' Analyses of the Natural Gas Market Are Not Given Any Weight**

30. Applicants present not one, not two, but three analyses of the natural gas market and a "five percent" rule, none of which is given any weight. The market concentration analysis presented by Applicants overstates the size of the relevant geographical market and the amount of pipeline capacity available to serve it during peak periods. PGW St. No. 1-SR at 10.

31. Applicants' five percent test masks a serious problem. Over the previous two years, New York prices have separated from PJM East prices on 23% of winter days and New England prices have separated from PJM East on 24% of winter days, a significant portion of the winter when PJM East gas prices are typically their highest. PGW St. No. 1-SR at 15-16. These are substantial and significant price differences which do not support a conclusion that New England and New York are in the same geographic market as PJM East. Even if Applicants' test is accepted, it shows that Exelon/PSEG can exercise market power during a significant portion of the season when gas prices in PJM East are highest.

**The Joint Petition for Settlement Does Not Adequately Protect the Public**

32. The Joint Settlement neither mitigates the merged entity's market power in the PJM East natural gas market nor protects customers from the exercise of market power by the merged entity in the PJM East gas market. In fact, the Joint Settlement does not even refer to competitive issues in the PJM East natural gas market. PGW St. No. 1-S at 3-4.

33. *Section I - Competitive Electric Markets - of the Joint Settlement requires* PECO to file an annual report with the Commission in 2007 - 2012 "addressing wholesale market prices and price trends in the PJM markets containing "information regarding price differentials between PJM East and other PJM regions and other information necessary to assess price and price trends in the PJM markets." All of this information involves electricity prices, not natural gas prices. PGW St. No. 1-S at 4.

34. The Section I report provides does not give the Commission any information it does not already have access to on the PJM website. More importantly, it does not give the Commission access to any additional information that would be useful in determining whether Exelon's affiliates were exercising market power in the

PJM East electricity market. The Commission currently has access to an annual report on PJM electricity markets prepared by the PJM Market Monitor that is more comprehensive than the report required of PECO in the Joint Settlement. PGW St. No. 1-S at 4-5.

35. The provisions of the Joint Settlement allowing a party to request that the Commission initiate an investigation, likewise, do not mitigate the market power that would be held by the merged entity. Parties already have the authority to file a complaint or to ask the Commission to initiate an investigation and the Joint Settlement does not establish with any specificity what threshold level or type of information is required in order for a party to show that it "reasonably believes" that PECO's affiliated generation company has unlawfully exercised market power. PGW St. No. 1-S at 5-6.

36. Finally, the Joint Settlement offers the typical residential customer a rate reduction of just $1.26 per month for two years, and just $0.63 per month for an additional two years. These rate reductions are inconsequential and of no real benefit to the public, especially when weighed against the risk to the public from an exercise of market power. These risks are in the form of higher price levels for natural gas and electricity than would otherwise be the case, and greater price volatility which increases costs for gas and electricity ratepayers in ways that are difficult to quantify in advance but potentially significant. PGW St. No. 1-S at 6-7.

37. The settlement rate reductions are short-term in duration. The merged entity, however, would likely be with us for a very long time. It is very difficult to undo a merger once it has been completed and difficult to monitor the market power activities of the resulting merged entity once the merger is complete. The merger should not be approved unless there is adequate mitigation to resolve the vertical market power problem it presents. PGW St. No. 1-S at 7.

**Directed Question 1**

38. *The merger would create an entity that has market power in the natural* gas markets that serve important regions of Pennsylvania and create powerful incentives for the merged entity to leverage that power into the PJM East electricity market. The merger and resulting concentration of market power, if left unremedied, is likely to substantially ***weaken*** Pennsylvania's ability to enhance its competitiveness with respect to access to economical energy resources while increasing the level and volatility of natural gas and power prices. PGW St. No. 1-SR at 32.

**Directed Question 5**

39. Based on a preliminary analysis of publicly available information concerning PECO revenue, cash flow and debt, a combination of PGW with the PECO Gas Division could result in a viable, profitable gas utility and there is sufficient data supporting the concept to warrant a more detailed due diligence type study. Consideration of a not for profit entity, such as an authority structure, to house the combined entity should be given in such a study. PGW St. No. 2 at 3-5.

## V. PROPOSED CONCLUSIONS OF LAW

1. This Commission has jurisdiction over the parties and subject matter of this proceeding.

2. Applicants have the burden of proof in this proceeding and, therefore, the duty to establish facts by a "preponderance of the evidence." 66 Pa. C.S. §332(a); *Se-Ling Hosiery, Inc. v. Margulies*, 364 Pa. 45, 70 A.2d 854 (1950)

3. Applicants have not demonstrated by a preponderance of the evidence that the merger, even as supplemented by the terms and conditions of the Joint Petition for Settlement, is necessary or proper for the service, accommodation, convenience or safety of the public as required by Section 1103 of the Public Utility Code. 66 Pa. C.S. §1103.

4. Applicants have not demonstrated by a preponderance of the evidence that the merger, even as supplemented by the terms and conditions of the Joint Petition for Settlement, will affirmatively promote the public interest as required by *City of York v. Pa. P.U.C.*, 449 Pa. 136, 295 A.2d 825 (1972).

5. Under the public interest test, in measuring the benefits and detriments of the merger and the terms and conditions of the Joint Petition for Settlement as they impact on all affected parties as required by *Middletown Township v. Pa. P.U.C.*, 85 Pa. Commonwealth Ct. 191 (1984), the evidence of record demonstrates substantial detriment to the public as a result of the merger, even as supplemented by the terms and conditions of the Joint Petition for Settlement.

6. The merger, even as supplemented by the terms and conditions of the Joint Petition for Settlement, is likely to result in anticompetitive or discriminatory conduct, including the unlawful exercise of market power in the retail electricity market and retail natural gas market. Section 2811(e) of the Electric Competition Act, 66 Pa.

C.S. §2811(e) and Section 2210(a) of the Natural Gas Competition Act, 66 Pa. C.S. §2210(a).

7. The Commission may not approve a merger that is likely to result in anticompetitive or discriminatory conduct, including the unlawful exercise of market power in the retail electricity market and retail natural gas market except upon such terms and conditions as it finds necessary to preserve the benefits of a properly functioning and workable competitive retail electricity and natural gas markets. Section 2811(e) of the Electric Competition Act, 66 Pa. C.S. §2811(e) and Section 2210(a) of the Natural Gas Competition Act, 66 Pa. C.S. §2210(a).

8. The terms and conditions proposed by Applicants for the merger, even as supplemented by the terms and conditions of the Joint Petition for Settlement, will not preserve the benefits of properly functioning and workable competitive retail electricity and natural gas markets.

9. As a condition precedent to the merger, divestiture of PECO Gas and PSE&G's gas operations is necessary in order to assure compliance with the Electric Competition Act and the Natural Gas Competition Act and to preserve the benefits of properly functioning and workable competitive retail electricity and natural gas markets and thus support and protect the public interest.

## VI. PROPOSED ORDERING PARAGRAPHS IDENTIFYING THE RELIEF SOUGHT AND CONCLUSION

1. The Joint Application of PECO Energy Company and Public Service Electric and Gas Company at Docket No. A-110550F0160 and the Joint Petition for Settlement at that same docket are denied.

2. The Joint Application would be approved if the merger is modified to provide for the divestiture of PECO Gas and PSE&G's gas distribution company (including the gas assets held and managed by PSEG ER&T).

*Respectfully submitted,*

By _____

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DATED: October 13, 2005
PGW Main Brief (NON-Proprietary Version).wpd

**Before The**
**PENNSYLVANIA PUBLIC UTILITY COMMISSION**

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**Administrative Law Judge**
**Marlane R. Chestnut, Presiding**

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

## CERTIFICATE OF SERVICE

I hereby certify that I have this 13th day of October, 2005, served a true and correct copy of the Main Brief of Philadelphia Gas Works, upon the persons and in the manner set forth below:

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October 13, 2005

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PA PUBLIC UTILITY COMMISSION
SECRETARY'S BUREAU

**Via United Parcel Service**

James J. McNulty, Secretary
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The Commonwealth Keystone Building
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Harrisburg, PA 17120

**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:

Enclosed please find the original and nine (9) copies of the Main Brief of the City of Philadelphia ("City") in the above-referenced proceeding. We have also enclosed a copy of the brief on diskette in Word format.

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

DOCUMENT
FOLDER

Sincerely,

Daniel W. Cantú-Hertzler

Enclosures

cc: Honorable Marlane Chestnut, Administrative Law Judge (via e-mail and hand delivery) (w/ diskette)
All Parties (per Certificate of Service)

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**Before the**
**PENNSYLVANIA PUBLIC UTILITY COMMISSION**

**Administrative Law Judge**
**Marlane R. Chestnut, Presiding**

| | | |
|---|---|---|
| **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** |

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PA PUBLIC UTILITY COMMISSION
SECRETARY'S BUREAU

# MAIN BRIEF OF THE CITY OF PHILADELPHIA

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Dated: October 13, 2005

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## I. STATEMENT OF THE CASE

On February 4, 2005, PECO Energy Company ("PECO") and Public Service Electric & Gas Company ("PSE&G") (jointly, "Applicants") filed with the Pennsylvania Public Utility Commission ("PUC" or "Commission") a Joint Application ("Application") for approval of the merger of PSE&G's parent, Public Service Enterprise Group, Inc. ("PSEG"), with and into PECO's parent, Exelon Corporation ("Exelon"), to form Exelon Electric & Gas ("EEG"). In the filing, the Applicants request that the Commission either find that approval of the proposed merger is not required under the Pennsylvania Public Utility Code, or determine that the proposed merger is necessary or proper for the service, accommodation, convenience, or safety of the public.

On March 4, 2005, The City of Philadelphia ("City") filed a Petition to Intervene in the merger proceeding. The City is a corporation and body politic, organized and existing as a city of the first class under laws of the Commonwealth of Pennsylvania and the Philadelphia Home Rule Charter, and is engaged in the government and administration of Philadelphia. The City is one of PECO's largest electricity customers, and Philadelphia is the site of PECO's headquarters, where PECO and many of its employees pay taxes to the City. The City, as both a customer and a political entity, relies on PECO infrastructure throughout Philadelphia.

The Commission assigned the Application to Administrative Law Judge ("ALJ") Marlane R. Chestnut, who conducted a Prehearing Conference on March 29, 2005. Pursuant to the established procedural schedule, the City submitted the Direct Testimony of Kent R. Miller, City of Philadelphia Statement No. 1 ("Phila-1"), on June 30, 2005. At that time, the City received the Direct Testimony of numerous intervening parties. On July 15, 2005, the City received the PUC's Secretarial Letter, which requested the parties respond to a series of question ("Directed

Questions") posed by Vice Chairman Cawley and Commissioner Shane. On July 29, 2005, the City received Rebuttal Testimony from PECO, as well as from the Office of the Consumer Advocate ("OCA") and Office of the Small Business Advocate ("OSBA"). On August 26, 2005, the City submitted the Supplemental Testimony of Kent R. Miller, City of Philadelphia Statement No. 1-Supplemental ("Phila-1S"), to respond to the Directed Questions. At that time, the City also received the Surrebuttal and Supplemental Testimonies of various intervening parties.[1]

Throughout this time, the parties engaged in a collaborative process in an attempt to resolve this proceeding without litigation. On September 12, 2005, PECO submitted a Joint Petition for Settlement ("Joint Petition" or "Settlement") with the PUC; however, not all of the parties to this proceeding joined the Settlement. In addition to the City, the PPL Companies ("PPL"), the First Energy Companies ("FE"), Philadelphia Gas Works ("PGW"), and the Labor Parties ("Union") were not signatories to the Settlement.

Evidentiary hearings were held in this proceeding on September 22, 23, and 26, 2005, to provide an opportunity for parties to perform cross-examination, stipulate to the submission of testimony, and address any outstanding procedural issues. Pursuant to the ALJ's revised procedural schedule, the City submits this Main Brief in order to address the PECO/PSE&G Application request, the parties' Joint Petition for Settlement, and the City's objections to both.

## II. SUMMARY OF ARGUMENT

The Applicants' proposed merger does not meet the requirements for approval under the Public Utility Code, as the Applicants have not met their burden of proving that this merger will

[1] During this period, the City received from and served on the Applicants numerous interrogatory requests and responses thereto.

result in affirmative public benefits. Rather, the merger, as stated in the Application, would provide significant benefit to the newly merged entity while maintaining ratepayer service at status quo, if not detrimentally harming ratepayers due to the significant market power concentration that could result from the merger. In addition, the City could be specifically harmed as the merger would decrease PECO employment levels in the City, resulting in a declining tax base. *See* Section III.A., *infra*.

While the Joint Petition provides some concessions on the part of the Applicants, the Settlement also results in concessions by most of the intervening parties. As a result, the Settlement provides some modest, short-term benefits; however, these benefits are largely insufficient to outweigh the long-term risks of the merger. For example, the Joint Petition does not provide any concrete protections against an increased ability of the newly merged company, EEG, to manipulate market power. Similarly, the Settlement does not ensure against an adverse impact to the economic condition of the City. Thus, the Joint Petition fails to provide the necessary, affirmative public benefits for ratepayers, while instead only ensuring that Exelon and PSEG shareholders reap significant benefits from the transaction. *See* Section III.B., *infra*.

For these reasons, the Commission must not approve the Joint Petition unless the Applicants are required to undertake additional, enforceable commitments that would ensure substantial benefits to ratepayers both now and in the future. If the Commission is unwilling to implement such additional requirements, then the PUC should hold in abeyance any ruling on the Settlement while the Applicants and intervening parties renegotiate additional commitments that would ensure affirmative public benefits stemming from the merger. Without such action, the Commission cannot ensure that the merger meets the necessary requirements under the Public Utility Code.

## III. ARGUMENT

### *A. PECO and PSE&G's Application for Merger Approval Does Not Meet the Requirements for Approval Under the Public Utility Code.*

According to the Application, the proposed merger will not diminish PECO's service, modify PECO's rates, rules, and regulations, or alter PECO's commitment to be an active member of the community. *See* Direct Testimony of Denis P. O'Brien, PECO Statement No. 1 ("PECO-1") at 6-11. In other words, Applicants contend the merger will not change the status quo. In addition to failing to provide any incremental benefits to ratepayers, however, the merger may actually harm customers. For example, the merger would increase the scale and scope of EEG's energy delivery and generation business, but would not provide any concrete assurances that PECO would continue its current level of community, reliability, and charitable actions in the future. Similarly, the merger would allow for continued financial strength and flexibility to PECO, but would not provide rate assurances to PECO ratepayers for the long term. Moreover, the merger would result in a sharing of "best practices" and "synergy savings" among the merged entities, but would not ensure continued workforce levels. *See id.* at 8-14. Indeed, Applicants make few commitments as to what EEG will consider as "best practices," leaving open the possibility that it could reject those that enhance public service and benefit, and instead embrace those that maximize shareholder return in the shorter run.

The merger would create the nation's largest utility, with significant market power strength, while providing PECO ratepayers with little or no improvement in terms of service, rates, or community development. *See* Phila-1 at 3. Because the PUC cannot approve a merger unless the Applicants prove it will bring substantial public benefits overall, the Commission must deny Applicants' request.

1. The Public Utility Code Permits Approval of a Merger Only if Ratepayers Will Receive a Substantial Benefit.

Under the *Public Utility Code*, a merger transaction requires Commission approval:

> Upon the application of any public utility and the approval of such application by the commission, evidenced by its certificate of public convenience first had and obtained, and upon compliance with existing laws, it shall be lawful:
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> > For any public utility or an affiliated interest of a public utility . . . to acquire from, or transfer to, any person or corporation, including a municipal corporation, by method or device whatsoever, including the sale or transfer of stock and including a consolidation, merger, sale, or lease, the title to, or the possession or use of, any tangible or intangible property used or useful in the public service.

66 Pa. C.S. § 1102(a)(3). In other words, any public utility undergoing a reformation must receive approval of this transaction from the PUC.

During the course of this proceeding, the Applicants have suggested that PUC approval of this merger is unnecessary because the merger would not result in a change in the control of PECO. *See* Application at 11. Contrary to Applicants' suggestion, this merger would significantly impact PECO, under the terms of Section 1102(a)(3), because the merger would significantly impact PECO's ultimate parent company and because the statute requires only a merger involving "an affiliated interest of a public utility," which clearly includes Exelon as an affiliate of PECO. *See DQE, Inc.*, 186 PUR 4th 39, 46 (1998) (PUC had jurisdiction to review merger of holding companies of West Penn Power Company and Duquesne Light Company). Applicants' vigorous litigation of this proceeding demonstrates their recognition that the merger requires PUC approval.

Because this merger requires the Commission's approval, the PUC must examine whether the merger is "necessary or proper for the service, accommodation, convenience, or safety of the public." 66 Pa. C.S. § 1103(a). Under this section, Applicants must meet the

burden of proving that the merger "will affirmatively promote the 'service, accommodation, convenience, or safety of the public' in some substantial way." *See York v. Pa. PUC*, 295 A.2d 825, 828 (Pa. 1972).[2]

Specifically, the Commonwealth Court of Pennsylvania has found that a merger "was not to be granted unless the Commission was able to determine by substantial evidence that public benefit would result from the merger." *ARIPPA v. Pa. PUC*, 792 A. 2d 636, 654-655 (Pa. Commw. 2002). In other words, the entity seeking approval of the merger must "demonstrate more than the mere absence of any adverse effect upon the public, *i.e.*, that the merger would promote the service, accommodation, convenience or safety of the public in some substantial way." *Id.* at 655. In addition, the PUC has held that the Commission may impose conditions on its granting of the requisite certificate of public convenience in order to ensure that a proposed merger is in the public interest. *See GPU, Inc.*, Docket No. P-00001860, Opinion and Order (PUC June 20, 2001).

The Electricity Generation Customer Choice and Competition Act ("Electric Competition Act") also gives the Commission responsibility "to consider whether the proposed merger . . . is likely to result in anticompetitive or discriminatory conduct, including the unlawful exercise of market power, which will prevent retail electric customers in this Commonwealth from obtaining the benefits of a properly functioning and workable competitive retail electricity market." 66 Pa. C.S. § 2811(e)(1); *see DQE, supra*, 186 PUR 4th at 46. In other words, the Commission is charged with ensuring that any merger would preserve and not impair the benefits of a properly functioning and workable competitive retail electricity market.

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[2] Applicants carry the burden of proof in this proceeding, as the Public Utility Code provides that "the proponent of a rule or order has the burden of proof." 66 Pa. C.S. § 332(a).

Similarly, the Natural Gas Choice and Competition Act ("Natural Gas Competition Act") requires that the Commission determine whether a proposed merger is likely to result in anticompetitive or discriminatory conduct, including the unlawful exercise of market power, which would prevent retail customers from obtaining the benefits of a properly functioning and effectively competitive retail natural gas market. 66 Pa. C.S. § 2210. Again, the Commission cannot approve a merger that could impair these benefits.

2. Applicants Have Only Proven that Shareholders, Rather Than Ratepayers and the Public, Will Keep Benefits from This Transaction.

Under the above requirements, Applicants have not proven that the public would substantially benefit from this merger. Although the Application addresses the benefits that shareholders would receive, Applicants can only suggest that ratepayers may not be harmed from this merger. For example, in describing the benefits of the merger, Applicants note that the "merger . . . will increase the scale and scope of the combined entity's energy delivery and generation businesses . . . [which] means a larger geographic 'footprint' and, as a result, a more diverse customer base." PECO-1 at 6. Applicants also suggest that the merger "will provide continued financial strength and flexibility associated with a company with strong balance sheets . . . [with] EEG hav[ing] approximately $70 billion in assets." *Id.* at 7. According to Applicants, the merger would create a significantly larger and stronger company with a much larger balance sheet. They commit few of these benefits, however, to PECO's ratepayers or the public.

Specifically, the merger would not "have a significant impact on PECO's day-to-day operations." *Id.* at 9. In other words, PECO's day-to-day service would not improve. Similarly, while PECO claims a willingness to continue to maintain its customer service, it does not promise to improve this service substantially. *Id.* To that same end, PECO notes that it will continue to contribute to the community as it has in years past, but does not offer any promises to

improve these commitments even in light of the significant benefits that PECO, and the newly formed EEG, will reap due to the merger. In fact, while the Application claims that EEG will become a bigger and stronger company with larger balance sheets, the merger will also result in a "modest" reduction in the workforce. *Id.* at 12.

In addition, according to the Application, "the merger is anticipated to result in costs below the levels that otherwise would have been achievable on a stand-alone basis for any of the utility operating companies." Direct Testimony of William D. Arndt, PECO Statement No. 2 ("PECO-2") at 4. In fact, the Applicants perceive net regulated business savings growing from a negative $70 million in 2006 to a positive savings level in excess of $107 million by 2009, and allocate approximately $46 million of net savings to PECO. *Id.* With respect to allocating these "synergy savings," the Applicants argue that the savings from the costs-to-achieve and net merger savings for the non-regulated business segments are not relevant to this proceeding because all merger savings from a non-regulated business should flow to the exclusive benefit of its shareholders. *Id.* at 50; *see also* Direct Testimony of Brian Kalcic, Office of Small Business Advocate Statement No. 1 ("OSBA-1") at 5.

Even with the possibility of these savings, the Application, as filed, does not provide any proposal to decrease PECO's rates. PECO-1 at 10. Rather, Applicants only agree that the rates fixed as part of PECO's last merger proceeding and its electric restructuring proceeding will remain in place. *Id.* In fact, Applicants offer only that the economies resulting from the merger may help to offset future increases in rates. *Id.* In other words, while Exelon and PSEG are reaping significant merger savings via both the regulated and the non-regulated portions of the companies, the Applicants, per the initial Application, have offered only not to impact ratepayers

detrimentally, rather than ensuring affirmative benefits via rate decreases, extensions of rate caps, and commitments to improve customer service.

Thus, while the Applicants have estimated corporate gross savings and synergies from the merger of approximately $500 million per year, the estimated savings that might accrue to the Pennsylvania utility operations, net of estimated costs to achieve, are an average of $11 million per year for both electric and natural gas operations. *See* Direct Testimony of Richard LaCapra, Office of Consumer Advocate Statement No. 1 ( "OCA-1") at 10. As correctly noted by the OCA, this amount is clearly negligible compared to the anticipated corporate gross savings expected, and the Applicants have not provided any concrete assurances that they will deliver these minimal net savings to Pennsylvania ratepayers. *Id.*

3. Rather than Benefiting Ratepayers, the Merger May Harm Customers Through the Resulting Market Power Concentrations.

In addition to failing to show that the proposed merger will provide substantial benefits to ratepayers, the Applicants only prove that the resulting merger may substantially harm customers due to the competitive market power that the merged entity will control. If the proposed merger occurred, then prior to mitigation, EEG would have a portfolio of over 51,000 MW of generation, with 40,000 MW within the boundaries of the market operated by PJM Interconnection, LLC ("PJM"). *See* Direct Testimony of Julia Frayer, Met-Ed/Penelec/Penn-Power Statement No. 1 ("FE-1"), Exhibit 3-A at 14. EEG would be the largest generator by far in the PJM market, owning over 66% of nuclear capacity in the Expanded PJM market and 100% within PJM East. *Id.*

As PECO itself notes, "the merger of two large generators in the Eastern portion of PJM would, absent mitigation, raise serious market power issues." Direct Testimony of William H. Hieronymus, PECO Statement No. 3 ("PECO-3") at 3. Pursuant to the requirements of the

Federal Energy Regulatory Commission ("FERC"), the Applicants performed a market power analysis, which determined that the merger would cause many segments of the wholesale generation market to be moderately or highly concentrated, with Applicants retaining over 46% of the market share.[3] *Id.* at 2-3; *see also* FE-1, Exhibit 3-A at 14. Because Applicants failed the Competitive Analysis Screen in every product segment and season in all three geographic dimensions, Applicants have offered a proposed market power mitigation plan. Under this plan, Applicants propose to divest the equivalent of 5,500 to 6,600 MW of energy, consisting of 2,600 MW of nuclear energy via a "virtual divestiture" and 2,900 to 4,000 MW of non-nuclear plant divestiture.[4] The virtual divestiture consists of proposed medium- and/or long-term contracts of power from the nuclear assets to third parties, an auction process, or both. *See* Direct Testimony of Joseph P. Kalt, PPL Statement No. 1 ("PPL-1") at 4.

Although Applicants claim that the proposed divestiture will sufficiently cure all screen failures, the evidence indicates that this mitigation may not adequately ensure protection from market power consequences. *Id.*; *see also* PPL-1; *see also* Direct Testimony of Paul R. Carpenter, PGW Statement No. 1 ("PGW-1"). Specifically, if Applicants' potential market power is not fully mitigated, Pennsylvania customers (after the removal of the generation rate

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[3] Exelon and PSEG, with all of their jurisdictional public utilities, made the FERC filing. This Main Brief will continue to use the term "Applicants" even in referring to the FERC filing, as the Applicants are among the jurisdictional public utilities of Exelon and PSEG.

[4] Initially, Applicants proposed to divest less non-nuclear energy; however, in response to the numerous protests filed at the FERC, the Applicants increased the proposed non-nuclear divestiture by 1,100 MW, and eliminated some of the limitations of qualifying buyers of divested energy and capacity that had been initially proposed. *See* PECO-1, Exhibit WHH-2 at 46-50. However, Applicants conditioned this proposal on a decision by the FERC not to conduct evidentiary hearings. The FERC initially approved the merger without conducting hearings, but has issued an order enabling it to reconsider its decision. Unless and until the order becomes final, the PUC must therefore analyze the merger based on divestiture of only 5,500 MW, or order further divestiture as a condition of any merger approval.

cap) may face higher retail prices (as a result of wholesale conditions) than they would have had to endure if the merger had not occurred. FE-1 at 13.

Several intervening parties suggest that the Applicants' market power analysis has significant shortcomings, including relying on market price thresholds that are not the most reasonable proxy for expected prices in PJM in 2006; using an unrealistic allocation of import transmission capacity; and failing to test modeling inputs and results against historical data. *Id.* at 16. Moreover, the Applicants have not considered all relevant geographic markets, established that the proposed virtual divestiture will eliminate the incentive for the merged firm to exercise market power, evaluated the importance of financial transmission rights, or considered the impact the merger may have on the regulation of the PJM market. *See* PPL-1 at 13.

Even the proposed mitigation plan has numerous shortcomings in that it does not identify the generation units that will be divested, relies on "virtual" rather than actual divestiture, and fails to identify the terms and conditions under which the long-term contracts would be entertained or auctions would be conducted. FE-1 at 16. Thus, the mitigation plan fails to provide any assurances whatsoever that the proposed merger will not result in significant market power control by the newly merged entity. *Id.* at 17. The plan is therefore wholly inadequate.

The market power implications that could result from the proposed merger are both significant and far-reaching. Although Applicants claim to have set forth measures that could mitigate these implications, further examination shows that these proposals fail to provide any concrete assurances that the Applicants will not be able to command significant market power to the detriment of PECO ratepayers and the PJM market in general.

Moreover, the merger would result in reductions to PECO's employment levels, with certain positions, primarily in the managerial and administrative ranks, being consolidated. *See*

PECO-1 at 12. Because these employees are most likely working within Philadelphia, this proposed employment loss could be extremely detrimental to the City, especially in terms of a decrease in wage taxes. See Phila-1 at 10.[5] In addition, the proposed reduction in workforce may contribute to an inadequate level of maintenance and service with respect to street light taps, traffic signal service connections, and underground conduits. *Id.* Thus, any workforce reductions stemming from the merger could harm the public interest.

In addition to failing to provide any substantive benefits to ratepayers through this proposed merger, the Applicants prove that the merger could significantly harm ratepayers due to the substantial market power implications and workforce reductions. Thus, the Application does not meet the necessary requirements under the terms of the Public Utility Code. While the Applicants argue that the modifications to the Application resulting from the terms of the Joint Petition resolve any such concerns, further review of the terms of the Settlement indicate that the Joint Petition provides, at best, short-term benefits that fail to address the long-term implications of the merger. As discussed more fully in the next section, the Joint Petition fails to assure net substantive public benefits, thereby requiring modification or denial by the Commission.

*B. The Joint Petition for Settlement Does Not Meet the Requirements for Approval.*

As a result of settlement discussions, several parties, including PECO, entered into the Joint Petition for Settlement ("JP"). According to the Settlement, the Joint Petition resolves "with prejudice all issues related to the Application and precludes the Joint Petitioners from asserting contrary positions in derogation of this Settlement with respect to any issues addressed herein." JP at 32. In other words, the parties have compromised their litigation positions in order to reach this Settlement. Unfortunately, the compromises reached therein do not serve the

[5] *See infra* at 27-28.

public good overall. In light of the harm the merger could cause the public, including ratepayers, the Settlement does not meet the standards for approval.

In examining the Joint Petition for Settlement, the Commission must still examine whether implementing the terms of the Settlement would affirmatively promote the service, accommodation, convenience, or safety of the public in any substantial way. *See York, supra*, 295 A.2d at 828. The Commission must examine whether the merger, as modified by the Joint Petition, would provide a substantial benefit to the public. As noted in Section III.A., *supra*, the initial Application failed to meet this requirement. Examining each of the components individually shows that the Joint Petition does not modify the terms of the Application in such a manner as to ensure substantial benefit to the public. Rather, the Settlement only achieves vague and illusory promises from PECO that will not ensure ratepayer benefit. As a result, the Commission cannot approve the Settlement without additional conditions to ensure public benefit from the resolution of this proceeding.

1. The Joint Petition Fails to Provide Any Protections for Ratepayers Post-2010, When Applicants Will Reap the Most Benefits from the Merger While Ratepayers Will Be the Most Vulnerable.

In order to ensure that PECO's ratepayers benefit from this merger, the PUC must ensure a Settlement that is in the public interest. Unfortunately, with respect to rates, rate caps, and customer service programs, the Joint Petition provides only short-term benefits that do not outweigh the long-term detriments of this merger. In order to find net public benefit, the Commission must ensure that PECO ratepayers are protected beyond 2010, when rate decreases, rate caps, and most customer service initiatives will expire under the Joint Petition. Unless some modifications are implemented, ratepayers will be subject to the vagaries of the market at the same time that the Applicants begin reaping the full rewards of the merger.

Under the Settlement, PECO would reduce its retail electric distribution rates by an aggregate $120 million over four years. *See* JP at 3. While a rate decrease is beneficial to customers, the Commission should compare the amount of this decrease with the overall savings that the Applicants would achieve as a result of the merger. The $120 million rate decrease is greater than the $46 million in "regulated" rate savings that PECO claims to achieve as part of the merger, but the $120 million decrease pales in comparison to the $500 million in gross savings that the newly merged entity would already achieve prior to 2010. *See* PECO-2 at 48.

PECO also proposes to extend its transmission and distribution rate caps through December 31, 2010, to coincide with the current rate cap for its generation rates. *See* JP at 10. The Applicants have indicated that the majority of the costs to achieve the merger would have been incurred prior by 2009. *See* PECO-2 at 48. As a result, the Applicants would enjoy the full benefits of the merger at the time PECO ratepayers were subject to market prices (or worse) for distribution, transmission, and generation rates. *See* City Statement in Opposition at 3. Indeed, it is not yet clear whether there will be a functioning market at that time.

Similarly, the Joint Petition provides that PECO would enhance the Customer Assistance Program ("CAP") through an increase of funding, outreach, and expansion. *See* JP at 19-23. Unfortunately, all of these enhancements will be implemented only through 2010. *See id.* Because PECO's rate decreases would expire in 2010, and the rate caps would be removed in 2010, customers would be vulnerable to the markets beginning January 1, 2011. By compounding this vulnerability with the end of CAP enhancements, low-income customers would be especially threatened by this uncertainty.

As with the other concessions, this portion of the Joint Petition would provide short-term benefits to customers without recognizing the detriment that could occur in the long term. In

order to ensure that the Joint Petition provides adequate benefit to ratepayers, the Commission must require that the low-income provisions be revised to expand the benefits beyond 2010.

In addition to providing enhancements for CAP, the Joint Petition requires PECO to contribute $12 million to the Pennsylvania Energy Development Authority ("PEDA") for projects of benefit to the PECO service territory; $8.0 million to PEDA for energy related economic development projects to the benefit of PECO's service territory; and $7.2 million to the Sustainable Development Fund ("SDF"). The PEDA contributions need only be used for projects "to the benefit" of PECO's service territory, rather than requiring that these projects be developed and implemented within PECO's service territory. Although $125,000 of the PEDA funds must be used within the PECO service territory, the remainder of the funds might be used outside of the service territory. JP at 23. In other words, PEDA could use most of the money to build wind farms in Erie, and argue that they would provide cleaner air to Pennsylvania, thereby benefiting the customers in PECO's service territory. The Commission should not permit PECO ratepayers to subsidize others to such an extent.

Two PUC Commissioners, through their Directed Questions, specifically sought to ensure that this merger provide economic development in the longer run, and the City proposed several means by which this could occur. *See* Phila-1-S at 2-6. For example, the City suggested a portion of the virtually divested energy could be set aside for economic development within the City and elsewhere within PECO's service territory. *Id.* at 3-5.

Instead of ensuring such direct benefits to PECO ratepayers, the Joint Petition provides but a small portion of funds to be contributed directly to ratepayer benefits, with the vast majority of these funds potentially going to entities outside of the PECO service territory. Thus, PECO ratepayers could receive few benefits from these contributions. To suggest that such a

provision provides a substantial benefit to ratepayers is inappropriate. Rather, the Commission should require that the Joint Petition provide substantial and direct benefits to PECO ratepayers in the form of a set-aside of energy via the virtual divestiture to provide economic development for the City and others within the service territory. Only such a mechanism would ensure direct net public benefit from this merger.

While the Joint Petition might provide some benefits for ratepayers in the form of rate reductions and rate caps for four years, the Joint Petition would fail to protect customers in any way post-2010, which is the time ratepayers will be most vulnerable. *Id.* Similarly, the economic development and environmental benefits of the Joint Petition would not provide a direct benefit to PECO customers, who would suffer the effects of the merger post-2010. The Commission should deny permission for the merger unless Applicants promise substantial rate protections post-2010; commit to corporate headquarters and sufficient employment levels beyond that date; address low-income funding programs beyond 2010; and ensure environmental and economic development funding that directly and substantially benefits PECO ratepayers.

2. The Joint Petition Fails to Provide Any Commitments for Reliability Beyond Those Currently Required by the Commission.

Under the Joint Petition, PECO would implement a Quality of Service Plan "designed to maintain or improve reliability and the quality of customer service provided by PECO in its service territory during the five year period from January 1, 2006 through December 31, 2010." JP at 12. While addressing reliability through the Joint Petition is important, the Commission must recognize that PECO's commitments do not extend beyond what the Public Utility Code already requires. In order to ensure that public benefit is achieved via the Joint Petition, the Commission must ensure that PECO is required to meet reliability commitments that improve reliability on the system beyond the current status quo.

Under Section 1501 of the Public Utility Code, a public utility "shall furnish and maintain adequate, efficient, safe, and reasonable service and facilities . . .." 66 Pa. C.S. § 1501. As correctly noted by the OCA, customers will remain "captive" of PECO for reliability of service associated with the distribution service. *See* Direct Testimony of Barbara Alexander, Office of Consumer Advocate Statement No. 4 ("OCA-4") at 3. In addition, the size of this merger carries with it additional risks for Pennsylvania customers in that the combination of three very large utilities could result in policy being dictated by a far-reaching corporation that does not reflect Pennsylvania-specific issues.[6] *Id.* at 23.

Under the Joint Petition, PECO has made promises with respect to reliability; however, no corresponding enforcement mechanisms ensure the keeping of these potentially vague promises. Rather than penalizing PECO for failing to meet the reliability and customer service standards set forth in the Joint Petition, parties could formally request the Commission to order penalties for service non-compliance. JP at 16. Considering that PECO's data is not always received in a form and process that is comprehensible for parties, it is incorrect to place the burden on customers, rather than the non-abiding party (*i.e.*, PECO), to prove whether penalties are warranted. Phila-1 at 6.

PECO has already indicated that the merger will result in significant benefits for the merging parties, including significant synergy savings. PECO should be required to utilize these synergy savings to implement substantial and verifiable reliability and customer service measures that will ensure an improvement in these services beyond that already required under the Public Utility Code. As part of this implementation, the Commission must require penalty

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[6] EEG would have three transmission and distribution utilities operating in three states (PECO in Pennsylvania, PSE&G in New Jersey, and ComEd in Illinois). EEG's headquarters would be in Chicago, Illinois. PECO-1 at 3-5.

mechanisms that will be automatically applied if PECO fails to meet these standards, subject to review by the Commission. Only by placing the burden of monetary penalties on PECO can the PUC ensure that the merger improves customer service and reliability.

3. The Joint Petition Fails to Address or Resolve the Competitive Market Issues That Would Arise as a Result of the Merger.

As noted previously, many of the parties raised significant concerns regarding the market power implications that could arise from this merger. *See* Section III.A., *supra*. Unfortunately, the Joint Petition fails to resolve, or even really address, these concerns. Rather, the Settlement provides for minor reporting requirements regarding prices and trends in the market, without any form of penalty should PECO attempt to exercise its market power. In order to ensure that ratepayers are not detrimentally impacted by this merger, the Commission must adhere to the requirements of the Public Utility Code and not approve the merger unless and until the Commission can be assured that no discriminatory or anticompetitive conduct will result.

According to the Settlement, PECO will file annual reports with the PUC from 2007 to 2012 addressing wholesale market prices and price trends in the PJM markets. *See* JP at 29. The signatories to the Settlement may also request that the Commission initiate an investigation if a signatory "reasonably believes that PECO's affiliated generation company has unlawfully exercised market power in any PJM market." *Id.* In other words, PECO will submit reports regarding pricing and trends, and the PUC may institute an investigation at the request of one of the parties; however, PECO will not be required to undertake any prior measures to ensure that the merger does not result in market power concentrations for EEG.

In addition to the other parties' concerns regarding horizontal market power issues, Philadelphia Gas Works ("PGW") raised significant vertical market power concerns.[7] According to PGW, the merged entity would possess market power in the downstream electricity market represented by PJM East, as well as possessing market power in the upstream market power for delivered natural gas in the same geographic area. *See* Direct Testimony of Paul R. Carpenter, PGW Statement No. 1 ("PGW-1") at 3-4. As a result, the merged entity will have the ability and incentive to raise the level and volatility of natural gas prices, and thus electricity prices, in PJM East:

> [EEG's] ability to raise the price of natural gas derives from the merged entity's control of substantial gas transportation rights, and its discretion and flexibility to draw on those rights depending on demand conditions in the market during particular days. The merged entity would control 2.5 billion cubic feet ("Bcf") per day of delivery capability into the market, over 1.9 Bcf per day of which is held currently by PSE&G's unregulated affiliate PSEG Energy Resources and Trading ("PSEG ER&T"). When demand conditions are such that pipeline transportation capacity in the region becomes heavily utilized, the merged entity will potentially have a pivotal supplier role in the gas market.

PGW-1 at 4. In other words, the merger raises significant vertical market power concerns, for which Applicants have proposed no remedy. While the Applicants have set forth, and modified, mitigation plans to address horizontal concerns (even though this proposal remains inadequate and contingent on final FERC approval), Applicants have not set forth any mitigation plans to address these vertical concerns. *Id.* at 5. Moreover, conduct that could result in an increase in the price of natural gas that might relate to these vertical concerns is very hard to detect after the

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[7] Vertical mergers involve entities that have positions in two product markets where one product (here, natural gas) supplies or is an important input to the production of a second product (here, electricity). PGW-1 at 8. The principal concern presented by a vertical merger is that the merged entity will use its market power in the first (input) product market to harm competition and raise prices in the second (output) product market. *Id.*

fact, which leaves the currently regulatory structure inadequate in terms of addressing these concerns. *Id.*

The Electric Competition Act requires the Commission to consider whether a proposed merger involving electric utilities will result in anticompetitive or discriminatory conduct, while the Natural Gas Competition Act requires the Commission to consider similar implications stemming from a proposed merger involving natural gas distribution companies. *See* 66 Pa. C.S. §§ 2811(e), 2210. As a result, the PUC must be concerned with the vertical market power implications stemming from this proposed merger.

As PGW's analysis has shown, the PJM East gas market would be highly concentrated post-merger, contrary to the Applicants' claims.[8] PGW-1 at 16-20. Because of this concentration, the merged entity will potentially have a pivotal supplier role in the marketplace, with the ability to increase gas price volatility through discretionary use of selected storage

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[8] In live rejoinder to surrebuttal, PECO put forward a witness who suggested that Dr. Carpenter's market definition was incorrect and that if New York and New England were indeed a separate market, as Dr. Carpenter found, the relevant boundary was Linden, New Jersey and not the Hudson River. Evidentiary Hearing Transcript of Sept. 23, 2005 ("Tr. 9/23") at 508:12-510:6. The witness thus proposed that PJM East – up to Linden – was a smaller market than suggested by PECO's earlier witnesses and that 800 Mcf of PSE&G's daily delivery capacity should be excluded from the PJM East gas delivery market. *Id.* at 509:23-510:6. He did not, however, offer evidence whether any non-PSE&G capacity should be excluded from the PJM East Market (which would increase the market concentration) or calculate the resulting market concentration index. The Commission should use this last-minute testimony, if at all, as evidence that the Applicants have not shown that they will be unable to exercise market power following the merger. Even under Applicants' calculations, they are close to the "highly concentrated" threshold and thus may have the opportunity to exercise market power on occasion.

PECO also suggested in cross-examination that PGW's attempt to build a liquefied natural gas terminal could increase gas supply to PJM East. Evidentiary Hearing Transcript of Sept. 26, 2005 ("Tr. 9/26") at 566:9-569:5. However, that cross-examination also established that such terminal is not of sufficient certainty that the PUC may rely on such capacity in its decision concerning the proposed merger. *See id.* at 557:8-561:11.

injection and withdrawal strategies at particular locations. *Id.* at 22-23. While existing federal and state regulations prohibit these forms of market manipulation, such conduct is very difficult for regulators to detect after the fact unless the regulators are collecting the right data, carefully monitoring the actions of the companies, and distinguishing between price movements caused by the actions of the company and price movements that are the result of complexities of market forces. *Id.* at 23.

The Public Utility Code prohibits the Commission from approving a transaction that could result in anticompetitive or discriminatory behavior. Based on the above, the merged entity would have significant abilities to manipulate the market, and the Joint Petition fails to address or rectify these problems. As a result, the Commission is prohibited under the Public Utility Code from approving the Settlement unless modifications are made to resolve these issues.

The Settlement's current provision (that PECO make certain reports) promises nothing by way of limiting market power, and would provide no penalty mechanism should EEG exercise market power. To ensure that the requirements of the Public Utility Code are met, the Commission must implement additional requirements. For example, the Commission could investigate and determine the quantity of upstream natural gas pipeline capacity that EEG must release to the market in order to prevent the exertion of vertical market power, especially in the winter peak months of natural gas consumption. Only by implementing proposals to address these market power concerns substantively can the Commission ensure that the merger does not result in a merged entity with a permanently dominant position in the regional electric market.

4. The PUC Must Address the Potential for Consolidation of Natural Gas Operations Prior to Consummation of the Merger.

As mentioned previously, two PUC Commissioners presented Directed Questions to the parties. Because a number of questions (and possible outcomes) regarding the proceeding had occurred to the Commissioners, the Directed Questions were an opportunity to ensure that these issues were addressed. One of those questions was whether the combination of the PSE&G gas division with the PECO gas division and PGW would provide critical mass for a viable, profitable, shareholder-owned public utility.[9] The Joint Petition fails to address the Commissioners' concerns substantially. Instead, the Settlement suggests that an investigation "may" occur, but only after the consummation of the merger. Because of the substantial public benefit that could be reaped by this combination, the Commission must ensure that due diligence and fact-finding occurs via an expedited investigation.

Under the terms of the Joint Petition, the Commission 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 into the natural gas distribution business of EEG. *See* JP at 31. While PECO agrees to cooperate in such a fact-finding and allow other parties to participate in this proceeding, the terms of the Joint Petition do not ensure that such an investigation will occur, much less occur expediently.

During the course of this proceeding, the City has noted that such a combination could be viable and deserves serious consideration, as economic benefits and financial advantages could be reaped from such a consolidation. *See* Phila-1-S at 6. PGW has also indicated that a merged entity could be viable and would create a potential for efficiency improvement. *See* Testimony

[9] As part of this question, the Commissioners assumed a revenue stream from off-system sales from a Liquefied Natural Gas Facility and separate resolution of PGW's debt problem.

of Craig E. White, PGW Statement No. 2 ("PGW-2") at 3-4.[10] Both the City and PGW have noted that additional due diligence and fact-finding would be required before a complete determination could be made; however, the City and PGW have indicated a willingness to cooperate in every way in order to move forward on this issue. *See* PGW-1 at 3; Phila-1-S at 7.

Unfortunately, the terms of the Joint Petition would impede this progress, prohibiting any substantial steps (including due diligence) until after consummation of the merger, which is many months away at the earliest. Thus the Settlement would impede resolution of this issue, which must be in the public interest.

Because of the important benefits that this issue could bring to the public, the Commission must ensure that this investigation occurs on a timely (and even expedited) basis. Specifically, the Commission must require PECO to institute an investigation into these issues upon conclusion of this proceeding (rather than waiting until consummation of the merger), with the proceeding being placed on an expedited track to ensure that the final report on these issues can be produced by the Commission no later than December 31, 2006.

5. The Corporate, Community, and Charitable Protection Provisions of the Joint Petition Fail to Provide Any Substantive Benefits to Ratepayers.

During this proceeding, several parties raised concerns regarding the effects of the merger on PECO's corporate presence in Philadelphia, PECO's charitable giving, and staffing levels for field and executive forces. *See, e.g.*, Phila-1 at 8-10; OCA-4 at 8. While the Joint Petition addresses these issues, the Settlement only provides modest protections that would not offer any public benefit over the status quo. Accordingly, the PUC must require PECO to

[10] PECO cross-examined Mr. White in an attempt to prove that PECO ratepayers would not be better off if transferred to control by PGW. *E.g.* Tr. 9/26 at 586:4-6, 588:3-6. Of course, a combined entity could also be viable if run by another entity. *See id.* at 595:18-20.

commit to ensuring corporate protections, increasing corporate and community presence, and maintaining adequate staff levels.

The Joint Petition would provide modest protections against EEG's use of PECO's assets and credits for unregulated entities. *See* JP at 24-27. Unfortunately, these provisions would not restrict EEG from transferring all of PECO's retained earnings via regular dividend, as PECO would only be subject to retrospective notice. Specifically, PECO would have to provide one-time notice to the Office of Trial Staff ("OTS") of the accounting controls and protocols it adopts concerning the pricing of transactions with its affiliates, but it appears that PECO could change those protocols at any time. *Id.* Similarly, PECO would not argue that increases in the price of purchased power are outside of PECO's control of simply because the purchase is from an affiliate, but PECO could still argue that it could not control prices it paid EEG.

As correctly noted by the OTS, the conditions provided in the Application to address these issues were insufficient to protect PECO's customers from the additional risks associated with Exelon's non-jurisdictional operations. *See* Direct Testimony of Kevan L. Deardorff, OTS Statement No. 3 ("OTS-3") at 4. Unfortunately, the reporting requirements set forth in the Settlement do not provide any additional, concrete assurances against such risks.

Accordingly, the Commission, as part of its ability to ensure that any such transaction does not result in anti-competitive or discriminatory conduct, must require PECO to provide substantive protections to ensure that EEG cannot use PECO's assets and credit for unregulated entities. The PUC could address these concerns most readily by limiting EEG's potential market power.

With respect to corporate and community presence, the Joint Petition fails to provide any benefit over the status quo. Under the terms of the Settlement, PECO will continue its charitable

giving and sponsorships at $3 million per year for four years, which does not provide any benefit above the status quo. *See* JP at 28.[11] Moreover, PECO has only committed to maintaining its corporate headquarters for its distribution business in Philadelphia through December 31, 2010. *Id.* Neither of these provisions ensure that PECO will maintain its historical support of Philadelphia, especially after rate caps expire in 2010.

PECO's charitable involvement is extremely important to the City and to other communities in the Commonwealth. Phila-1 at 8. As noted previously, the Applicants will reap significant benefits from this merger in the form of $500 million in gross savings over the next four years. Conversely, the Joint Petition retains the charitable involvement at most at the status quo, thereby failing to provide any direct benefit to ratepayers from this merger. *Id.* Moreover, in light of the fact that a third distribution utility (*i.e.*, PSE&G) will be joining the EEG family, the possibility exists that PECO's charitable dollars may be reduced, which could result in a reduction in PECO's charitable giving within its service territory. *Id.*

As correctly noted by the OCA, PECO should be required to increase its charitable giving significantly (*e.g.*, $8 million per year for at least five years) as a condition of the merger. *See* OCA-4 at 8. To allow PECO to maintain its purported current giving for a very limited period of time would harm the public interest, create the potential for PECO to shift millions of dollars in historical support away from the City and elsewhere within its service territory, and compound the problems that could arise post-2010. For that reason, PECO must be required to increase its charitable contributions above the status quo through at least 2014, at which time ratepayers and the public may be in a better position to react to any decrease in these charitable dollars.

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[11] Indeed, this may represent a step back, as PECO has contributed more than $3 million a year within the Philadelphia alone in recent years, apart from contributions outside the City.

Similarly, the Joint Petition provides that PECO will commit to maintaining its corporate headquarters for its distribution business in Philadelphia only through December 31, 2010. *See* JP at 28. PECO's headquarter location in Philadelphia is of vital importance to the City and to the PECO employees who work in Philadelphia. Phila-1 at 8. In light of the merger of PSE&G, a New Jersey based utility, the possibility exists that EEG could seek to achieve future synergy savings by combining PECO's headquarters with those of other subsidiaries, outside of Philadelphia. *Id.* In addition, as part of the previous PECO/Unicom merger proceeding, the public interest ensured a commitment of eight years from PECO with respect to retaining headquarters in Philadelphia. In order to ensure that the public interest is served in this proceeding, PECO must be required to maintain its headquarters in Philadelphia through 2014.

Finally, the Commission must ensure that PECO commits to adequate and appropriate staffing levels, rather than merely providing illusory promises. Under the Joint Petition, PECO will not make any reductions to its current field forces prior to January 1, 2011. *See* JP at 28. PECO also agrees not to make reductions, other than those already indicated in the Application, to other areas "as a result of the merger." *Id.* Nothing in the Settlement, however, will preclude PECO from sizing its workforce to reflect future efficiencies and process improvements "unrelated to the merger." *Id.* Unfortunately, these "concessions" by PECO fail to provide any concrete commitments with respect to staffing in the coming years.

Under the terms of the Joint Petition, PECO can modify its workforce size if this reduction is unrelated to the merger. In other words, any party claiming an inappropriate reduction in staffing would have to prove that the reduction stemmed from the merger. This would be a formidable task. As William Arndt testified for PECO:

> It is very difficult to measure the actual savings and cost reductions related to a specific initiative or event, largely because of changing market and business

> environment conditions. For example, once the Exelon merger was completed in October 2000, the business environment for the energy industry changed dramatically . . .. Therefore, the distinction was blurred between the synergies made possible by the merger and the benefits of restructuring and cost containment initiated after the merger due to changes in the economic market and business environment.

Rebuttal Testimony of William Arndt, PECO Statement No. 2-R (PECO-2-R), at 12-13. Moreover, the Settlement imposes no limits on the reductions in employment by PECO's affiliates, nor does the Settlement address PECO's ever-increasing use of contract employees. *See* Phila-1 at 9-10.

Philadelphia relies on Exelon employees, beyond just field forces, and any reduction in these numbers could significantly impact the City. Many of PECO's employees are residents of the City and remit City wage tax. *See* Phila-1 at 8-9. In addition, the City gains revenues from having PECO employees in Philadelphia through spending that would be diminished if these positions were eliminated. At this time, the Applicants have not identified the positions and locations of employees that will be lost by the merger, as well as whether the positions of any transferring employees will be filled. *See* PECO-2-R at 8. Assuming hypothetically that half of the 250 positions to be cut, *see id.* at 6 and Rebuttal Testimony of Denis O'Brien, PECO Statement No. 1-R at 20-21, are or would be filled by those living or working in Philadelphia, that half of those with such connections to the City pay resident wage tax, and that the average "synergized" employee subject to that tax earns about $73,000 annually,[12] then at the blended

[12] As of January 1, 2005, the average salary of the 1,002 employees of PECO and other Exelon affiliates at PECO's Philadelphia headquarters was $73,303, the average salary of the 312 employees in Philadelphia outside of headquarters was $67,478, and the average salary of the 3,596 employees located *outside* the City was $76,292. *See* Phila-1 Exhibit KRM-3 Attachment COP-1-15-7, PECO responses to Questions 15.a, 15.b, 15.d. The weighted average salary of all 4,900 employees was thus $75,112. The City's hypothetical of $73,000 assumes the layoffs among those subject to City wage tax will be predominantly among those employed within the City.

wage-tax rate,[13] the merger would directly cost the City as much as $384,000 *per year* in wage taxes alone – almost $1.45 million from 2007 through 2010, with somewhat lower rates thereafter – and would cost the Exelon workforce in Pennsylvania more than $75,000,000 every four years. Despite PECO's contention, *see* PECO-2-R at 7, the Commission must consider the merger's effects on "unregulated" employment as well as on PECO in determining the net benefit or detriment to the public of the merger.

Nor should the Commission accept PECO's illogical argument that actual job and economic losses will be less if it eliminates positions that are currently vacant or if its current employees retire.[14] Exelon could not count on such positions for "synergy savings" unless it would otherwise have continued or filled those positions absent the merger. The Commission should count the costs carefully and determine that the merger would not benefit the public

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[13] The respective resident and nonresident rates, including the 1.5% PICA surcharge on residents, are to be 4.66% and 3.7557% for 2007, 4.219% and 3.7242% for 2008, 4.169% and 3.685% for 2009, 4.0158% and 3.6046% for 2010, 3.8626% and 3.5338% for 2011, 3.7094% and 3.4659% for 2012, 3.5562% and 3.3994% for 2013, 3.403% and 3.3237% for 2014, and 3.25% for residents and nonresidents thereafter. Phila. Code §§ 19-1502(1)(a)-(b), 19-2803(1)(a).

[14] First, position reductions do not translate into "job losses" on a one-for-one basis. Some positions being eliminated may be vacant. Alternatively, some employees in eliminated positions could transfer to continuing but unfilled positions. Therefore, "job losses" as such will likely be less than 100.

> Second, position reductions will be implemented to the maximum extent possible through attrition so that economic impacts will be mitigated. Attrition includes employees who choose to retire. As to retiring employees, the reductions will not withdraw all wages and benefits from the economy . . ., because the former employee continues to receive income and benefits from PECO, which remain part of the local economy.

PECO-2-R at 8. PECO is correct that certain severance payments would mitigate such losses in part, *see id.*, but only for a limited period. Absent the merger, employees would receive full wages and benefits, and so would retirees.

overall. Absent the merger, the City and the Commonwealth would have greater employment. *See* Phila-1 at 8-9.

Accordingly, the potential impact to the City, as well as to other areas in PECO's service territory, could be great if PECO has the ability to vacate positions without any concrete commitments to the parties otherwise. In order to avoid harm to the public, the Commission should require PECO to maintain minimum staffing levels post-deregulation, maintain the current total of full- and part-time employees within the City, and require PECO to bear the burden of proving any reduction in force over that committed to in the Settlement is not related to the merger.

## IV. PROPOSED FINDINGS OF FACT

At the direction of the Administrative Law Judge, the City is proposing only such proposed findings as are directly relevant to its contentions or likely to be disputed.

1. The City of Philadelphia is a corporation and body politic and a city of the first class organized and existing under laws of the Commonwealth of Pennsylvania and the Philadelphia Home Rule Charter. Act of March 11, 1789, § 2, as amended, 53 P.S. § 16252; Act of June 25, 1895, P.L. 275, § 1, as amended, 53 P.S. § 101; Act of April 21, 1949, as amended, 53 P.S. § 13101; Philadelphia Home Rule Charter.

2. The City properly intervened in this proceeding and filed testimony and statements.

3. The merger would create the nation's largest utility, with significantly increased market power over that currently enjoyed separately by PECO and PSE&G.

4. The merged company would be the largest electricity generator by far within the territory of PJM Interconnection, with 40,000 MW of generating capacity within PJM prior to

mitigation, and would own all nuclear generating capacity within PJM-East and 66% within PJM. FE-1, Ex. 3-A at 14.

5. Absent mitigation, all parties agree that the merger would create excess market power. PECO-3 at 2-3; FE-1, Ex.3-A at 14.

6. The Federal Energy Regulatory Commission issued an order granting permission for the merger, but then granted reconsideration of that order.

7. Under the terms of the Application, at least until the FERC's order becomes irrevocably final without an evidentiary hearing, the proposed mitigation is 2,600 MW of nuclear power and 2,900 MW of nonnuclear power.

8. The merger would have no significant impact on PECO's day-to-day operations. PECO-1 at 6.

9. Under the Application, the merger would provide no significant improvement in terms of service, rates, or community development.

10. Under the Application, the merger would provide no substantial benefits to the public in Pennsylvania.

11. Under the Joint Petition for Settlement, the merger would bring some public benefits for four years.

12. Under the Joint Petition for Settlement, PECO would not increase its level of charitable giving, and could later decrease it.

13. Under the Joint Petition for Settlement, the merger would provide no substantial benefits to the public in Pennsylvania after 2010.

14. The merger would cause significant detriment to the public in Pennsylvania.

15. Under the Application and the Joint Petition for Settlement, the merger would result in the loss of 250 employees in Pennsylvania. PECO-1-R at 20-21; PECO-2-R at 6.

16. The loss of 250 positions would cost employees about $75,000,000 every four years, plus benefits, not including any anticipated salary increases. Phila-1 Exhibit KRM-3 Attachment COP-1-15-7, PECO responses to Questions 15.a, 15.b, 15.d.

17. The loss of 250 positions, estimating half subject to the City's wage tax and/or PICA surcharge, would directly cost the City of Philadelphia approximately $1.45 million during the years 2007-2010, again not including any anticipated increases. Phila-1 Exhibit KRM-3 Attachment COP-1-15-7, PECO responses to Questions 15.a, 15.b, 15.d; Phila. Code §§ 19-1502(1)(a)-(b), 2803(1)(a).

18. Under the Joint Petition for Settlement, EEG would be largely free to decrease its workforce further unless another party could prove that the reduction was a direct result of the merger, and would have no commitments as to workforce levels after 2010.

19. Under the Joint Petition, EEG could relocate PECO's headquarters out of Philadelphia after 2010.

20. Under the Application and the Joint Petition for Settlement, the merger could facilitate the exercise of market power against the public interest. FE-1 at 13, 16-17; PPL-1 at 13.

21. More specifically, the merger would give EEG the ability to use its market power in the natural gas market in PGW-East to drive up the marginal price for gas during various peak periods, which would in turn raise electricity prices unfairly. PGW-1 and PGW-1-R, *passim*.

22. As pointed out by the Commissioners in their directed questions, the proposed virtual divestiture presents the opportunity to set aside a block of such power for economic

development purposes within the Commonwealth. A long-term commitment of modest amount of such power would be a very effective tool. Phila-1-S at 2-6.

23. Under the Joint Petition for Settlement, the merger would provide no such set-aside, and would not target PECO's service territory with the even more modest amounts committed for four years.

24. Under the Joint Petition for Settlement, the merger would provide no reliability commitments beyond what the Public Utility Code already requires.

25. Under the Joint Petition for Settlement, the merger would proceed with no significant constraints on EEG's market power.

26. Despite the Commissioner's directed question concerning the Philadelphia Gas Works and the need to mitigate market power in the vertical gas/electric market, the Joint Petition for Settlement would delay any consideration of the possibility of a separate combination of gas companies until after the merger. JP at 31.

27. A combination of PECO Gas and/or PSE&G Gas with PGW is feasible enough to warrant due diligence, especially given the need to mitigate market power. Phila-1-S at 6-7; PGW-2 at 3-4.

28. On balance, the reasonably likely public benefits do not outweigh the reasonably likely public detriments of the merger, even under the terms of the proposed Settlement, especially when considering the market post-2010.

## V. PROPOSED CONCLUSIONS OF LAW

1. The Commission has jurisdiction over the merger application, because a merging company, Exelon, is an affiliate of a regulated public utility, PECO. 66 Pa. C.S. § 1102(a)(3).

2. The Commission cannot approve a merger unless the Applicants have demonstrated that the merger on specified terms will affirmatively promote the service, accommodation, convenience, or safety of the public in some substantial way. *York v. Pa. PUC*, 295 A.2d 825, 828 (Pa. 1972).

3. The Commission cannot approve a merger unless the Applicants have demonstrated that the merger on specified terms will provide substantial public benefits overall. *See ARIPPA v. Pa. PUC*, 792 A.2d 636, 654-655 (Pa. Commw. 2002).

4. The Commission may impose conditions on a certificate of public convenience in order to ensure that a proposed merger is in the public interest. *GPU, Inc.*, Docket No. P-00001860 (PUC June 20, 2001).

5. In determining whether to grant a certificate of public convenience, the Commission should consider whether the proposed merger is likely to result in anticompetitive or discriminatory conduct, including the unlawful exercise of market power, that could prevent retail electric and gas customers in Pennsylvania from obtaining the benefits of properly functioning and workable competitive retail markets. 66 Pa. C.S. §§ 2811(e)(1), 2210.

6. The Applicants have failed to prove that the proposed merger is unlikely to result in the merged company's ability to manipulate electricity prices during some peak periods.

7. The Federal Energy Regulatory Commission's merger approval without an evidentiary hearing is not currently final.

8. A certificate of public convenience is not warranted under the proposed terms.

## VI. CONCLUSION

The Applicants have not met their burden of proving that the merger, with or without the conditions proposed in the Joint Petition for Settlement, would bring substantial benefits overall

to the public in the Commonwealth. Instead, the proposed benefits would be temporary and in many instances vague and illusory. Moreover, Applicants propose that at the time in which the newly merged entities would reap the most significant benefits from the synergy savings, ratepayers should lose any protections obtained under the merger (and Joint Petition).

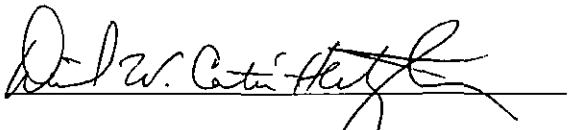
The Joint Petition fails to require PECO to improve its services above the status quo, and would result in significant market power concentration without imposing limitations on EEG's exercise of market power. In addition, the Settlement fails to adequately and timely respond to the issues raised in the Directed Questions, in that the Joint Petition rejects economic-development set-asides and delays any fact-finding and due diligence regarding the feasibility of consolidation of applicable natural gas operations. Finally, the Settlement does not require any substantive corporate protections, any long-term charitable and community provisions, or any concrete commitments with respect to staffing levels. As a result, the Joint Petition does not modify the Application in a manner that would allow the Commission to determine that the merger would provide substantive benefits to the public.

**WHEREFORE**, the City of Philadelphia respectfully requests that the Pennsylvania Public Utility Commission either apply the aforementioned conditions to the Joint Petition for Settlement submitted in this proceeding in order to ensure that the public receives substantive benefits from the proposed merger; or hold the Joint Petition in abeyance until the Applicants

and Intervenors are able to reach agreement regarding the specific conditions and deadlines that must be imposed in order to ensure substantive benefits for the public as a result of this merger.

Respectfully submitted,

ROMULO L. DIAZ, JR., CITY SOLICITOR

By: 

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Dated: October 13, 2005

## 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), via e-mail and via first-class mail except as otherwise indicated.

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Dated this 13th day of October, 2005 in Philadelphia, Pennsylvania.

Pennsylvania Department of Environmental Protection

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ORIGINAL

DOCUMENT FOLDER

Honorable James McNulty
Secretary
Public Utility Commission
P.O. Box 3265
Harrisburg, PA 17105-3265

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.
PUC Docket No. A-110550F0160.

Dear Secretary McNulty:

Please find for filing an original and nine copies of the Department of Environmental Protection's Proposed Finding of Fact and Conclusions of Law in the above referenced matter.

Sincerely,

Scott Perry
Assistant Counsel

cc: Honorable Marlane Chestnut, PUC ALJ

enclosure

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**COMMONWEALTH OF PENNSYLVANIA**
**BEFORE THE PUBLIC UTILITY COMMISSION**

| | | |
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| **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** |

# DEPARTMENT OF ENVIRONMENTAL PROTECTION'S PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW

The Department submits that the testimony of Daniel Desmond, the Joint Petition for Settlement, and the Department's Statement in Support of the Joint Petition for Settlement fully support the Commission's approval of the merger of PSEG with and into Exelon Corporation. As such, the Department will not be submitting a main brief in support of the proposed merger. The Department reserves the right to file a reply brief if necessary. The Department does, however, offer the following proposed findings of fact and conclusions of law.

## I. Proposed Findings of Fact

1. Executive Order Number 2002-8 of July 18, 2002 declares that ensuring an affordable energy supply is critical to the welfare of Pennsylvania's citizens and to the continued economic prosperity of the Commonwealth. DEP St. No. 3 at 2.

2. Executive Order Number 2002-8 of July 18, 2002 further declares that maintaining a diverse and reliable energy portfolio will be critical to minimizing the effects of any single energy source on Pennsylvania's consumers and maintaining a sustainable supply of energy. DEP St. No. 3 at 3.

3. Continued or improved reliability of service is a major consideration in determining whether a merger will benefit the public in some substantial way. DEP St. No. 3 at 2.

4. Reliance on a few sources of fuel for the Commonwealth's energy needs is detrimental to electric system reliability. DEP St. No. 3 at 4.

5. Energy efficiency and energy conservation reduce the amount of generation required to meet demand and reduce load on the transmission and distribution system. DEP St. No. 3 at 6-7.

6. The Joint Petition for Settlement will assist the Commonwealth in carrying out Executive Order Number 2002-8 of July 18, 2002, will promote the use of efficient, clean and diverse energy technologies in Pennsylvania, will be of benefit to the PECO service territory, and will contribute to the continued economic prosperity of the Commonwealth by providing $20 million over four years to the Pennsylvania Energy Development Authority. DEP Statement in Support of Joint Petition for Settlement at 2, 3.

7. The Pennsylvania Energy Development Authority is an independent public financing authority that was created in 1982 by the Pennsylvania Energy Development Authority and Emergency Powers Act. DEP Statement in Support of Joint Petition for Settlement at 3.

8. The Authority's mission is to finance clean, advanced energy projects in Pennsylvania, including solar energy, wind, low-impact hydropower, geothermal, biomass, landfill gas, fuel cells, integrated gasification combined cycle, waste coal, coal-mine methane and demand management measures. DEP Statement in Support of Joint Petition for Settlement at 3.

9. The Joint Petition for Settlement will reduce retail electric distribution rates over a four year period for an aggregate total savings to PECO customers of $120 million and will also cap its transmission and distribution charges for a four year period, from January 1, 2007 through December 31, 2010. DEP Statement in Support of Joint Petition for Settlement at 4.

10. The Joint Petition for Settlement will protect hundreds of jobs that are vital to service reliability because PECO has agreed to limitations on any reductions in its field forces prior to January 1, 2011. DEP Statement in Support of Joint Petition for Settlement at 4.

## II. Proposed Conclusions of Law

1. This Commission has jurisdiction over the subject-matter of the Application which initiated these proceedings.

2. This Commission has jurisdiction over the parties to these proceedings.

3. Under Pennsylvania law, a public utility seeking approval of a merger must obtain a certificate of public convenience, 66 Pa.C.S. § 1102(a)(3), which shall be granted only if "necessary or proper for the service, accommodation, convenience, or safety of the public." 66 Pa.C.S. § 1103(a).

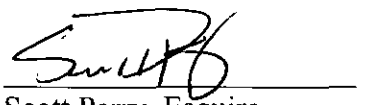
4. In granting a certificate of public convenience, the Commission may impose such conditions as it may deem to be just and reasonable. 66 Pa.C.S. § 1103(a).

5. A certificate of public convenience approving a merger will not be granted unless the Commission finds that the public will benefit as a result of the merger. *City of York v. Pennsylvania Public Utility Commission*, 449 Pa. 136, 141, 295 A.2d 825, 828 (1972).

6. Through the Joint Petition for Settlement, the Joint Applicants have met their burden of demonstrating that a Certificate of Public Convenience should be granted pursuant to 66 Pa.C.S. §§ 1102, 1103.

7. The credible evidence of record, as set forth in the Findings of Fact, demonstrates that the merger of Public Service Enterprise Group with and into Exelon Corporation, conditioned upon the approval of the Joint Petition for Settlement, is in the public interest under 66 Pa.C.S. § 1103(a).

Respectfully submitted,



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Dated: October 13, 2005

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SECRETARY'S BUREAU

**COMMONWEALTH OF PENNSYLVANIA**
**BEFORE THE PUBLIC UTILITY 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** |

## CERTIFICATE OF SERVICE

I do hereby certify that on this day, I served a true and correct copy of the Department of Environmental Protection's Proposed Findings of Fact and Conclusions of Law, upon the participants listed below, in accordance with the requirements of § 1.54 (relating to service by a participant).

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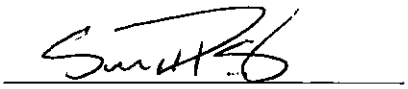

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400 North Street
Harrisburg, PA 17105

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:

Pursuant to 52 Pa. Code § 5.502(a), enclosed for filing please find an original and nine (9) copies of **Action Alliance et al.'s Proposed Findings of Fact and Conclusions of Law**, along with a copy on disk. We are not filing a Main Brief in this matter, as the Main Brief of the Office of Consumer Advocate is supportive of our position, particularly at pages 12 through 14. Copies of the enclosed have been served upon the Administrative Law Judge and other parties as set forth on the Certificate of Service.

Sincerely,

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Enclosure
cc: service list

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OCT 14 2005
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SECRETARY'S BUREAU

**BEFORE THE**
**PENNSYLVANIA PUBLIC UTILITY 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** |

# ACTION ALLIANCE et al.'s PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW

Action Alliance of Senior Citizens of Greater Philadelphia, the Association of Community Organizations for Reform Now, and the Tenants' Action Group (collectively "Action Alliance et al."), through counsel Community Legal Services, Inc., submits that the Main Brief of the Office of Consumer Advocate, specifically at pages 12 through 14, sets forth the reasons for approving the Joint Petition for Settlement. Further, Action Alliance et al. submits that the testimony of Harry S. Geller, the Joint Petition for Settlement, and Action Alliance et al.'s Statement in Support of the Joint Petition support approval of the Joint Settlement. Action Alliance et al. will not be submitting a main brief in this matter; however, Action Alliance et al. offers the following proposed findings of fact and conclusions of law:

## FINDINGS OF FACT

1. For customers enrolled in its customer assistance program (CAP), PECO will increase the monthly usage levels eligible for discounts for customers taking service under CAP Rates B, C, D and E from 500 kWh to 650 kWh effective for regular billing cycles beginning after January 1, 2007.

2. An additional payment arrangement will be available to CAP customers who become delinquent and who either (a) are transitioning from one CAP Rate level to another with a greater discount (e.g., from CAP Rate "C" to CAP Rate "B"); (b) have experienced "extenuating circumstances," as that term is defined in the Customer Assistance Program Rider of PECO's tariff; (c) incur increases greater than 30% of their monthly household expenses in non-discretionary costs essential to the customer's well-being; or (d) have experienced a material decline in household income. The payment arrangements shall consist of the current CAP payment plus $5.00 per month for those customers on CAP Rates A, B and C and the current CAP payment plus $15.00 per month for those customers on CAP Rates D and E.

3. PECO will provide $500,000 per year in each of the years 2007, 2008, 2009 and 2010 to the Matching Energy Assistance Fund ("MEAF"), to be distributed for use to assist PECO customers in accordance with the allocation formula provided in the Settlement, in addition to any PECO matching of contributions and any reimbursement of administrative costs to the MEAF agencies. PECO also agrees to authorize an increase in maximum MEAF grants from $500 to $1000.

4. PECO will include MEAF check-off options and bill inserts in customers' bills for contributions to MEAF, as provided in the Settlement.

5. PECO will spend $1.2 million ($300,000 per year in each of the years 2007, 2008, 2009 and 2010) on additional CAP enrollment outreach, and will work with the LIURP Advisory Committee in the planning and implementation of such outreach program. This outreach will be directed toward those customers who may not know about PECO's CAP Rate program and who do not know about the special needs programs (including CAP Rates A, B and C).

6. For the purpose of CAP outreach and referrals, PECO will provide $0.4 million ($100,000 per year in each of the years 2007, 2008, 2009 and 2010) to the Energy Coordinating Agency ("ECA") to be directed to Neighborhood Energy Centers ("NECs") in Philadelphia and to other Community Based Organizations ("CBOs") in the surrounding counties; and agrees to continue to reimburse 33% (up to a maximum of $200,000 per year) of the annual administrative costs of the Utility Emergency Services Fund ("UESF") in each of the years 2007, 2008, 2009 and 2010.

7. To better serve current CAP and CAP-eligible customers, PECO will enhance its CAP application and recertification process, as set forth in the Settlement.

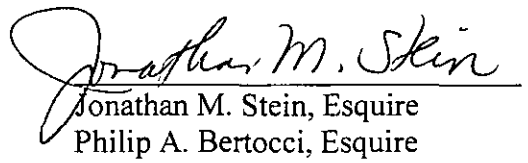
8. In addition to its current practice of providing training on an informal basis, PECO will conduct at least four training sessions annually in each of the years 2007, 2008, 2009 and 2010 to educate staff members of community organizations and healthcare providers such as NECs, CBOs and legal service organizations located in its service territory regarding the availability and operation of its CAP Rate Program (including CAP Rates A, B and C) and other programs intended to benefit low income customers.

9. PECO will consider alternative LIURP treatment measures (to include but not limited to white reflective coating of roofs and solar hot water heaters), if approved by the Commission, among the various LIURP treatment options available for eligible customers.

## CONCLUSIONS OF LAW

1. Based on the Joint Settlement, the Commission's approval of the proposed merger will affirmatively promote the public interest, service, accommodation, convenience, or safety of the public in a substantial way. See, City of York v. Pa. P.U.C., 449 Pa. 136, 295 A.2d 825 (1972).

Respectfully submitted,



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## CERTIFICATE OF SERVICE

I hereby certify that I have this day, served a copy of Action Alliance et al.'s Proposed Findings of Fact and Conclusions of Law upon the persons listed below in accordance with the requirements of § 1.54 (relating to service by a participant).

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OCT 14 2005

PA PUBLIC UTILITY COMMISSION
SECRETARY'S BUREAU

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**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**

**Main Brief of the PPL Companies**

DOCUMENT FOLDER

Dear Secretary McNulty:

Enclosed for filing please find an original and nine (9) copies of the Main Brief of the PPL Companies in the above-captioned proceeding.

Copies of this brief are being served upon all of the parties to this proceeding in accordance with the attached certificate of service.

If you have any questions regarding this matter, please do not hesitate to contact the undersigned.

Sincerely,

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SECRETARY'S BUREAU

**BEFORE THE**
**PENNSYLVANIA PUBLIC UTILITY COMMISSION**

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| **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** |

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**BEFORE THE**
**PENNSYLVANIA PUBLIC UTILITY 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** |

# MAIN BRIEF OF THE PPL COMPANIES

Pursuant to Prehearing Order No. 7 issued by Administrative Law Judge ("ALJ") Marlane R. Chestnut on September 12, 2005, PPL Electric Utilities Corporation; PPL EnergyPlus, LLC; PPL Brunner Island, LLC; PPL Holtwood, LLC; PPL Martins Creek, LLC; PPL Montour, LLC; PPL University Park, LLC; Lower Mount Bethel Energy, LLC and PPL Susquehanna, LLC (collectively, the "PPL Companies") submit this post-hearing Main Brief on the Joint Application of PECO Energy Company ("PECO") and Public Service Electric and Gas Company ("PSE&G") (collectively, the "Joint Applicants" or the "Merging Parties") for Approval of the Merger of Public Service Enterprise Group Incorporated ("PSEG") With and Into Exelon Corporation.[1]

## I. INTRODUCTION AND STATEMENT OF THE CASE.

The Joint Applicants propose to create an entity so huge and powerful that even they recognize that the merger cannot be permitted without significant mitigation to

[1] The PPL Companies' proposed Findings Of Fact, Conclusions Of Law, and Ordering Paragraphs Specifically Identifying The Relief Sought are attached hereto in Appendix 1.

prevent the unlawful exercise of market power. While the Joint Applicants propose mitigation, their measure of the market power to be mitigated is flawed and the essential specifics of their proposed divestiture are missing. Accordingly, the merger as proposed should not be accepted by the Pennsylvania Public Utility Commission ("Commission").

The Joint Applicants' market concentration analyses are incomplete, inconsistent with accepted competition law principles, and inaccurate. First, the Joint Applicants refuse to consider the anticompetitive effects of the proposed merger on the PJM Classic market. When analyzed properly, the record evidence demonstrates that the proposed merger repeatedly exceeds the thresholds at which federal antitrust agencies and the Federal Energy Regulatory Commission ("FERC"), with a full record before them, would conclude that a likelihood of competitive harm exits. Second, ignoring the record evidence, the Joint Applicants fail to allocate imports based on FTR ownership, and thus significantly understate the market concentration in PJM East. When these imports are appropriately recognized, numerous market screen failures result – none of which are accounted for by the Joint Applicants' proposed mitigation plan.

As currently proposed, Joint Applicants' suggested market mitigation, while perhaps clever, is not effective. The underpinning of Joint Applicants' plan is their reliance on "virtual" divestiture to remedy the undisputed anticompetitive effects of the proposed merger. Virtual divestiture lacks the tangible benefits that accompany the actual transfer of ownership. Simply put, the Joint Applicants' attempt to re-define medium-term forward contracts as divestiture of assets cannot credibly pass for true merger relief. Absent significant changes to the Joint Applicants' proposal, the proposed merger will increase market concentration to unacceptable levels and lessen competition

in both wholesale and retail electricity markets. If permitted to proceed without modification, the proposed merger will adversely affect both suppliers and consumers of electric energy in the Commonwealth.

Accordingly, unless significant and effective additional relief is ordered, approval of the proposed merger would be antithetical to the fundamental principles of the Electricity Generation Customer Choice and Competition Act.[2] Adopted in 1996, the Competition Act was grounded in part on the General Assembly's finding that:

> [B]ecause 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 and businesses of this commonwealth.[3]

Clearly, the premise upon which retail competition was introduced in the Commonwealth was the existence and continuation of a viable and workable competitive wholesale market. The proposed merger of Exelon and PSEG threatens that premise. The Joint Applicants have put forth no basis upon which the Commission can be confident that the proposed merger will not adversely affect competition without undertaking a complete overhaul of the Joint Applicants' market power mitigation proposal.

The Commission fortunately has subjected the Joint Application to close scrutiny via discovery and cross-examination.[4] Although the hearing before the ALJ was short, that hearing, along with the written testimony, provide a rich record upon which the

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[2] 66 Pa.C.S. § 2801, *et seq.* ("Competition Act").

[3] 66 Pa.C.S. § 2802(3).

[4] FERC approved the merger without the benefit of a full evidentiary hearing. That decision is being challenged at this time, as noted in Section II.C below.

Commission may find that the proposed merger will confer market power to the Joint Applicants in the PJM Classic and PJM East markets – areas that include, respectively, most of the Commonwealth and the Philadelphia metropolitan area. As discussed below, that record demonstrates that the Joint Applicants' "virtual divestiture" is not divestiture at all, but rather an opportunity to earn monopoly profits through forward electricity sales. Finally, the Commission will see that the recently submitted settlement among the Joint Applicants and a number of parties[5] does not address these critical competitive issues, and therefore does nothing to cure the injury to competition caused by the proposed merger.

While the PPL Companies take no position on the Joint Applicants' claim that the Commission lacks jurisdiction to approve the proposed merger,[6] if the Commission determines that it *does* have jurisdiction over the proposed transaction, any approval thereof must be conditioned upon the Joint Applicants' unqualified agreement to: (1) convert their virtual divestiture proposal to a definitive plan for the actual transfer of ownership of baseload generation; (2) provide additional, actual divestiture to cure the market screen failures identified when the PJM Classic market is considered separately,[7] and to remedy the screen failures in the PJM East market when FTR ownership is considered in measuring market shares;[8] (3) identify with specificity the units to be

[5] 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) ("Joint Petition").

[6] *See* Joint Application at pp. 10-12.

[7] *See* Kalt Direct Testimony, Exhibit JPK-11.

[8] *See* Kalt Direct Testimony at pp. 28-29 and Exhibit JPK-7.

divested; and (4) participate in additional proceedings so the Commission can fully consider and rule on the effectiveness of the revised mitigation plan.

If the Commission finds that it does *not* have jurisdiction to approve the proposed merger, the Commission still has an important role. Acting under Section 2811 of the Competition Act, it: (1) must make clear findings based on the record before it and, as explained herein, (2) certify those findings to the appropriate federal and state agencies responsible for investigating and approving the proposed merger. The Commission's authority under the Competition Act to make and certify findings regarding the competitive impact of a proposed merger is beyond question. The Commission should use that voice to declare that the proposed merger, with its flawed market power mitigation measures, will threaten competition in wholesale electricity markets in PJM and in retail electricity markets in Pennsylvania.

## II. HISTORY OF THE PROCEEDING.

### A. Exelon 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 PSEG, the corporate parent of PSE&G, with and into Exelon Corporation ("Exelon"), which will become the ultimate corporate parent of the Joint Applicants.[9] The Joint Application contained the written testimony of Denis P. O'Brien,

[9] 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").

PECO President;[10] William D. Arndt, Senior Vice President, Financial Operations for Exelon;[11] and Dr. William D. Hieronymus, Vice President of Charles River Associates.[12]

Also on February 4, 2005, the Joint Applicants filed an application under Section 203 of the Federal Power Act ("FPA") with FERC, requesting approval of the merger of Exelon and PSEG's jurisdictional public utilities and the subsequent internal restructuring of Exelon and PSEG corporate subsidiaries.[13] The FERC Application included the supporting testimony of Dr. Hieronymus, which described his analysis of the merger conducted pursuant to Appendix A of the FERC Merger Guidelines.[14] This written testimony submitted to FERC, including the merger analysis, was included as part of Dr. Hieronymus' written testimony submitted in this proceeding.

Dr. Hieronymus' Appendix A analysis conceded that the proposed merger produced failures in the competitive analysis screens for the economic capacity measure of generation ownership during the peak, off-peak and super-peak load conditions in several PJM markets during all three seasons studied.[15] According to the analysis, the

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[10] PECO Statement No. 1, Direct Testimony of Denis P. O'Brien, on behalf of Exelon Corporation (filed Feb. 4, 2005).

[11] PECO Statement No. 2, Direct Testimony of William D. Arndt on behalf of Exelon Corporation (filed Feb. 4, 2005).

[12] PECO Statement No. 3, Direct Testimony of William H. Hieronymus ("Hieronymus Direct Testimony") (filed Feb. 4, 2005). The Direct Testimony of William H. Hieronymus included, as Exhibit WHH-1, 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").

[13] Exelon Corporation, Public Service Enterprise Group Incorporated, Application for Authorization of Disposition of Jurisdictional Assets Under Section 203 of the Federal Power Act, FERC Docket No. EC05-43-000 (filed Feb. 4, 2005) ("FERC Application").

[14] Hieronymus FERC Direct Testimony at p. 2.

[15] *Id.* at pp. 47-49.

largest merger screen failures occurred in PJM East, which is the market in which the bulk of PECO's and PSEG's generation is located.[16]

In response to the market screen failures, the Merging Parties proposed to divest control of approximately 5,500 MWs of generating capacity in these various PJM markets.[17] The divestiture proposal included the proposed physical divestiture of generation facilities and a proposal to "virtually divest" 2,600 MW of baseload nuclear capacity through long-term firm sales contracts.[18] The proposed "virtual divestiture" would occur through either of two forms: (1) firm long-term sales contracts for a term that expires no later than 15-years following the close of the transaction or through a swap of assets with owners of generation facilities located outside of the PJM footprint; or (2) an annual auction of 3-year firm entitlements to baseload energy in 25 MW blocks.[19] As part of their initial merger proposal, the Joint Applicants also proposed that market participants with market shares as low as 5 percent would be ineligible to acquire any of the divestures, whether fossil fuel plants or the virtually-divested baseload energy contracts.[20]

Numerous protests were submitted in the FERC proceeding, which challenged Dr. Hieronymus' Appendix A analysis and the associated mitigation proposal. In response to those protests, the Merging Parties submitted a supplemental application with FERC on May 9, 2005, which increased their proposed actual divestiture by 1,100 MW of non-

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[16] Hieronymus Direct Testimony at p. 4.

[17] Hieronymus FERC Direct Testimony at pp. 67-68.

[18] *Id.* at p. 6.

[19] Hieronymus Direct Testimony at pp. 3-4.

[20] *Id.*

nuclear plant output and relaxed the buyer restrictions. The supplemental application did not alter the virtual divestiture concept.[21] The Merging Parties also submitted supplemental testimony by Dr. Hieronymus, which included a revised Appendix A analysis that addressed certain comments of the protesting parties, increased the divestiture amounts, and eliminated the buyer restrictions. The Merging Parties' supplemental testimony to FERC was submitted in this proceeding on May 27, 2005.[22]

**B. PPL Testimony.**

On June 28, 2005, thirteen parties filed twenty-four written statements in response to the Joint Applicants' proposed merger application and supplemental application in this proceeding. The PPL Companies filed the Direct Testimony of Dr. Joseph P. Kalt,[23] which demonstrated how Dr. Hieronymus' original and supplemental analyses of the merger's competitive market impacts are inaccurate and incomplete.[24] Specifically, Dr. Kalt highlighted the fact that the Joint Applicants' Original and Supplemental merger proposals depend heavily on highly questionable virtual divestiture "as an antidote to the prospective adverse effects of the merger on market competitiveness."[25] Dr. Kalt also exposed flaws in Dr. Hieronymus' economic capacity analysis and conclusions regarding the competitive impacts of the merger on the market. Dr. Kalt noted that Dr. Hieronymus

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[21] *Joint* Application, Exhibit WHH-1a, Supplemental Testimony and Exhibits of William H. Hieronymus on behalf of Exelon Corporation at p. 46 (filed May 27, 2005) ("Hieronymus Supplemental Testimony").

[22] *Id.*

[23] 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").

[24] *Id.* at pp. 6-9.

[25] *Id.* at p. 7.

completely ignored financial transmission rights ("FTRs") in his economic capacity analysis,[26] and failed to analyze the impact of the merger on competition in all of the relevant markets that are likely to be affected by the proposed merger, including the area of PJM prior to its expansion – commonly referred to as PJM Classic.[27]

On July 29, 2005, the Joint Applicants, the Office of Consumer Advocate ("OCA"), and the Office of Small Business Advocate ("OSBA") submitted rebuttal testimony by fourteen witnesses. The Joint Applicants put forth testimony by several witnesses, including Dr. Hieronymus who responded to the testimony of Dr. Kalt, and Mr. Jack Crowley who testified with respect to market monitoring in PJM.[28]

On August 26, 2005, eleven parties submitted surrebuttal testimony by seventeen witnesses. These written statements included responses to the five Directed Questions posed by Vice Chairman James H. Cawley and Commissioner Bill Shane on July 15, 2005. The PPL Companies submitted the surrebuttal testimony of Dr. Kalt, who responded to Dr. Hieronymus' claims on rebuttal and the Directed Questions posed by Vice Chairman Cawley and Commissioner Shane.

### C. FERC Proceedings.

On July 1, 2005, FERC issued an order authorizing the proposed merger and associated mitigation scheme on the condition that the Joint Applicants make a

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[26] *Id.* at pp. 14-19.

[27] *Id.* at pp. 24-30.

[28] 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, Rebuttal Testimony and Exhibits of PECO Energy Company and Public Service Electric and Gas Company, PECO Statement No. 3-R, Rebuttal Testimony of William H. Hieronymus ("Hieronymus Rebuttal Testimony") at p. 1, and PECO Statement No. 9-R, Rebuttal Testimony of Jack Crowley at pp. 4-5 (filed July 29, 2005).

compliance filing upon completion of the merger.[29] As part of that compliance filing, the Joint Applicants must submit an Appendix A analysis of the merger's effect on competition in energy and capacity markets, which reflects the actual plants divested and identifies the acquirers of the divested assets.[30]

In response to the FERC Merger Order, nine parties, including the PPL Companies, OCA, and Philadelphia Gas Works/City of Philadelphia filed requests for rehearing on August 1, 2005. Specifically, these parties objected to FERC's failure conduct a hearing under Section 203 of the FPA given the significant number of material issues in dispute. In addition, the PPL Companies also noted that the FERC Merger Order ignored the evidence presented by the various parties, which identified errors in the Joint Applicants' market power analysis, the ineffectiveness of their virtual divestiture proposal, their failure to address FTRs in their economic capacity analysis of PJM East, and their refusal to analyze the PJM Classic market as a separate and distinct market within PJM.[31] FERC has yet to rule on the pending requests for rehearing.

**D. Proposed Partial Settlement.**

On September 12, 2005, the Joint Applicants along with the Office of Trial Staff ("OTS"), OCA, OSBA, 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

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[29] *Exelon Corp., et al.*, 112 FERC ¶ 61,011 (2005) ("FERC Merger Order").

[30] *Id.* at Ordering Paragraph G.

[31] *See, e.g.*, Request for Rehearing of the PPL Companies, FERC Docket No. EC05-43-000 (filed Aug. 1, 2005).

Senator Anthony Williams (collectively, the "Settling Parties") filed a Joint Petition for Settlement (the "Joint Petition") which purports to resolve the issues raised by those parties regarding the merger application.[32] The Settling Parties agreed to several items, which they assert would promote the public interest, including a reduction in PECO's annual rates and a cap on PECO's retail electric transmission and distribution charges for a four-year period from January 1, 2007 through December 31, 2010. On September 14, 2005, several of the Settling Parties submitted statements in support of the Joint Petition.[33]

The PPL Companies are not a party to the settlement. On September 16, 2005, the Joint Applicants 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.[34] On September 19, 2005, the PPL Companies submitted a statement indicating that the PPL Companies neither supported nor opposed the settlement, and reiterating their belief that the Commission must specifically address the potential of the merged entity to exercise market power.[35] Also on September 19, 2005, the City of Philadelphia and Philadelphia Gas Works submitted testimony and statements opposing the settlement.

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[32] Joint Petition at p. 2.

[33] Statements were filed by OCA, Department of Environmental Protection, OSBA, OTS, PECO, the PennFuture Parties and The Reinvestment Fund.

[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, Stipulation Regarding Market Power Issues (filed Sept. 16, 2005) ("Stipulation Regarding Market Power Issues").

[35] 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

### E. Hearings.

Three days of evidentiary hearings were held on September 22-23 and 26, 2005 in Philadelphia, Pennsylvania. At the evidentiary hearings, five witnesses appeared under oath and were subject to cross-examination, including Dr. Hieronymus, who was cross-examined by the PPL Companies on September 22, 2005. Additional statements from other witnesses were admitted into evidence by stipulation, including the statements of Dr. Joseph P. Kalt on behalf of the PPL Companies. The evidentiary record was closed on September 26, 2005. In accordance with the schedule established by the ALJ, the PPL Companies submit herewith the Main Brief in this proceeding.

## III. ARGUMENT SUMMARY.

The record evidence establishes conclusively that the proposed merger of Exelon and PSEG will increase market concentration to unacceptable levels in the Commonwealth's wholesale and retail electricity markets. Under Pennsylvania law, the Commission cannot ignore these anticompetitive consequences. Section 2811 *requires* the Commission to investigate the effect of the proposed merger on the competitive retail electricity market in Pennsylvania. Any such analysis must necessarily be guided by the incipiency standard of Section 7 of the Clayton Act and the analytical framework of the federal antitrust agencies' merger guidelines. With this framework in mind, there can be no dispute that, absent effective market power mitigation, the proposed merger will allow the merged entity to unlawfully exercise market power.

First, the proposed merger significantly increases concentration in the PJM Classic market, thereby causing numerous market screen failures, which the Joint

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Into Exelon Corporation, Docket No. A-110550F0160, Statement of the PPL Companies Regarding the Joint Petition for Settlement (filed Sept. 19, 2005).

Applicants' deficient proposed mitigation plan does not remedy. Second, when imports are properly allocated based on FTR ownership, similarly unacceptable increases in market concentration are apparent in the PJM East market. The record evidence is clear: as proposed, the merger of Exelon and PSEG will adversely affect competition and cannot be permitted to proceed without additional, effective relief.

The Joint Applicants' current mitigation plan is ineffective. Their "virtual" divestiture proposal stops far short of the actual transfer of ownership, and thus does not remedy – and may actually enhance – the merged entity's ability to engage in anticompetitive conduct. Moreover, the Joint Applicants' steadfast refusal to identify the actual plants to be divested makes it impossible for the Commission to determine whether the structural divestiture proposal, in fact, will remedy the post-merger concentration in the relevant electricity markets.

As an effective mitigation tool, the proposed settlement fares no better. The agreement relies on promises of future reports and nebulous commitments to remedy future increases in market concentration, should they occur. However, such hollow concessions are no substitute for long-term structural relief. Indeed, the PPL Companies and Joint Applicants have already agreed that the settlement does not fully address the market power issues raised herein.

The Commission thus is left with two choices. Should it chose to assert jurisdiction over the proposed merger, any approval thereof must be conditioned on the Joint Applicants' acceptance of significant, critical modifications to their proposed mitigation plan. Regardless of the Commission's determination on its jurisdiction, it should nevertheless certify the record of this proceeding, along with its specific findings

regarding the anticompetitive impact of the proposed merger, to the Attorney General of Pennsylvania, the Department of Justice, FERC, and the New Jersey Board of Public Utilities ("NJBPU").

## IV. ARGUMENT

### THE RECORD IN THIS PROCEEDING DEMONSTRATES THAT THE MERGER OF EXELON AND PSEG, EVEN WITH THE PROPOSED MARKET POWER MITIGATION, WILL LESSEN COMPETITION IN WHOLESALE AND RETAIL ELECTRICITY MARKETS IN PENNSYLVANIA.

There is no dispute that the proposed merger will significantly increase concentration in wholesale electricity markets in Pennsylvania. Such an increase in concentration will permit the merged entity to exercise market power, *i.e.*, competitive constraints will not be sufficient to prevent the merged entity from raising prices. As such, the proposed merger presents a substantial threat to competition, harming both suppliers of electrical energy who must pay higher wholesale prices in order to compete with the merged entity, and consumers who must pay higher retail prices that result from increases in the underlying wholesale prices.

The Joint Applicants' own analyses demonstrate that the proposed merger exceeds the thresholds at which federal antitrust agencies and FERC find a likelihood of competitive harm. Further, as discussed below, these analyses understate the anticompetitive impacts of the merger. When the market is correctly defined and FTR ownership is properly accounted for, the severity of market concentration levels become more apparent, and the deficiencies of the Joint Applicants' mitigation plan become more evident and more troubling.

### A. The Commission Is Authorized To Investigate The Proposed Merger, Determine Whether The Merger Could Result In The Unlawful Exercise Of Market Power, And Recommend Relief.

#### 1. Section 2811 Authorizes The Commission To Investigate The Impact Of The Proposed Merger On The Proper Functioning Of A Fully Competitive Retail Electricity Market And To Refer Its Findings To Federal And State Authorities.

The Commission has an unquestioned statutory obligation to investigate the impact of the proposed merger on competition in retail electricity markets in Pennsylvania.[36] Section 2811 of the Commonwealth's Public Utility Law requires that the Commission consider the evidence before it in this proceeding and make appropriate findings.[37] Regardless of whether those findings are the basis for a Commission order requiring the Joint Applicants to mitigate the anticompetitive effect of the merger, or the basis of a recommendation to other governmental authorities that have the power to require appropriate mitigation, the Commission has a responsibility to proceed carefully, weigh the evidence, make appropriate recommendations, and publish its conclusions.

Two parts of Section 2811 are relevant to the Commission's authority to make appropriate findings with respect to the competitive impact of this merger. Section 2811(e)(1) directs the Commission to "consider whether the proposed merger . . . 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

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[36] The Joint Applicants have asked the Commission to disclaim jurisdiction over the proposed merger and have questioned the Commission's authority to require that they obtain Commission approval before consummating the merger. Joint Application at para. 20. The PPL Companies do not take a position on PECO's request that the Commission disclaim jurisdiction to approve the proposed merger.

[37] 66 Pa.C.S. § 2811.

electricity market."[38] Section 2811(e)(2) provides that the Commission shall provide an opportunity for an open public evidentiary hearing on the merger. Section 2811(e)(2) further provides that the Commission shall not approve a merger which could result in the unlawful exercise of market power, except upon "such terms and conditions as it finds necessary to preserve the benefits of a properly functioning and competitive retail electricity market."[39] The ALJ and the Commission can and should make appropriate findings based upon the evidentiary record that has been accumulated on the competitive impacts of the proposed merger.

Regardless of whether specific Commission approval is legally required before the Applicants can consummate their merger, Section 2811(b) makes clear that the Commission has the power to make specific findings on the competitive impact of the merger and refer those findings to other governmental agencies that must make a determination on competitive issues before the Joint Applicants can close their transaction. Specifically, the Commission is authorized to conduct an investigation of the impact on "the proper functioning of a fully competitive retail electricity market, including the effect of mergers, consolidations or acquisitions or dispositions of assets or securities of electricity suppliers[.]"[40] The hearings on the proposed merger before the ALJ constitute the Commission's investigation. If the Commission determines, based upon the record evidence, that the proposed merger could adversely affect competition to serve Pennsylvania retail electricity customers, the Commission is required, at a minimum, to refer those findings (and the evidentiary record underlying them) to several

[38] 66 Pa.C.S. § 2811(e)(1).

[39] 66 Pa.C.S. § 2811(e)(2).

[40] 66 Pa.C.S. § 2811(b).

governmental agencies, including the Attorney General of Pennsylvania, the United States Department of Justice and FERC.[41]

### 2. Based On The Record, The Commission Should Find That By Creating Market Power In Wholesale Electricity Markets, The Proposed Merger Will Have Both A Direct And An Indirect Impact On The Competitive Retail Electricity Market In The Commonwealth.

Based on the record before it, the Commission should find that the proposed merger poses a serious threat to competition and wholesale and retail electricity markets, even with the mitigation proposed by the Joint Applicants. As discussed more fully herein, the proposed merger will significantly reduce competition in wholesale electricity markets and increase the market power of the merged entity.[42] As suppliers pass through the resulting increased cost for wholesale power, Pennsylvania retail customers will suffer.[43] 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 (Electric Generator Suppliers or "EGSs") have been able to capture electric utility customers, clearly revealing the linkage between wholesale and retail electricity prices.[44] Moreover, when existing price caps expire, retail electricity prices increase and decrease in step with wholesale power prices.[45] Thus, to the extent the merged entity causes

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[41] 66 Pa.C.S. § 2811(d).

[42] Kalt Direct Testimony at p. 4.

[43] *Id.*

[44] *Id.* at pp. 5-6.

[45] *Id.* at p. 6.

wholesale prices to increase through an exercise of market power, retail prices will move in tandem, leading to higher costs for electricity.[46]

Another serious consequence of the Joint Applicants' ability to exercise market power would be that 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.[47]

Thus, the Commission must: (1) find that the proposed merger will result "in anticompetitive or discriminatory conduct, including the unlawful exercise of market power, which will prevent retail electricity customers in the Commonwealth from obtaining the benefits of a properly functioning and workable competitive retail electricity market;"[48] and (2) refer such findings to federal and state authorities.

### B. In Evaluating The Impact Of The Merger On Competition, The Commission Should Employ The Incipiency Standard Of Section 7 Of The Clayton Act And The Analytical Framework Of The DOJ/FTC Merger Guidelines.

Although Section 2811 requires the Commission to assess the competitive impact of a proposed merger, it does not specifically set forth the standards the Commission is to apply. To provide content to its obligations, the Commission should look to federal

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[46] *Id.*

[47] *Id.*; Tr. at 428.

[48] 66 Pa.C.S. § 2811(e).

antitrust law for guidance. Through decades of experience in dealing with mergers, federal courts and the federal antitrust enforcement agencies have developed an extensive body of law and expertise in applying antitrust principles.[49] It is the practice of federal administrative agencies that address competitive issues, including the competitive impact of mergers, to apply "the fundamental national economic policy expressed in the antitrust laws."[50]

The competitive effects of mergers and acquisitions are principally governed by Section 7 of the Clayton Act, which prohibits such transactions "where in any line of

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[49] Unlike numerous other states, Pennsylvania has no state antitrust law. However, states that have such laws, either by statute or precedent, often defer to federal precedents. Antitrust Law Developments, A.B.A. Sec. Antitrust L., p. 811 nn.57-58 (5th ed. 2002). Indeed, State Attorneys General, including the Pennsylvania State Attorney General's Office, have challenged a large number of mergers under Section 7 of the Clayton Act, usually in circumstances where the merger would allegedly lessen competition in local geographic markets in their states. *Id.* at p. 326 & n.69 (5th ed. 2002) (citing *Pennsylvania v. Providence Health Sys., Inc.*, 1994-1 Trade Cas. (CCH) ¶ 70,603 (M.D. Pa. 1994) (challenging hospital merger); *Pennsylvania v. Russell Stover Candies, Inc.*, 1993-1 Trade Cas. (CCH) ¶ 70,224 (E.D. Pa. 1993) (challenging merger in boxed chocolates market); City of *Pittsburgh v. May Dep't Stores Co.*, 1986-2 Trade Cas. (CCH) ¶ 67,304, at 61,551-52 (W.D. Pa. 1986) (suit by state, county, and city to enjoin merger of two department store chains); *California v. Sutter Health Sys.*, 84 F. Supp. 2d 1057 (N.D. Cal.), *aff'd*, 217 F.3d 846 (9th Cir. 2000) (challenging hospital merger); *New York v. Kraft of Gen. Foods, Inc.*, 862 F. Supp. 1035 (S.D.N.Y. 19994) (challenging acquisition by Kraft of the ready-to-eat cereal assets of Nabisco); *Washington v. Texas Ref. & Mktg., Inc.*, 1991-1 Trade Cas. (CCH) ¶ 69,346 (W.D. Wash. 1991) (challenging merger of retail gasoline stations); *Connecticut ex rel. Riddle v. Wyco New Haven, Inc.*, 1990-1 Trade Cas. (CCH) ¶ 69,024 (D. Conn. 1990) (challenging merger of oil terminal facilities in New Haven harbor); *California ex rel. Van de Kamp v. American Stores Co.*, 697 F. Supp. 1125, 1127 (C.D. Cal. 1988), *aff'd in part and rev'd in part*, 872 F.2d 837 (9th Cir. 1989), *rev'd*, 495 U.S. 271 (1990) (suit by state to challenge supermarket acquisition); *Massachusetts v. Campeau Corp.*, 1988-1 Trade Cas. (CHH) ¶ 68,093 (D. Mass. 1988) (suit by three states to enjoin merger of two department store chains)).

[50] *Gulf States Utils. Co. v. FPC*, 411 U.S. 747, 759-60, *reh'g denied*, 412 U.S. 944 (1973). *See, e.g., FMC v. Svenska Amerika Linien*, 390 U.S. 238, 244 (1968); *FCC v. RCA Commc'ns, Inc.*, 346 U.S. 86, 94 (1953); *McLean Trucking Co. v. United States*, 321 U.S. 67, 80 (1944); *FPC v. Conway Corp.*, 426 U.S. 271, 279 (1976); *California v. FPC*, 369 U.S. 482, 484-85 (1962); *Kansas Power & Light Co. v. FPC*, 554 F.2d 1178, 1184 (D.C. Cir. 1977); *Maryland People's Counsel v. FERC*, 761 F.2d 780, 786 (D.C. Cir. 1985); *Atlantic Seaboard Corp. v. FPC*, 404 F.2d 1268, 1272 n.10 (D.C. Cir. 1968); *Connecticut Light & Power Co.*, 8 FERC ¶ 61,187, at p. 61,653, *reh'g denied*, 9 FERC ¶ 61,313 (1979).

commerce or any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly."[51] Section 7 was enacted to reach incipient anticompetitive effects not reached by Section 1 of the Sherman Act.[52]

In construing Section 7 of the Clayton Act, the United States Supreme Court has ruled that Congress intended for market concentration to be confronted in its incipiency. Congress viewed the process of concentration in American business as a dynamic force, and sought to provide the Federal Trade Commission and the courts with "the power to brake this force at its outset and before it gathered momentum."[53] No restraints, monopolies, or substantial lessening of competition need actually occur to violate Section 7.[54] The United States Supreme Court has held that Section 7 is concerned with probabilities, not certainties.[55] The statute laid the foundation for a thorough review of an acquisition before it is consummated, which in turn allows an informed assessment of whether the increased concentration will likely result in anticompetitive effects. It thus provides antitrust enforcement authorities with an opportunity to block an acquisition or structure sufficient relief to prevent any competitive harm from occurring. The Department of Justice and the Federal Trade Commission – the primary federal agencies charged with enforcing Section 7 – have published guidelines and statements setting forth their merger enforcement policies, including the Horizontal Merger Guidelines published

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[51] 15 U.S.C. § 18 (2000).

[52] *United States v. Penn-Olin Chem. Co.*, 378 U.S. 158, 170-71 (1964).

[53] *Brown Shoe Co. v. United States*, 370 U.S. 294, 317-318 (1962); *see also Cargill, Inc. v. Monfort of Colorado, Inc.*, 479 U.S. 104, 125 (1986) (citing *Brown Shoe*).

[54] *Midwestern Mach., Inc. v. Northwest Airlines, Inc.*, 167 F.3d 439, 442 (8th Cir. 1999).

[55] *Brown Shoe*, 370 U.S. at 323.

in 1992.[56] FERC also adopted the analytical framework of the Horizontal Merger Guidelines in its 1996 Merger Policy Statement,[57] and in Appendix A to that statement, developed a prescribed methodology for calculating changes in market concentration caused by the merger in the relevant destination markets.[58]

The Horizontal Merger Guidelines' analysis requires identifying the relevant product markets affected by the merger in each geographic market area serviced by the Merging Parties, as well as identifying all other suppliers competing in those markets. Pre- and post-merger market concentrations are then calculated using the Herfindahl-Hirschman Index ("HHI") index, as well as the changes in market concentrations.[59] The Horizontal Merger Guidelines address three ranges of market concentration:

> (1) an unconcentrated post-merger market – if the post-merger HHI is below 1000, regardless of the change in HHI the merger is unlikely to have adverse competitive effects; (2) a moderately concentrated post-merger market – if the post merger HHI ranges from 1000 to 1800 and the change in HHI is greater than 100, the merger potentially raises significant competitive concerns; and (3) a highly concentrated post-merger market – if the post-merger HHI exceeds 1800 and the change in HHI exceeds 50,

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[56] *See* 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) ("Horizontal Merger Guidelines").

[57] 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) ("Merger Policy Statement").

[58] Merger Policy Statement, 61 Fed. Reg. at 68,606-07.

[59] The HHI is calculated by summing the squares of the market shares of all market participants. The change is calculated by simply comparing the pre- and post-merger HHIs. Thus, a market with a single competitor would have an HHI of 10,000 (100 percentage points squared). A market with five 20 percent firms would have an HHI of 2000 (20 squared (400) times 5), and be viewed as a highly connected market. If two of those firms merged to form a 40 percent share firm, the HHI would increase to 2800 (40 squared (1600) plus 20 squared times 3), an increase of 800 and under the Guidelines, the merger would be considered presumptively unlawful.

> the merger potentially raises significant competitive concerns; if the change in HHI exceeds 100, it is presumed that the merger is likely to create or enhance market power.[60]

The federal agencies have applied this analysis in thousands of merger investigations over the past twenty years. The Horizontal Merger Guidelines have also been accepted in numerous federal cases that have considered challenges to proposed mergers under Section 7 of the Clayton Act.[61] The Joint Applicants' merger application and proposed mitigation is based on the Horizontal Merger Guidelines' principles and Appendix A analysis prepared by its expert, Dr. Hieronymus, as is the analysis of Dr. Kalt. Given its wide acceptance, the Commission should adopt the Horizontal Merger Guidelines' analysis analysis in evaluating the Joint Applicants' proposed merger.

### C. Unless Properly Mitigated, The Proposed Merger Will Permit The Exercise Of Market Power, Thus Lessening Competition.

The record evidence is clear – the proposed merger will cause significant increases in market concentration in the PJM Classic and PJM East markets, thereby lessening competition in those markets and permitting the exercise of market power. The Joint Applicants made three errors in carrying out their flawed market concentration analysis: (1) they ignored the PJM Classic market; (2) they ignored FTR ownership in calculating imports and market share in the PJM East market; and (3) they proposed only virtual divestiture of nuclear baseload capacity – something that will do little to mitigate the merged entity's ability and incentive to exercise market power.

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[60] *Merger Policy Statement*, 61 Fed. Reg. at 68,601 n.33; *see* Horizontal Merger Guidelines, § 1.51.

[61] *See, e.g., FTC v. Cardinal Health, Inc.*, 12 F. Supp. 3d 34 (D.D.C. 1998); *New York v. Kraft Gen. Foods, Inc.*, 926 F. Supp. 321 (S.D.N.Y. 1995); *Community Publishers, Inc. v. Donrey Corp.*, 892 F. Supp. 1146, 1153 n.6 (W.D. Ark. 1995), *aff'd*, 139 F.3d 1180 (8th Cir. 1998); *Bon-Ton Stores, Inc. v. May Dep't Stores Co.*, 881 F. Supp. 860 (W.D.N.Y. 1994)..

When the Joint Applicants' analysis is corrected for these analytical flaws, a far different picture of the proposed merger emerges. Contrary to the Joint Applicants' claims regarding their mitigation proposals, the transaction will significantly increase market concentration and provide the merged entity with the ability to exercise substantial market power, as the following two tables illustrate. The first table, excerpted from the PPL Companies' Exhibit JPK-5, shows the increase in market concentration and market share if virtual divestiture fails as effective mitigation in the PJM Classic market. There are screen failures in each of the load/price conditions, with a highly concentrated market (above 1800 HHI) in two markets, where the proposed merger is presumed to create or enlarge market power.[62]

[62] Merger Policy Statement, 61 Fed. Reg. at 68,601 n.33.

**PJM Classic Market Assuming Virtual Divestiture Fails**

| Period | Pre-Merger HHI | Post-Mitigation Market Share | Post-Merger Post-Mitigation HHI[63] | Increase in HHI | Merger Screen Failure |
|---|---|---|---|---|---|
| S_SP1 | 983 | 32% | 1261 | 278 | Yes |
| S_SP2 | 960 | 32% | 1264 | 304 | Yes |
| S_P | 1008 | 33% | 1299 | 291 | Yes |
| S_OP | 1395 | 44% | **2250** | 855 | Yes |
| W_SP | 931 | 31% | 1232 | 301 | Yes |
| W_P | 980 | 32% | 1258 | 278 | Yes |
| W_OP | 1050 | 32% | 1456 | 406 | Yes |
| SH_SP | 1016 | 33% | 1319 | 303 | Yes |
| SH_P | 1055 | 32% | 1468 | 413 | Yes |
| SH_OP | 1343 | 42% | **2096** | 753 | Yes |

The next table, excerpted from the PPL Companies' Exhibit JPK-8, shows the increase in market concentration and market share if virtual divestiture fails as effective mitigation in the PJM East market and FTRs are considered in calculating market shares. There are screen failures and highly concentrated markets in all ten of the load/price conditions, with market shares exceeding 40% in every load price condition and 50% in four. In each of the load/price conditions, the proposed merger would be presumed as "likely to create or enhance market power or facilitate its exercise."[64]

[63] Highly concentrated markets are shown in bold face type.

[64] Horizontal Merger Guidelines, § 1.51; *see* Merger Policy Statement, 61 Fed. Reg. at 68,601 n.33.

**PJM East Market Assuming Virtual Divestiture Fails And FTRs Are Used To Calculate market Shares**

| Period | Pre-Merger HHI | Post-Mitigation Market Share | Post-Merger Post-Mitigation HHI[65] | Increase in HHI | Merger Screen Failure |
|---|---|---|---|---|---|
| S_SP1 | 1491 | 40% | **1991** | 499 | Yes |
| S_SP2 | 1437 | 41% | **2032** | 594 | Yes |
| S_P | 1705 | 45% | **2268** | 563 | Yes |
| S_OP | 2083 | 60% | **3679** | 1596 | Yes |
| W_SP | 1455 | 42% | **2069** | 615 | Yes |
| W_P | 1643 | 44% | **2187** | 545 | Yes |
| W_OP | 1930 | 54% | **3129** | 1199 | Yes |
| SH_SP | 1439 | 41% | **1981** | 543 | Yes |
| SH_P | 1705 | 51% | **2746** | 1041 | Yes |
| SH_OP | 2039 | 58% | **3504** | 1465 | Yes |

Set forth below is the record support for a Commission finding that, even accounting for Joint Applicants' flawed mitigation scheme, the proposed merger of Exelon and PSEG will lessen competition in the PJM markets.

### 1. The Proposed Merger Increases Concentration In The Original PJM Classic Market.

Although the historical PJM Classic market was enlarged in 2002, when Allegheny Power ("APS") integrated into PJM, PJM's Western Interface still creates congestion that separates APS' service territory from the PJM Classic market.[66] Both Dr. Hieronymus and Dr. Kalt agree that the Bedington-Black Oak line, which is a pathway

[65] Highly concentrated markets are shown in bold face type.

[66] Kalt Direct Testimony at p. 14.

between APS and the PJM Classic market,[67] was identified by PJM as "the single most constrained facility in PJM during 2004."[68] In fact, as Dr. Kalt explains, the congestion associated with the Bedington-Black Oak line, combined with the APS south interface, restrict west-to-east flows of power.[69] As a result, these limitations on facilities located upstream from the PJM Classic market clearly result in price separation between PJM Classic and the rest of PJM for sustained periods.[70] The result is sustained price differentials between APS and PJM Classic, as depicted in Dr. Kalt's Exhibit JPK-2.[71]

As Dr. Kalt explains, "[p]roper examination of PJM Classic [] requires the Merging Parties to treat APS-owned generation as competing for scarce transmission imports."[72] Dr. Kalt examined the PJM Classic market as shown in his Exhibit JPK-4. Under the Joint Applicants' mitigation assumptions (including their dubious virtual divestiture plan), the proposed merger increases concentration well above acceptable levels in six of the ten load/price conditions. Dr. Kalt's analysis was based upon a discovery response of the Joint Applicants.[73] While the Joint Applicants have disputed

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[67] Dr. Hieronymus attempts to make much of the fact that the Bedington-Black Oak line is not defined as part of PJM Western Interface. However, his distinction is one without a difference. The PJM Western Interface has been a defined internal PJM interface since the beginning of the PJM market. *Atlantic City Elec. Co., et al.*, 86 FERC ¶ 61,248, at p. 61,896, *reh'g denied*, 88 FERC ¶ 61,039 (1999). At that time APS was external to PJM. Bedington-Black Oak is now internal to PJM, yet like the traditional Western Interface, separates substantial generation from most of the load in PJM Classic. Tr. at 418.

[68] Kalt Direct Testimony at p. 17; Kalt Surrebuttal Testimony, JPK-13 (Hieronymus Deposition Transcript) at p. 3 (agreeing with Dr. Kalt that the Bedington-Black Oak line is the most constrained interface in PJM); Tr. at 419:4-7 (recognizing same).

[69] Kalt Direct Testimony at p. 18 (citing PJM 2004 State of the Market Report at 218).

[70] *Id.*

[71] *Id.*; Kalt Direct Testimony, Exhibit JPK-2.

[72] Kalt Surrebuttal Testimony at p. 11.

[73] *See* Kalt Direct, Exhibit JPK-11.

the existence of a PJM Classic market, they have not disputed the accuracy of Exhibit JPK-11.

Nonetheless, the Merging Parties refuse to analyze the PJM Classic market separately from the APS zone. Their unstated reason for doing so is readily apparent. By combining APS' significant generation supply with the PJM Classic market, Dr. Hieronymus is able to inflate the amount of competing generation that is not affiliated with the Merging Parties, which, in turn, dilutes the impact the Merging Parties' generation has on the market analysis. However, when APS' presence in that market is removed, the Merging Parties opportunities to exert market power become readily apparent, as numerous market screen failures are observed.[74]

Despite this clear record evidence, Dr. Hieronymus refuses to concede that the PJM Classic market must be separately considered. Instead, Dr. Hieronymus defends his decision to combine PJM Classic and APS by relying upon the fact that since APS joined PJM, PJM is able to redispatch generation units when the Western Interface is constrained, thereby preserving the flows from west to east and eliminating the potential for constraint.[75] Although Dr. Hieronymus' response may explain PJM's plan to reduce constraints across the Western Interface, it does not explain the significant price differentials that exist between the two sides of the Western Interface,[76] nor does it address the congestion that causes the need to redispatch in the first place.[77] In fact, by

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[74] Kalt Direct Testimony, Exhibits JPK-4 and JPK-11 (demonstrating the impact of the proposed merger on the PJM Classic market).

[75] Hieronymus Supplemental Testimony at p. 22.

[76] Kalt Direct Testimony, Exhibits JPK-2 and JPK-3.

[77] Kalt Surrebuttal Testimony at p. 12 n.15.

acknowledging that redispatch occurs, Dr. Hieronymus essentially admits that higher prices are being sustained on the eastern side of the Western Interface.[78]

It is important to note that, although "congestion" and "constraint" are often used interchangeably, in reality they are not the same. Markets can separate as a result of congestion even if that congestion never reaches the point of an actual constraint limiting the power flowing over a line. As Dr. Kalt explains:

> Congestion occurs when available, low-cost energy cannot be delivered to all loads because of limited transmission capabilities. When the least cost available energy cannot be delivered to load in a transmission-constrained area, higher cost units must be dispatched in this constrained area to meet that load. The result is that the price of energy in the constrained area is higher than elsewhere because of transmission limitations.[79]

Although redispatch may allow PJM to prevent a constraint it does not mean congestion has been eliminated. Rather, as Dr. Hieronymus admits, redispatching is a sign of congestion and requires PJM to call on more expensive units on the high-price side of the constraint to alleviate the congestion and prevent constraint.[80] Redispatching more expensive units on the high-price side of the constraint is not evidence supporting the existence of a single geographic market. Rather, if PJM Classic cannot call upon less expensive units in APS because of congestion, and is forced to redispatch more expensive units within the PJM Classic area, this confirms that PJM Classic is a separate market.[81]

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[78] *Id.*

[79] Kalt Direct Testimony at p. 16 (quoting PJM Interconnection, L.L.C., Market Monitoring Unit, 2004 State of the Market Report at 201 (Mar. 8, 2005) (footnotes omitted) ("PJM 2004 State of the Market Report"), *available at* http://www.pjm.com/markets/market-monitor/som.html).

[80] Kalt Direct Testimony at p. 16; Kalt Surrebuttal Testimony at p. 12 n.15. *See also* Kalt Surrebuttal Testimony, Exhibit JPK-13 (Hieronymus Deposition Transcript) at p. 2 (admitting that redispatch generally involves higher prices on the downstream side of the interface).

[81] Kalt Surrebuttal Testimony at p. 12 n.15.

The evidence indicates that higher prices are sustained on the eastern side of the Western Interface and that a separate market, PJM Classic, exists.[82] In fact, a review of the price differentials on either side of the western constraint reveals persistent average price differentials that at times become significant across the Western Interface.[83] As Dr. Kalt's Exhibit JPK-2 illustrates, there are persistent price differences between the APS zone and the other end of its path into PJM Classic at the PEPCO Zone.[84] Such price differentials are readily traceable to specific congestion problems identified in the PJM 2004 State of the Market Report.[85]

Dr. Hieronymus tries to discredit the price differentials found in Dr. Kalt's Exhibit JPK-2 by comparing them to price differentials in other markets.[86] As Dr. Hieronymus admits, however, the prices depicted in Exhibit JPK-2 and in his Exhibit WHH-3 are average prices.[87] And although Dr. Hieronymus may be able to divide up other markets to demonstrate higher average price differentials, this does not eliminate the fact that price differentials exist between APS and PJM Classic.

Moreover, when the summer and winter periods are isolated from the yearly average price, the price differentials are more severe.[88] As Dr. Kalt demonstrates in Exhibit JPK-3, although the average yearly price differential between the APS and PEPCO zones in 2004 was $3.27 per MWh, the monthly price differentials between those

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[82] *Id.*

[83] Kalt Direct Testimony, Exhibits JPK-2 and JPK-3.

[84] Kalt Direct Testimony, Exhibit JPK-2; *see also id.* at p. 18.

[85] *See* Kalt Direct Testimony at p. 17.

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

[87] Tr. at 406:15-16.

[88] Kalt Direct Testimony at p. 18 and Exhibit JPK-3.

zones reached as high as $15 per MWh in the winter and summer months. Dr. Kalt explained that, when examined over a period of several months, a pattern emerges demonstrating sustained price differentials of $5-10/MWh during the summer and winter months.[89] Such seasonal price differentials demonstrate further congestion, which isolates the APS zone from the historical PJM Classic market.[90]

### 2. The Proposed Merger Increases Concentration In The PJM East Market To An Even Greater Extent Than Conceded By Joint Applicants When FTR Ownership Is Considered In Determining Market Shares.

There is no question that the impact of the proposed merger on the PJM East market is significant. That is where most of the Joint Applicants' 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] Dr. Kalt demonstrated that the Joint Applicants' analysis of post-merger market concentration in PJM East is flawed. The Joint Applicants claim to have proposed sufficient mitigation to address the increase in market concentration caused by the merger. However, when generation imports into PJM East are assigned based on FTR ownership, rather than the *pro rata* or "squeeze down" method used by Dr. Hieronymus, a different picture of the effect of the proposed merger, even with the proposed divestiture, emerges. Dr. Hieronymus ignored the impact of FTRs in his analysis of the merger's impact on a post-merger market place.[93] That choice has a significant effect on his ability to predict the proposed merger's impact on market

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[89] *Id.*

[90] Kalt Direct Testimony at p. 18.

[91] Hieronymus Direct Testimony at p. 4.

[92] Tr. at 413.

[93] Tr. at 415; Kalt Direct Testimony at 24.

concentration levels and ultimately its impact on Pennsylvania retail customers.[94] Set forth below is a table based on Exhibit JPK-7 that shows revised market concentration calculations when transmission import capability across the Eastern Interface are allocated based upon FTR ownership.

| Period | Pre-Merger HHI | EEG Post-Mitigation Market Share | Post-Merger Post-Mitigation HHI[95] | Increase in HHI | Merger Screen Failure |
|---|---|---|---|---|---|
| S_SP1 | 1491 | 37% | 1774 | 282 | Yes |
| S_SP2 | 1437 | 36% | 1734 | 297 | Yes |
| S_P | 1705 | 38% | **1807** | 102 | Yes |
| S_OP | 2083 | 45% | **2300** | 217 | Yes |
| W_SP | 1455 | 37% | 1757 | 302 | Yes |
| W_P | 1643 | 37% | 1741 | 99 | No |
| W_OP | 1930 | 43% | **2150** | 220 | Yes |
| SH_SP | 1439 | 35% | 1661 | 223 | Yes |
| SH_P | 1705 | 41% | **1987** | 282 | Yes |
| SH_OP | 2039 | 45% | **2263** | 224 | Yes |

As this analysis demonstrates, when allocating imports based upon FTRs, even accounting for both the actual and virtual divestitures proposed by the Joint Applicants, the post-merger mitigated market would be more concentrated. Indeed, there would be market 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. The table provides a telling snapshot of how the Merging

[94] Kalt Direct Testimony at p. 29. *See also Id.*, Exhibit JPK-7 (demonstrating the effects of FTR on the economic capacity analysis).

[95] Highly concentrated markets are shown in bold face type.

Parties' FTRs would play a significant role in their ability to exercise market power in a post-merger market – an impact the Joint Applicants chose to ignore.

### a) FTRs Provide The Merging Parties With The Incentive To Withhold And The Ability To Benefit From The Withholding.

As Dr. Hieronymus recognizes, FTRs are financial rights to congestion costs along a given transmission pathway,[96] and hence allow a holder to hedge against price increases in prices in a given market.[97] By obtaining FTRs, entities such as Exelon and PSEG are able to ensure that their costs are predictable when buying power outside of PJM East to meet their load obligations within PJM East.[98]

FTRs also allow the Joint Applicants to use their generation resources located outside of PJM East to compete effectively in PJM East. Because Exelon and PSEG own a combined total of 5,500 MW of capacity on the western side of the eastern interface, PSEG and Exelon are "viable importers into PJM East."[99] Dr. Kalt explains that "[b]ecause the Merging Parties have preferential access to significant quantities of FTRs, they can compete, in effect, as if their generation resources located outside of PJM East were actually located in PJM East."[100] As a result, if prices rise in PJM East, the Merging Parties are able to use their FTRs to ensure that they are not penalized by the increased congestion costs associated with their imports of generation from western PJM, even if those price increases result from an exercise of market power.

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[96] Tr. at 383:11-17.

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

[98] Kalt Direct Testimony at pp. 26-27.

[99] Kalt Direct Testimony at p. 26.

[100] Kalt Surrebuttal Testimony at p. 14.

As an example, Dr. Kalt describes a likely scenario involving PECO's use of FTRs to move energy from its nuclear facilities west of the eastern interface into the constrained PJM East market:

> As an example, PECO holds FTRs that inject (source) power at the Three Mile Island and Peach Bottom nuclear unit buses and deliver (sink) power in the PECO service territory. By holding these rights, PECO can schedule an injection of power in PJM west of the eastern interface and a companion delivery into its service territory. Although there is no physical right or path whereby the power is necessarily delivered over the transmission system to PECO's service territory (although some of the generation surely reaches its service territory), financially PECO's costs for this transaction are predictable (as Dr. Hieronymus notes at page 20 of his Rebuttal Testimony) and enable it, in economic effect, to compete on the congested side of the affected interface. When competing and pricing power for future delivery into PJM East, PECO can take into account the merged entity's generation located outside PJM East.[101]

As this example demonstrates, the Merging Parties essentially are able to rely upon this 5,500 MW as if it is located in a constrained PJM East.[102]

Ownership of significant amounts of FTRs also provides the Merging Parties with an incentive to withhold generation in PJM East because any such withholding will increase the value of both their generation *and* their FTRs.[103] As Dr. Hieronymus acknowledged during the hearing, if the value of generation in PJM East increases relative to generation outside of PJM East, the value of the FTRs across the interface into PJM East will also increase.[104] He conceded that this provides an incentive for withholding.[105]

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[101] Kalt Surrebuttal Testimony at p. 15.

[102] *Id.* at p. 14.

[103] *Id.* at p. 18.

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

[105] *See* Kalt Surrebuttal Testimony, Exhibit JPK-13 at pp. 8-9.

Dr. Hieronymus has been unable to refute the analysis performed by Dr. Kalt, but refuses to revise his economic capacity analysis to account for the Merging Parties' FTR ownership. Instead, Dr. Hieronymus continues to rely on his hypothetical *pro rata* "squeeze down" method for assigning shares of transmission imports in his economic capacity analysis. In contrast to Dr. Kalt's reasoned analysis of the impact of PJM East import capacity on market shares, when questioned, Dr. Hieronymus was unable to identify how much import capacity his hypothetical method actually allocated to market participants in PJM East.[106] Indeed, Dr. Hieronymus submitted his testimony and rebuttal testimony in this proceeding without even bothering to check whether his proposed allocation of PJM East import capacity made sense or could be checked.[107] Such uncertainty on an issue that affects whether the proposed merger violates the market concentration screens in PJM East is unacceptable.

**b) Dr. Hieronymus' Attempt To Rebut Dr. Kalt's Use Of FTRs To Allocate Imports Contains Serious Flaws.**

Dr. Hieronymus mounts two arguments against the use of FTRs to allocate PJM East import capacity for purposes of calculating market shares. First, he argues that FTRs have a life of only one year and do not provide the same certainty as ownership of generation.[108] Second, he claims that any advantage of FTR ownership would be

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[106] Tr. at 413:10-414:3.

[107] *Id.* Apparently, at the time he submitted his testimony, Dr. Hieronymus did not know enough about his own model's treatment of import capacity allocation to know how it could be checked. He admitted that, at the time he testified at his deposition on August 17, 2005, he erroneously believed that import capacity allocation could only be checked "with extreme difficulty." Tr. at 414:4-10.

[108] Hieronymus Rebuttal Testimony at pp. 20-21.

"washed out" by the obligation to serve load.[109] Both arguments are flawed and should be rejected.

It is true that ownership of grandfathered FTRs – those allocated by PJM rather than sold through the secondary market – generally follows load serving obligations in PJM. It is not true, however, that the Merging Parties cannot count on the continued receipt of a substantial amount of FTRs for the foreseeable future. Particularly for a handful of pre-1998 load-serving entities in PJM, such as PECO and PSEG, that have been given "preferential access" to FTRs, this can provide a significant advantage. As Dr. Kalt explains:

> The PJM Open Access Transmission Tariff provides a means by which so-called "network service users" (primarily load-serving entities, "LSEs") may request auction revenue rights ("ARRs") in relation to the load they serve using network service. Load-serving entities in a zone may elect ARRs that source from a list of generators that existed in 1998, and sink at the distributed load in the zone, up to the LSE's prorated share of the load in the zone. While ARRs entitle their holder to receive a share of the revenue from the annual PJM auction of FTRs, they also can be "self scheduled," i.e., converted into an FTR along the same source/sink path as the ARR. Because the Merging Parties own generation west of the PJM East constraint that has historically (as of 1998) been used to serve load in PJM East, they are in a position to match this generation with their self-scheduled FTRs and are hedged against congestion charges when moving that generation into PJM East. To the extent the merged entity will continue to serve relevant load, preferential rights (ARRs) are available that will allow the merged company to obtain these financial hedges with considerable certainty.[110]

Any claim that this "preferential access" will not continue into the future ignores the reality of the grandfathering process by which the Merging Parties are able to obtain their

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[109] *Id.*

[110] Kalt Surrebuttal Testimony at p. 14 (citations omitted).

annual allotment of FTRs.[111] 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. Therefore, PECO can expect to continue to receive a significant amount of ARRs each year based upon this load amount.[112]

In his oral rejoinder, Dr. Hieronymus attempts to undermine Dr. Kalt's concerns by claiming 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 in the constrained PJM East.[113] Dr. Hieronymus claims "the incentive effect is washed out."[114] Dr. Hieronymus' response, however, contains several obvious flaws.

First, the significant amounts of FTRs owned by the Merging Parties allow them to treat their generation located outside of PJM East as if were located inside PJM for pricing purposes. 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] Second, Dr. Hieronymus' contention that the incentive is "washed out" by the increased cost to serve load ignores the fact that Dr. Kalt's analysis, which accounts for FTRs, 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]

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[111] Hieronymus Rebuttal Testimony at pp. 21-22.

[112] Kalt Surrebuttal Testimony at p. 17.

[113] Tr. at 384:4-14.

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

[115] Kalt Surrebuttal Testimony at p. 18.

[116] Kalt Direct Testimony, JPK-8.

[117] Hieronymus FERC Direct Testimony at p. 47.

As Dr. Hieronymus is fully aware, load is not considered in an economic capacity analysis.[118] Therefore, there would be no "wash out" effect.

Moreover, even assuming that the Merging Parties' load is accounted for in the analysis, the incentive to withhold generation *still exists*. Contrary to Dr. Hieronymus' claims, load and FTRs are not linked. Load can be supplied by many sources, including being self-supplied from affiliate generation located in PJM East. A careful review of Dr. Hieronymus' available economic capacity analysis of the PJM East market demonstrates that, in all time periods analyzed, both Exelon and PSEG have sufficient quantities of generation supply in PJM East to serve their native load obligations.[119] Therefore, FTRs are not necessary to supply their load. Accordingly, an increase in the cost of supplying load will not "wash out" the gains experienced by increasing the value of the FTRs.

### 3. The Joint Applicants' Virtual Divestiture Proposal Does Not Eliminate Their Incentive To Exercise Market Power.

Central to the Joint Applicants' case is their reliance upon "virtual divestiture" as the means by which the anticompetitive effects of the proposed merger of two large fleets of generating plants will be mitigated. *Without the* acceptance of virtual divestiture as a cure-all, the proposed merger would produce significant increases in market concentration and, hence, significant failures in the competitive impact screens in both the PJM Classic and PJM East markets – and even in the PJM pre-2004 relevant market defined by Dr. Hieronymus.[120] However, as discussed below, the Joint Applicants'

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[118] Hieronymus Rebuttal Testimony at pp. 21-22.

[119] Hieronymus Supplemental Testimony, Exhibit J-19.

[120] *See, e.g.*, Kalt Direct Testimony at pp. 10, 23, and 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

virtual divestiture proposal is not a magic elixir that remedies the unlawful increases in market power that would result from the merger. Virtual divestiture lacks the significant benefits to the competitive marketplace that occur with an actual transfer of ownership. In fact, this virtual divestiture proposal may actually provide additional opportunities for the merged entity to engage in anticompetitive conduct.[121]

**a) Structural Relief Is Superior To Contractual Relief.**

Mere contracts for the sale of power are poor substitutes for the divestiture of actual ownership of divested assets.[122] Unlike virtual divestiture, actual structural relief provides certainty of result and eliminates the need for continued regulatory monitoring and intervention by the regulator at both the state and federal levels. As the Department of Justice recognizes, "[s]tructural remedies are preferred to conduct remedies in merger cases because they are relatively clean and certain, and generally avoid government entanglement."[123] In contrast, a conduct remedy "typically is more difficult to craft, more cumbersome and costly to administer, and easier than a structural remedy to circumvent."[124]

Despite the clear preference for the actual transfer of ownership of generating assets, the Joint Applicants propose to "virtually" divest 2,600 MW of baseload nuclear

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failures are severe when the virtual divesture of nuclear facilities is ineffective as merger mitigation). *See also* Kalt Direct Testimony at p. 19 and 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 p. 5.

[121] *See* Kalt Direct Testimony at p. 20; Kalt Surrebuttal Testimony at p. 8.

[122] *See* Kalt Direct Testimony at p. 20 ("As far as merger mitigation is concerned, contracts for sale of power cannot reasonably be expected to replicate the benefits of actual ownership of divested assets.").

[123] U.S. Department of Justice, *Antitrust Division Policy Guide to Merger Remedies* at 8 (Oct. 2004) ("*DOJ Merger Remedies Guide*").

[124] *Id.*

capacity either through firm long-term contracts or annual auctions of three-year firm entitlements.[125] No right to control the plants will accompany the contracted-for energy, and thus the first option is likely to be much less attractive to potential buyers.[126] Accordingly, the vast majority of the virtually divested capacity will be sold in auctions, with one-third of the divested amount initially auctioned for one year forward, one-third auctioned for two years forward, and one-third for three years forward.[127] Thereafter, during each future year, one-third of the virtually divested capacity will be auctioned off again for three-year terms.[128] As explained below, the Joint Applicants' retention of control over their nuclear facilities, combined with the expected repeated auctions for three-year forward sales of "virtually divested" capacity, create incentives for the merged entity to discover means to repeatedly affect near-term forward market electricity prices.

**b) Virtual Divestiture Leaves The Joint Applicants With The Incentive And Ability To Exercise Market Power.**

As the Joint Applicants have indicated on numerous occasions, a primary driver for the merger is the combination of the Joint Applicants' nuclear assets.[129] Given that nuclear plants are the most efficient generators of electricity, any means by which prices realized by these facilities can be increased will significantly increase earnings for the merged entity. Even if the extent to which the merged entity can control the operation of its nuclear facilities is limited by technical and economic concerns, the continued

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[125] Hieronymus Direct Testimony, Exhibit WHH-1 at pp. 7-8; *see also* Kalt Direct Testimony at pp. 20-21. 2,400 MW will be virtually divested in PJM East, while 200 MW will be virtually divested in the larger PJM Pre-2004 region. *See* Tr. at 421:15-18.

[126] Kalt Direct Testimony at pp. 21-22.

[127] *See* Hieronymus FERC Direct Testimony at p. 7; Kalt Direct Testimony at pp. 21-22.

[128] *See* Hieronymus FERC Direct Testimony at p. 7; Kalt Direct Testimony at p. 21.

[129] Joint Application at para. 27.a(iii), c, e; *see also* Kalt Surrebuttal Testimony at p. 5.

ownership of those facilities will provide a strong incentive to withhold other, more flexible generating facilities to affect price. Thus, the proposed merger creates an incentive to withhold generating capacity, and thereby increase the profit to be realized from the virtual divestiture auctions.[130]

By refusing to physically divest their nuclear facilities, the Joint Applicants will retain control of their operation and will be able to use this control to influence the price of energy at the annual three-year virtual divestiture auctions. The Joint Applicants' own expert, Dr. Hieronymus, admits that the purchasers of the virtually divested capacity will have no say in how the nuclear units are run, the scheduling of maintenance, or whether output will be increased or decreased:

> Q. Now, you also agree that the buyers in the virtual divestiture auctions will not have any say as to how the units are run; is that correct?
>
> A. Physically? No, no.
>
> Q. They won't determine maintenance schedules, for example?
>
> A. Not directly. I mean, obviously, the contractual rights that they have and the costs pertinent thereto will weigh on how EEG decides to do its maintenance scheduling, but in the sense that, do they get to say, "I want you to start maintenance on February 16th," the answer is no, they can't.[131]

One of Dr. Kalt's concerns with the proposed virtual divestiture proposal was that it "will not result in the transfer of control of the nuclear facilities to the owners of the contracts."[132] Dr. Kalt explained that "this fact, combined with the expected repeated auctions for three-year forward sales of 'virtually' divested capacity, can create

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[130] Kalt Surrebuttal Testimony at pp. 5-6.

[131] Tr. at 425:13-24. *See also* Kalt Surrebuttal Testimony, Exhibit JPK-13 at pp. 12-13.

[132] Kalt Direct Testimony at p. 22.

incentives for the merged entity to discover means for affecting near-term forward market electricity prices."[133] Dr. Kalt offered the following example:

> [B]y controlling the nuclear units, the Merging Parties can reasonably be expected to exert substantial control over unit availability. Thus, when nuclear units are out on maintenance, the Merging Parties retain control over when units return to service. Moreover, the Merging Parties will be able to affect maintenance planning. While the Merging Parties now offer up a group-oversight type of system, it remains the case that the capacity at issue is nuclear, and strong reasons can exist for not pushing for the return of a unit to service in the face of any party's – including, here, the owner's – reservations about re-starting. Finally, following the transaction, the merged entity will control considerably more capacity in the relevant geographic markets, creating greater incentives for monopolistic withholdings of supply than exist currently.[134]

As the foregoing makes clear, key attributes of ownership – including perfect knowledge of the condition and operation of each nuclear unit and the ability to control the units' maintenance schedules, the timing of shut down and restart after maintenance, and the timing of restart after an unscheduled outage – will allow the Joint Applicants to use their enhanced market power to signal higher going-forward prices and to increase demand for, and the price of, the power being sold under the "virtual divestiture" nuclear contracts.[135] The Joint Applicants' own expert, Dr. Hieronymus, does not dispute that this incentive exists and, in fact, agrees that ownership of nuclear units represents a clear incentive to withhold, regardless of whether the nuclear units themselves are withheld.[136]

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[133] *Id.*

[134] *Id.*

[135] *Id.* at pp. 22-23.

[136] *See* Kalt Surrebuttal Testimony, Exhibit JPK-14 at p. 2. Moreover, because generation "outages" and maintenance decisions are discretionary, it will be difficult for the Commission, FERC, and other market participants to evaluate the merits of such decisions to ensure that the Joint Applicants are not using these outages to increase market prices. Any decision justified or based on safety or maintenance concerns to take or keep a nuclear unit offline is not likely to be challenged. *See* Kalt Direct Testimony at pp. 22-23.

Even if the Joint Applicants' ability to control the output of their nuclear facilities were limited, the merged entity would still have the incentive and ability to profit from withholding output from the other, non-nuclear plants.[137] Dr. Hieronymus agrees. For example, while averring that withholding nuclear plant output can create high opportunity costs, Dr. Hieronymus acknowledges that the incentive exists to withhold the output from other facilities as the benefits of higher prices will be realized by all plants owned by an entity that is able to deliver in the relevant geographic market:

> Structural market power measures are used to evaluate both the ability and incentive to exercise market power. While the lack of *ability* to exercise market power may exist with respect to some units, there may theoretically remain an *incentive* to exercise market power (e.g., nuclear units can earn extra profits if other units can be withheld to raise market prices). For this reason, it is appropriate when measuring market shares to include all capacity that receives market prices.[138]

Given the quantity of generating resources that the merged entity would continue to control, the incentive to withhold power (and thus artificially inflate prices) could be acted upon even with virtual divestiture.[139] In particular, because as much as one-third of the virtually divested nuclear energy will be up for sale each year,[140] the merged entity naturally will consider how the pricing of these forward sales could be improved.[141] This incentive to increase forward prices prior to an annual auction logically will be affected by the merged entity's continued ownership of the nuclear facilities, and the ability to

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[137] Kalt Surrebuttal Testimony at pp. 7-8.

[138] Kalt Surrebuttal Testimony, Exhibit JPK-14 at p. 2 (Joint Applicants' response to OCA-V-6) (emphasis in original). *See id.*, Exhibit JPK-13 at pp. 10-11; *see also id.* at p. 6.

[139] Kalt Surrebuttal Testimony at pp. 7-8.

[140] Kalt Direct Testimony at pp. 19-21; Kalt Surrebuttal Testimony at p. 8.

[141] Kalt Surrebuttal Testimony at p. 8.

withhold supplies from fossil fuel facilities so as to strengthen prices in forward markets in which nuclear energy will be repeatedly auctioned.[142]

Dr. Hieronymus' only response to the claim that the incentive to withhold is strong under the Joint Applicants' virtual divestiture proposal is that the merged entity would not engage in such conduct because it would not be profitable.[143] Dr. Hieronymus' argument, however, misses the mark. His assertion that any such withholding strategy would require the Joint Applicants to "be willing to incur short-term costs for the dubious possibility of higher long-term profits"[144] ignores the fact that *any* withholding need not carry on for three years and that the energy withheld need not be nuclear.[145] As Dr. Hieronymus admits, there is an active, informal forward market in PJM.[146] Fossil fuel facilities could be withheld and benefits could be obtained by simply elevating the next month's or two months' forward prices at the time of the auction.[147] Regardless of how the merged entity specifies the pricing of the virtually divested energy (e.g., yearly, monthly, levelized for three years, etc.), potential buyers will carefully incorporate currently reported wholesale electricity forward prices and supply projections into their offers.[148] To the extent near-term forward prices can be strategically increased by the

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[142] *Id.* Indeed, the withholding need not all come from one unit or in large increments, and thus may remain largely undetected by the Commission, FERC, or the PJM Market Monitoring Unit ("PJM MMU"). Nevertheless, the merged entity will be able to exercise market power, thereby causing other market participants to pay a market power premium. *See generally* Kalt Direct Testimony at pp. 20-23.

[143] Hieronymus Rebuttal Testimony at pp. 35-38.

[144] *Id.* at p. 37.

[145] Kalt Surrebuttal Testimony at pp. 8-9.

[146] Tr. at 407:5-7.

[147] Kalt Surrebuttal Testimony at p. 9.

[148] *Id.*

merged entity, the price for the virtually divested capacity (and the profits associated therewith) will be elevated as well.[149]

The Commission's merger review must consider these concrete, post-merger abilities to exercise market power. Once consummated, the merger, realistically, cannot be undone. The only means by which the Commission can ensure that these supply withholding strategies will not be profitable for the post-merger entity is if much, if not all, of the virtual divestiture is replaced by real asset sales.[150]

### c) Virtual Divestiture Requires Expanded Regulatory Intervention Into Competitive Markets And Is Antithetical To The Principles Of Market-Based Competition.

If accepted, the Joint Applicants' virtual divestiture proposal would require expanded regulatory intervention into a competitive market, a result that is antithetical to the principles of market competition. Ironically, the Joint Applicants herald the fact that they are willing to appoint an independent monitor and establish a public website to help oversee their virtual divestiture proposal. What the Joint Applicants ignore, however, and what the Commission must not forget, is that the effectiveness of such actions will depend entirely on the Commission's, FERC's, and other interested parties' constant supervision.

A prime example of the need for continued regulatory oversight is FERC's acknowledgement in its Merger Order that continued monitoring is necessary to ensure the effectiveness of the proposed virtual divestiture.[151] Indeed, FERC conditioned

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[149] *Id.*

[150] *Id.*

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

approval of the merger on the Joint Applicants' agreement that they would physically divest additional assets if the virtual divestiture proved ineffective as a mitigation tool.[152] Obviously, such a condition will require FERC – and the Commission, unless it is willing to cede to FERC its role in protecting Pennsylvania retail customers – to continually monitor the Joint Applicants' virtual divestiture process to ensure that it is an effective mitigation device. Even FERC admits that this task will be difficult.[153] If, after continuously monitoring the Joint Applicants' website, it is determined that the Joint Applicants are not in compliance with their virtual divestiture requirements, a formal proceeding would still be necessary to act on this non-compliance. Thus, should the Commission accept, without modification, the Joint Applicants' virtual divestiture proposal, it would all but ensure that otherwise unnecessary regulatory oversight of the PJM market will continue indefinitely.

Moreover, the Commission should choose market solutions over regulatory solutions where market solutions advance the Commission's and the Commonwealth's goals of moving to a competitive electricity market.[154] Here, the market solution is divestiture to entities that value these assets highly and can operate them efficiently. Once divestiture is carried out, the Commission can rely on market forces to keep prices

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[152] *Id.* at P 134.

[153] *Id.* at P 135.

[154] *See* 66 Pa.C.S. § 2802. *See DOJ Merger Remedies Guide* at 18 ("[c]onduct remedies generally are not favored in merger cases because they tend to entangle the Division and the courts in the operation of a market on an ongoing basis and impose direct, frequently substantial, costs upon the government and public that structural remedies can avoid.").

just and reasonable and need not continue to monitor closely both pricing and the operational decisions of the merged entity.[155]

**d) Joint Applicants' Proposal To Reduce Their Mitigation Obligation By Withholding Capacity From The Market Is Inconsistent With Sound Antitrust Principles And Further Impairs An Already Deficient Remedy.**

The Joint Applicants' proposal to reduce their obligation to divest capacity megawatt for megawatt to the extent that they retire capacity creates an unjustified loophole in an already deficient mitigation scheme, and is contrary to sound antitrust principles. The Joint Applicants' claim that the retirement of capacity will reduce their market share is a falsity. Reducing the merged entity's virtual divestiture obligation in response to retirements is the equivalent of withholding, and will allow the merged entity to artificially inflate prices in a given market to its own advantage. As Dr. Hieronymus admits:

> Q. And would it also be true that the price increase resulting from physically withholding generation would take place regardless of whether a generator was temporarily taken out of service or permanently taken out of service?
>
> A. Well, at least in the short run. In the longer run, if permanently taken out, they may affect somebody else's decisions about to build, but the short run impact

[155] *See* Edwin M. Zimmerman, *New Directions in Department of Justice Enforcement Policy: The Antitrust Division's Decree Review and Private Litigation Programs*, 51 Antitrust L.J. 105, 109-110 (1982) ("An ideal decree was described as a one-shot affair – *e.g.*, divesting assets or ending a pricing system – and enforcement of the antitrust laws was not to give birth to a system of continuing regulation with the Division functioning as a regulatory agency. If under a decree the Division is required to adjudge the propriety of a variety of conduct of a defendant for years to come, the Division is likely to suppress competition.").

> doesn't distinguish between whether it's down temporarily or down permanently.[156]

As such, allowing the Joint Applicants to reduce divestiture on a megawatt for megawatt basis with the retirement of units provides the merged entity with the ability to eliminate competition for these virtually divested units, which would remain in the merged entity's control. These problems, of course, would be completely avoided with physical divestiture, since the merged entity could not control if and when a unit was retired.

#### 4. Even As To The Proposed Structural Divestiture, The Joint Applicants Must Identify The Plants To Be Divested.

Even with respect to the Joint Applicants' proposed structural divestiture, the means by which their market power allegedly will be reduced is specious at best and grounded in little more than a vague commitment. The Merging Parties should be required to identify the specific units that will be divested.[157] The PJM MMU indicates in its analysis of the proposed merger that, without the identification of the exact units to be divested, the PJM MMU could not make a meaningful assessment of the impact of the proposed merger on competition in the market place.[158] Nevertheless, the Joint Applicants refuse to identify the specific units to be divested and, indeed, admit that not all of the units listed as eligible for divestiture will be made available.[159]

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[156] Tr. at 426:17 - 427:1.

[157] FERC's Merger Policy Statement requires specific unit identification. FERC Merger Order at P 141. *See also id.* at P 57 n.44 (citing Merger Policy Statement, FERC Stats. & Regs. at p. 30,136).

[158] FERC Merger Order at P 106 (citing PJM Market Monitoring Unit, Exelon/PSEG Merger Analysis at pp. 18-19 (May 24, 2005)).

[159] *See* Tr. at 426:5-9.

Allowing the Joint Applicants simply to establish a non-specific "pool" of generators eligible for divestiture, enables the merged entity to divest only its least valuable units, thereby retaining a significant amount of market control.[160] As Dr. Hieronymus acknowledges, the Joint Applicants will have the final say in which units will be part of the divestiture plan.[161] Absent identification of the specific units to be divested, there is nothing to prevent the merged entity from refusing to divest units that are of the highest value to competitors, and thus most likely to contribute to the maintenance of a competitive market place. As Dr. Hieronymus states:

> Q. Is it your understanding that, for example, in order to meet their obligations to divest generating units to meet market power concerns during the summer peak period, applicants could divest a unit that is just barely economic $55, choosing to retain a unit of much lower cost?
>
> A. Yes, at least from my perspective.[162]

Given the limited universe of units to be divested and buyers' expectations that the Joint Applicants' continued control of the virtually divested units will permit them to exercise market power in the future, buyers may be willing to pay more than competitive market prices for the lower-value units, thereby permitting the Joint Applicants to "capitalize" their monopoly profits.[163] If the Joint Applicants were required to divest specific units, their ability to do so would be limited.

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[160] Kalt Direct Testimony at p. 35.

[161] Tr. at 423:20 - 424:5 (noting also that FERC will have the ability to comment on the units that the Joint Applicants propose to divest).

[162] Tr. at 424:11-16.

[163] For example, if buyers of divested assets anticipate that prices in the future will be higher due to ineffective merger relief (i.e., insufficient divestiture, reliance on virtual divestiture, or divestiture of inefficient generating units), they will be willing to bid more for the units that are divested in anticipation of receiving those higher, market power affected prices. On the other

Not requiring the Joint Applicants to establish a binding list of units that must be divested also serves to further extend the period of uncertainty for post-merger market concentration levels.[164] Prior to the merger's approval, the Commission will not know the units to be sold or the entity purchasing them. The merged entity, in effect, will be able to control its, as well as its competitors', respective market shares. Moreover, by not requiring the Joint Applicants to identify the actual units to be divested, it will be difficult for the Commission to determine whether these units, in fact, will mitigate the post-merger concentration in the PJM market. Such an approach leaves too much to chance and is inconsistent with the practices of the antitrust enforcement agencies.[165]

### D. The Proposed Settlement Does Not Address The Harm To The Competitive Market That Would Be Caused By The Merger.

Although the Joint Applicants have negotiated and filed a Joint Petition for Settlement in this proceeding, it falls short of addressing the market concentration issues raised by the PPL Companies. Indeed, the PPL Companies and the Joint Applicants agree that: (1) the Joint Petition does not specifically address the market power issues advanced by the PPL Companies; and (2) neither the ALJ nor the Commission is

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hand, if relief is effective, buyers of divested assets will anticipate only competitive prices in the future, and therefore will bid the lower, true competitive market value for divested assets.

[164] Kalt Direct Testimony at p. 35.

[165] *See generally DOJ Merger Remedies Guide* at 9 and 11. The Joint Applicants will also have an incentive to delay identification of the divested assets until the end of the one-year commitment that they have made to FERC, particularly if they determine that there are merger screen failures in a post-merger divested PJM marketplace. By delaying the identification of the divested assets, the Joint Applicants will be able to delay the follow-up market concentration analysis; and thus, their proposed merger may well be complete by the time the divested assets are assessed, thereby complicating both FERC and the Commission's ability to order further relief.

precluded from considering the evidence or arguments presented by the PPL Companies on these issues.[166]

The key purpose of any merger remedy is to restore the competition lost as a result of the acquisition.[167] Any relief proposed by the Merging Parties: (a) must be fashioned to reduce the merged entity's incentive and ability to exercise market power; and (b) should be reviewed carefully and thoroughly to ensure that that goal has been achieved. The Joint Petition does nothing to advance those goals.

The Joint Petition submitted to the Commission on September 12, 2005, among other things, purports to: (i) reduce PECO's retail electric distribution rates; (ii) cap PECO's retail electric transmission and distribution charges through December 31, 2010; (iii) preclude PECO from seeking future rate recovery of expenses attributable to achieving merger-related savings; (iv) maintain and/or improve PECO system reliability and customer service; (v) enhance PECO's electric universal service programs; (vi) supplement PECO's support for energy efficiency and renewable energy programs; (vii) adopt several corporate structure protections to insulate retail customers from the risks of affiliates not regulated by the Commission; (viii) require a continued PECO corporate presence in Southeastern Pennsylvania; and (ix) foster various economic development efforts.[168]

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[166] Stipulation Regarding Market Power Issues at paras. 1, 3, 5.

[167] *United States v. E.I. du Pont de Nemours & Co.*, 366 U.S. 316, 326 (1961); *Ford Motor Co. v. United States*, 405 U.S. 562, 573 (1972).

[168] Joint Petition at pp. 2-3.

While the Joint Petition may satisfy important concerns raised by the various settling parties, its provisions under the heading, "Competitive Electricity Market"[169] does not provide the type of robust and effective relief needed to ensure the long-term restoration of competition envisioned by the antitrust principles and incorporated into Section 2811.[170] The Joint Applicants ask the Settling Parties to accept on faith that the proposed mitigation will be sufficient to restore the loss of competition resulting from the merger, and to rely on future reports and investigations to remedy the situation if it does not. In the Joint Petition, PECO commits to file annually with the Commission, beginning in 2007 and continuing through 2012, a report addressing wholesale market prices and price trends in PJM. The Joint Applicants also promise to include information regarding price differentials between PJM East and other PJM regions in the annual report, and to make the reports available to the public.[171] Further, any settling party may ask the Commission to initiate an investigation if it "reasonably believes" that PECO's affiliated generation company (or any other affiliated entity) has "unlawfully exercised market power in any PJM market, or for any other reason set forth in 66 Pa.C.S. § 2811."[172] These are hollow concessions, given that neither the Commission nor the settling parties are obtaining information or rights not currently available to them.

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[169] *Id.*, Section III.I.

[170] 66 Pa.C.S. § 2811.

[171] Joint Petition at para. 53.a.

[172] *Id.* at para. 53.b.

For example, the promised price reports do not offer the Commission any information that it would not otherwise be able to access on the PJM website.[173] The PJM Market Monitor also prepares an annual State of the Market Report on the PJM electricity markets that is far more comprehensive than the reports promised by PECO.[174] As for the provision that permits a settling party to seek future investigations upon "reasonable belief" that the merged entity may have unlawfully exercised market power, that option is available to anyone today under Section 2811(b).[175] More importantly, nothing in the Joint Petition *requires* the Commission to open an investigation in response to such a request.

The Antitrust Division of the United States Department of Justice ("Antitrust Division") has acknowledged that it is a disservice to consumers to accept proposed remedies without analyzing whether they are sufficient to redress the violation.[176] In reviewing the Joint Petition, the Commission should follow that same well-established principle, and avoid the seduction of short-term monetary concessions that are not equivalent to the kind of long-term structural relief favored by the antitrust agencies. The time to investigate and remedy any potential competitive harm that might result from the

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[173] Daily Real Time price data for PJM East and other PJM hubs is available at http://www.pjm.org/markets/jsp/lmp.jsp, and Daily Day Ahead price data is available at http://www.pjm.org/markets/jsp/lmpda/jsp.

[174] For the PJM 2004 State of the Market Report, see http://www.pjm.org/markets/market-monitor/som.html.

[175] 66 Pa.C.S. § 2811(b) ("Upon complaint or upon its own motion for good cause shown, the Commission shall conduct an investigation of the impact on the proper functioning of a fully competitive retail electricity market, including the effect of mergers, consolidations, acquisitions or disposition of assets or securities of electricity suppliers . . . .").

[176] *DOJ Merger Remedies Guide* at 4.

merger is *now*, while the matter is before the Commission, and not after the fact when the damage is done and far more difficult to cure.

### E. The Commission Should Condition Approval Of The Proposed Merger Upon The Joint Applicants' Agreement To Specific Remedial Measures That Address The Merger's Adverse Impact On Competition In Wholesale And Retail Electricity Markets In Pennsylvania And Should Make Specific Findings And Recommendations To Federal And State Authorities Under 66 Pa.C.S. § 2811(d).

#### 1. If The Commission Finds That It Has Jurisdiction Over The Proposed Merger, It Must Not Approve The Transaction Until Specific Remedial Actions Are Taken By The Joint Applicants.

In their Joint Application, the Joint Applicants ask the Commission to disclaim jurisdiction over the proposed merger.[177] While the PPL Companies take no position on the Joint Applicants' request, if the Commission determines that it has jurisdiction over the proposed merger, it should insist that the following conditions be satisfied before approving the proposed merger: (1) the Joint Applicants must convert their virtual divestiture proposal to a definitive plan for the actual transfer of ownership of the baseload generation; (2) the Joint Applicants must agree to additional, actual divestiture to cure the market screen failures identified (a) in the PJM Classic market when this market is considered separately,[178] and (b) in the PJM East market when imports are allocated based on FTR ownership;[179] (3) the Joint Applicants must identify with specificity the units to be divested; and (4) the Commission must hold additional proceedings to fully consider and rule on the effectiveness of the revised mitigation plan. The necessity of such conditions is amply supported by the record of this proceeding as

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[177] *See* Joint Application at pp. 10-12.

[178] *See* Kalt Direct Testimony, Exhibit JPK-11.

[179] *See supra* at p. 22.

discussed throughout this Main Brief. Such conditions would also be entirely consistent with – and indeed are mandated by – Section 2811(e)(2), which provides that the Commission shall not approve a merger that could result in the unlawful exercise of market power except upon "such terms and conditions as it finds necessary to preserve the benefits of a properly functioning and competitive retail electricity market."[180]

### 2. The Commission Should Make Specific Findings And Recommendations To The Attorney General Of Pennsylvania, The Department Of Justice, FERC And The NJBPU.

The Commission must make specific findings regarding the anticompetitive impact of the proposed merger, and certify the record of the proceedings, along with the Commission's findings, to the Attorney General of the Commonwealth, the Antitrust Division of the United States Department of Justice, and FERC pursuant to Section 2811. In addition, as discussed more fully below, the PPL Companies recommend that the Commission make its findings and recommendations available to the NJBPU, which is also actively considering the impact of the proposed merger on competition. The Commission is obligated to do this regardless of the outcome of its jurisdictional determination.

As the Joint Applicants have disclosed, the Antitrust Division has initiated an investigation of the merger pursuant to its authority under the Hart-Scott-Rodino Antitrust Improvements Act, 15 U.S.C. § 18a, and has issued an extensive civil investigative demand in furtherance of that investigation to PJM.[181] Based upon this information, the PPL Companies are informed and believe that the Antitrust Division's

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[180] 66 Pa.C.S. § 2811(e)(2).

[181] Kalt Surrebuttal Testimony, Exhibit JPK-12.

investigation is active and ongoing. Findings by the ALJ and the Commission with respect to the merger will be timely and will provide valuable assistance to the Antitrust Division.

As the Commission knows, FERC approved the proposed merger without the benefit of discovery or hearings in which witnesses were cross examined.[182] However, FERC's July 1, 2005 order is subject to rehearing requests filed by the PPL Companies and by other parties to the FERC proceeding.[183] Indeed, the proposed settlement in the instant case carved out from the settlement the continued pursuit of these rehearing requests and any further proceedings that may result.[184] The certification of appropriate findings by this Commission and the record of these proceedings could be an important factor in FERC's consideration of the various rehearing requests.

Accordingly, even though FERC has approved the merger, the PPL Companies urge the Commission to certify its record and findings to FERC. Doing so will permit FERC to have the benefit of a record containing evidence tested at hearing and developed

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[182] *See supra* note 29.

[183] The PPL Companies strongly believe that FERC has not met its responsibilities under the FPA to consider the impact of the merger on competition and wholesale electricity markets. The FERC Merger Order conditionally approving the merger was deficient in a number of critical aspects. Most significantly, of course, FERC did not hold an evidentiary hearing or allow discovery. FERC Merger Order at pp. 214, 217. It also ignored the evidence submitted by the PPL Companies, including evidence introduced at the hearing in this case that the PJM Classic market should be analyzed separately to determine whether the proposed merger would increase competition and threaten the exercise of market power in the PJM Classic market. *Id.* at pp. 68, 113, 123. The FERC Merger Order also completely ignored the PPL Companies' evidence that FTR ownership should be used in determining the ability to import into the PJM East market, something that was well developed in the record before this Commission. *Id.* at pp. 112, 122. FERC also accepted the Joint Applicants' virtual divestiture proposal, which as the PPL Companies demonstrated before this Commission, would not be sufficient to check the market power the Joint Applicants would achieve through the merger. *Id.* at p. 135. Finally, FERC left the Joint Applicants with almost complete discretion regarding the timing of the divestiture and to the identification of the precise generating units to be divested. *Id.* at pp. 135, 141.

[184] Joint Petition at para. 53.d.

after extensive discovery. The PPL Companies believe that an appropriate recommendation by this Commission will encourage FERC to conduct a more complete inquiry into the impact of the merger on competition.

Section 2811(d) also provides that the Commission may forward its findings to the Attorney General of Pennsylvania. While it is unknown whether or not the Attorney General has initiated a formal investigation of the proposed merger, the Attorney General has the authority to bring cases on behalf of the Commonwealth under the Clayton Act.[185] The record before the Commission and the Commissions' findings may assist the Attorney General in determining whether such a course of action is appropriate. The Attorney General, of course, could make his views known to the United States Department of Justice.

Finally, the PPL Companies recommend that the Commission certify the record in this case and its findings to the NJBPU. Although Section 2811(d) does not provide specifically for a referral to other states, such a recommendation would be consistent with the spirit of the statute and certainly within the discretionary authority of the Commission. The NJBPU's schedule for consideration of the proposed merger is behind that of the Commission and hearings are not scheduled to begin until January.[186] The Commission's decision could be very helpful to the NJBPU's decisional process.

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[185] 15 U.S.C. § 11, *et seq.* *See also* 71 Pa. Stat. Ann. 732-204 (2005) (authorizing the Attorney General to represent the Commonwealth for acts in violation of the antitrust laws of the United States or the Commonwealth).

[186] *In the Matter of the Joint Petition of Public Service Electric and Gas Company and Exelon Corporation for Approval of a Change in Control of Public Service Electric and Gas Company and Related Authorizations*, N.J. OAL Docket No. PUC 1874-05, BPU Docket No. EM05020106, Order Modifying Procedural Schedule (issued Oct. 7, 2005).

In sum, regardless of whether the Commission determines it has authority to approve the proposed merger, it should make and publish specific findings that: (1) 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; and (2) that the mitigation proposed by the Joint Applicants is insufficient to prevent such lessening of competition. The Commission should further find that:

1. The Joint Applicants have failed to analyze all relevant markets in their presentation before the Commission, including, specifically, the PJM Classic market;

2. The proposed merger will result in an unacceptable increase in concentration in a PJM Classic market in violation of the Department of Justice/FTC Merger Guidelines;

3. The proposed merger will result in an unacceptable increase in concentration in the PJM East market in violation of the Department of Justice/FTC Merger Guidelines;

4. The Joint Applicants have failed to adequately analyze the PJM East market by refusing to take into account the ownership of FTRs in assessing the incentive of the Joint Applicants to exercise market power post-merger;

5. The Joint Applicants have failed to propose sufficient divestitures of specific assets to demonstrate that mitigation will alleviate the risk of the exercise of market power in each of the relevant time period/load conditions under which the Joint Applicants could exercise market power;

6. The Joint Applicants' proposal for virtual divesture will not adequately restrain their ability to exercise market power in forward markets in either the PJM Classic or PJM East markets; and

7. The Joint Petition for Settlement fails to adequately mitigate the market power that the Joint Applicants will obtain through the proposed merger, nor does it provide the tools to stop them from exercising that market power.

## V. CONCLUSION.

For the foregoing reasons, the PPL Companies urge the ALJ to recommend that the Commission 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 the Joint Applicants is insufficient to prevent such lessening of competition. Further, the PPL Companies urge the ALJ to recommend that the Commission either: (1) condition its approval of the proposed merger on the Joint Applicants' agreement to effective relief, as set forth herein; or (2) 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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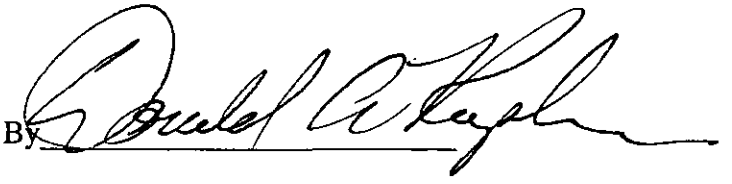
By 

October 14, 2005

# APPENDIX 1

## APPENDIX 1

# FINDINGS OF FACT

**THE PROPOSED MERGER.**

1. The proposed merger between Exelon and PSEG involves two of the largest generators of electricity in PJM. Hieronymus FERC Direct Testimony, Exhibit J-9.

2. Post-merger, the merged entity will be the single largest producer of electric energy in the Commonwealth. Kalt Direct Testimony at p. 36; Kalt Surrebuttal Testimony at p. 7.

3. Even after the Joint Applicants' proposed mitigation and divestiture, the merged entity will continue to own 37,100 MW of generation in PJM, including 14,400 MW (or approximately 40 percent) of the capacity in PJM East, the most constrained market in PJM. *See* Kalt Direct Testimony at Exhibit JPK-6a; Kalt Surrebuttal Testimony at p. 17; Hieronymus Direct Testimony at p. 4.

**THE IMPACT OF THE PROPOSED MERGER ON WHOLESALE ENERGY MARKETS.**

4. The Department of Justice ("DOJ") and Federal Trade Commission ("FTC") have published guidelines and statements, including the Horizontal Merger Guidelines published in 1992 and revised in 1997, which set forth their merger enforcement policies.

5. The Federal Energy Regulatory Commission ("FERC") adopted the analytical framework of the Horizontal Merger Guidelines in its 1996 Merger Policy Statement, and in Appendix A to that statement, developed a prescribed methodology for calculating changes in market concentration caused by the merger in the relevant destination markets. Merger Policy Statement, 61 Fed. Reg. at 68,596, 68607.

6. The Horizontal Merger Guidelines' analysis requires identifying the relevant geographic markets serviced by the Joint Applicants, and the relevant product markets affected by the merger in each geographic market, as well as identifying all other suppliers competing in those product and geographic markets.

7. The relevant product market is electricity generated during different time periods throughout the day, for each seasonal period throughout the year.

8. PJM Classic is a separate geographic market in accordance with Horizontal Merger Guidelines analysis. Kalt Direct Testimony at pp. 14-19.

9. PJM East is a separate geographic market in accordance with Horizontal Merger Guidelines analysis. Hieronymus FERC Direct Testimony at pp. 32-33.

10. Pre- and post-merger market concentrations, as well as the changes in market concentrations, are determined by the Herfindahl-Hirschman Index ("HHI") index. *See* Horizontal Merger Guidelines, § 1.0.

11. The Horizontal Merger Guidelines address three ranges of market concentration: (1) an unconcentrated post-merger market – if the post-merger HHI is below 1,000, regardless of the change in HHI the merger is unlikely to have adverse competitive effects; (2) a moderately concentrated post-merger market – if the post merger HHI ranges from 1,000 to 1,800 and the change in HHI is greater than 100, the merger potentially raises significant competitive concerns; and (3) a highly concentrated post-merger market – if the post-merger HHI exceeds 1,800 and the change in HHI exceeds 50, the merger potentially raises significant competitive concerns; if the change in HHI exceeds 100, it is presumed that the merger is likely to create or enhance market power.

*Revised Filing Requirements Under Part 33 of the Commission's Regulations*, Order No. 642, 65 Fed. Reg. at 70,999 n.62. (Nov. 28, 2000), FERC Stats. & Regs., Regulations Preambles (July 1996 – Dec. 2000) ¶ 31,111 (2000) ("Order No. 642"), *order on reh'g*, Order No. 642-A, 66 Fed. Reg. 16,121 (Mar. 23, 2001), 94 FERC ¶ 61,289 (2001).

12. The proposed merger's effect on competition in the relevant markets has been evaluated over ten separate time and seasonal periods: Super Peak, Peak and Off-Peak periods for Summer, Winter and Shoulder seasons, along with an extreme Summer Super Peak. Hieronymus FERC Direct Testimony at p. 36.

13. The Joint Applicants' market concentration analyses show that, without mitigation, the proposed merger between Exelon and PSEG will significantly increase market concentration, and thus produce Appendix A market screen failures in all season/load conditions in PJM East, PJM Pre-2004 and PJM Expanded, with the screen failures being most severe in PJM East. *See, e.g.*, Kalt Direct Testimony at pp. 10, 23 and Exhibit JPK-5; Hieronymus Prepared Direct Testimony at pp. 4, 47-49.

**THE IMPACT OF THE PROPOSED MERGER ON RETAIL ENERGY MARKETS.**

14. Although currently in Pennsylvania most regulated electric utilities 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 (Electric Generator Suppliers or "EGSs") have been able to capture electric utility customers. Kalt Direct Testimony at pp. 5-6.

15. Moreover, when existing price caps expire, retail electricity prices increase and decrease in step with wholesale power prices, demonstrating the link between wholesale and retail electricity prices. Kalt Direct Testimony at pp. 5-6.

16. As long as most electric distribution companies in the Commonwealth remain under price caps, EGSs will be viable competitors while wholesale prices remain below the retail shopping credit. Kalt Direct Testimony at pp. 5-6.

17. To the extent the merged entity is able to use its increased market power to increase wholesale electricity prices, retail prices are likely to increase as well. Another serious consequence of the Joint Applicants' ability to exercise market power would be that it could drive existing EGSs from the Pennsylvania retail electricity market and discourage new EGSs from entering. Kalt Direct Testimony at p. 6.

18. This increase in retail prices will likely reduce (or eliminate) the profits of EGSs and prevent them from offering (and hence customers from receiving) competitive products and services. Kalt Direct Testimony at p. 6.

**PROBLEMS IDENTIFIED WITH THE JOINT APPLICANTS' MARKET CONCENTRATION ANALYSES: FAILURE TO SEPARATELY ANALYZE THE PJM CLASSIC MARKET.**

19. Joint Applicants' market concentration analyses did not separately consider the PJM Classic market. Kalt Direct Testimony at pp. 14-15; Tr. at 419:12-18.

20. The record evidence demonstrates that: (a) significant average price differentials exist for sustained periods across the Western Interface and between the APS Zone and the other end of its path into PJM Classic at the PEPCO Zone (Kalt Direct Testimony at pp. 14-15, 18 and Exhibits JPK-2, JPK-3); and (b) the Bedington-Black Oak line, which is a pathway between APS and the PJM Classic market, was the single most constrained facility in PJM during 2004. *See* PJM 2004 State of the Market Report at 214; Kalt Direct Testimony at p. 17; Kalt Surrebuttal Testimony, Exhibit JPK-13 at p. 3; Tr. at 419:4-7.

21. When the summer and winter periods are isolated from the yearly average price, the price differentials between the APS Zone from the PJM Classic market are more severe, with differences as high as $15/MWh and sustained price differentials of $5-10/MWh. Kalt Direct Testimony at p. 18 and Exhibit JPK-3.

22. When congestion occurs along the Bedington-Black Oak transmission line, more expensive generation units within PJM Classic are redispatched to account for the shortfall of electricity across the Western interface, thereby demonstrating that PJM Classis is a separate market. Kalt Direct Testimony at p. 16; Kalt Surrebuttal Testimony at p. 12 n.15, JPK-13 at p. 2.

23. When asked by the PPL Companies in discovery to analyze the competitive impact of the proposed merger on the PJM Classic market, the Joint Applicants' analysis revealed market screen failures in six of the ten season/load conditions. *See* Kalt Direct Testimony at Exhibit JPK-4; *see also* Kalt Surrebuttal Testimony at pp. 11-12.

24. The Joint Applicants' proposed mitigation does not correct for the Appendix A market screen failures that occur for the PJM Classic market. Kalt Surrebuttal Testimony at pp. 10-11.

**PROBLEMS IDENTIFIED WITH THE JOINT APPLICANTS' MARKET CONCENTRATION ANALYSES: FAILURE TO ALLOCATE IMPORTS BASED ON FTRS.**

25. The Joint Applicants' market concentration analyses failed to consider the ownership of Financial Transmission Rights ("FTRs") when allocating imports and market shares in the PJM East market. Kalt Direct Testimony at p. 24; *see also* Tr. at 413:10-14; Tr. at 414:24 - 425:2.

26. FTRs are import rights that allow an owner to take generation at a particular source outside of a particular market and "sink," or deliver, it at a different point or zone on the system. Kalt Direct Testimony at p. 24; Kalt Surrebuttal Testimony at p. 13.

27. FTRs thus allow a holder to financially hedge congestion costs across a given interface. Kalt Surrebuttal Testimony at p. 14; Tr. at 383:11-17.

28. The Joint Applicants have preferential access to FTRs through grandfathered rights, as well as through the auction and sale of non-grandfathered FTRs. Kalt Direct Testimony at p. 24.

29. The Joint Applicants own a combined total of 5,500 MW of capacity on the western side of the Eastern Interface and over 40 percent of on-peak and off-peak FTRs (more than 3,000 MW in each case), which allow the Joint Applicants to "sink" their lower-cost generation into PJM East. Kalt Direct Testimony at pp. 26-27 and Exhibits JPK-6a, JPK-6b.

30. There is every reason to believe that the Joint Applicants will continue to receive the same or similar allotments of FTRs in the future. *See* Kalt Direct Testimony at pp. 27-28; Kalt Surrebuttal Testimony at pp. 14-17.

31. The Joint Applicants' annual allotments of FTRs will provide the merged entity with the incentive and ability to withhold generation in PJM, and thus increase not only the value of such generation relative to the generation outside PJM East, but also the value of their FTRs across the interface into PJM East. Kalt Surrebuttal Testimony at p. 18; *see also* Tr. at 414:21-23.

32. When imports into PJM East are properly assigned based on FTR ownership, market concentration levels increase and market screen failures are evident in all but one of the post-merger markets, with five of them being "highly concentrated." *See* Kalt Direct Testimony at pp. 28-29 and Exhibit JPK-7.

33. The Joint Applicants' proposed mitigation does not account for these market screen failures which result when FTR ownership is properly considered. *See* Kalt Direct Testimony at pp. 29-30 and Exhibit JPK-8.

THE JOINT APPLICANTS' PROPOSED MITIGATION: ACTUAL DIVESTITURE.

34. FERC's guidelines clearly indicate that if the HHI statistics exceed the thresholds, the applicants must either propose mitigation measures that would remedy the merger's potential adverse effects on competition or address the other DOJ/FTC merger analysis factors. Order No. 642, 65 Fed. Reg. at 70,999.

35. The Antitrust Division of the United States Department of Justice published a Policy Guide to Merger Remedies in 2004, which sets forth a framework for and factors to consider in fashioning and implementing appropriate relief in merger cases.

36. In response to the market screen failures, the Joint Applicants propose to divest control of 5,600-6,600 MW of generating capacity in the various PJM markets. *See* Kalt Direct Testimony at p. 4; Hieronymus FERC Direct Testimony at pp. 67-68.

37. Of this total, the Joint Applicants propose to actually divest 2,900 MW of generation capacity in PJM East to address the peak and super-peak screen failures. Hieronymus FERC Direct Testimony at pp. 10, 13. 60.

38. FERC's Merger Policy Statement requires the merging parties to identify the specific units that will be divested. FERC Merger Order at P 141; *see also id.* at P 57 n.44 (citing Merger Policy Statement, FERC Stats. & Regs. at p. 30,136).

39. In addition, the PJM Market Monitoring Unit indicates in its analysis of the proposed merger that, without the identification of the exact units to be divested, the PJM MMU cannot make a meaningful assessment of the proposed merger. FERC Merger Order at P 106 (citing PJM MMU Merger Analysis at p. 2).

40. The Antitrust Division of the United States Department of Justice has acknowledged that it is a disservice to consumers to accept proposed remedies without analyzing whether they are sufficient to redress the violation. *DOJ Merger Remedies Guide* at 4.

41. Although the Joint Applicants have created a non-specific "pool" of generators eligible for divestiture, they have not identified the specific generating units they intend to divest. *See* Tr. at 422:18-23; Tr. at 426:5-9.

42. The Joint Applicants intend to make the final determination as to which specific units will be divested. Tr. at 423:20-23.

43. Absent the identification of the actual units to be divested, it is impossible to tell whether the divested units will in fact mitigate the post-merger concentration in the PJM market. Kalt Direct Testimony at p. 35.

44. The Joint Applicants propose to make a compliance filing showing the merger's effect on market concentration once the actual acquirers of the actual divested assets are known. FERC Merger Order at PP 128, 135, 144.

45. The Joint Applicants also agreed to file annual reports with the Commission, beginning in 2007 and continuing through 2012, which address wholesale market prices and price trends in PJM. Joint Petition at para. 53.a.

46. The Joint Applicants promise to include information regarding price differentials between PJM East and other PJM regions in the annual report, and to make the reports available to the public. Joint Petition at para. 53.a.

47. The effectiveness of the Joint Applicants' divestiture plan thus will depend upon the continued oversight of the Commission, FERC, or other interested parties. FERC Merger Order at P 134-35 and Ordering para H.

48. If the Joint Applicants are ordered to sell, rather than virtually divest, assets, the Commission can rely on market forces to keep prices just and reasonable and need not continue to monitor closely both pricing and the operational decisions of the merged entity. *See* Edwin M. Zimmerman, *New Directions in Department of Justice Enforcement Policy: The Antitrust Division's Decree Review and Private Litigation Programs*, 51 Antitrust L.J. 105, 109-110 (1982).

**THE JOINT APPLICANTS' PROPOSED MITIGATION: VIRTUAL DIVESTITURE.**

49. The Joint Applicants propose to "virtually" divest 2,600 MW of nuclear baseload capacity to address the market screen failures in the off-peak periods. Hieronymus Prepared FERC Direct Testimony at p. 6; *see also* Kalt Direct Testimony at pp. 20-21. 2,400 MW will be divested in PJM East, while 200 MW will be divested in the larger PJM Pre-2004 region. *See* Tr. at 421:15-18.

50. The Joint Applicants' proposed virtual divestiture will take one of two forms: (1) a firm sales contract expiring no earlier than 15 years after the date the merger is consummated; or (2) an annual auction of 3-year entitlements to baseload energy, in 25 MW blocks. Hieronymus Direct Testimony at pp. 3-4.

51. Under the Joint Applicants' virtual divestiture proposal, the merged entity will retain ownership of the divested energy and control over the scheduling and duration of outages. Tr. at 425:13-24; *see also* Kalt Direct Testimony at pp. 20, 22; Kalt Surrebuttal Testimony, Exhibit JPK-13 at pp. 12-13.

52. The Joint Applicants' continued ownership and control over the operation of the nuclear facilities creates both the ability and incentive to unilaterally exercise market power by withholding generating capacity to signal higher going-forward prices, thereby increasing demand for, and the price of, the power being sold at the annual three-year virtual divestiture auctions. *See* Kalt Direct Testimony at pp. 20, 22-23; Kalt Surrebuttal Testimony at pp. 5-6.

53. Absent the relinquishment of ownership and the ability to control the operation of the divested units, the proposed remedy cannot effectively mitigate the merged entity's incentive and ability to unlawfully exercise market power. Tr. at 425:13-24; *see also* Kalt Direct Testimony at pp. 20-23; Kalt Surrebuttal Testimony, Exhibit JPK-13 at pp. 12-13.

54. Even if the Joint Applicants' ability to control the output of their nuclear facilities were limited, the merged entity would still have the incentive and ability to profit from withholding output from other, non-nuclear plants. Kalt Surrebuttal Testimony at pp. 7-9 and Exhibit JPK-14; *see also id.*, Exhibit JPK-13 at pp. 10-11.

55. The Joint Applicants also propose to reduce, megawatt-for-megawatt, their virtual divestiture obligation in response to the retirement of capacity. Hieronymus FERC Direct Testimony at pp. 7-8.

56. Dr. Hieronymus admits that reducing the merged entity's virtual divestiture obligation in response to retirements is the equivalent of withholding, and will allow the merged entity to artificially inflate prices in a given market to its own advantage. Tr. at 426:17 - 427:1.

57. The record evidence demonstrates that, when virtual divestiture fails as effective mitigation, the proposed merger produces significant increases in market concentration, and hence significant merger screen failures in the PJM Classic, PJM East, and the PJM Pre-2004 markets. Kalt Direct Testimony at p. 23 and Exhibit JPK-5.

**THE PROPOSED SETTLEMENT.**

58. On September 12, 2005, the Joint Applicants along with the Office of Trial Staff, Office of Consumer Advocate, the Office of 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, which purports to resolve all issues raised by those parties regarding the merger application. Joint Petition for Settlement at p. 2.

59. The proposed settlement did not address the market power concerns raised by the PPL Companies, and preserved those issues for consideration by the Administrative Law Judge and the Commission. Stipulation Regarding Market Power Issues at paras. 1, 5.

## CONCLUSIONS OF LAW

1. The Electricity Generation Customer Choice And Competition Act requires the Commission to "consider whether the proposed merger . . . 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." 66 Pa.C.S. § 2811(e).

2. The Commission is required to make specific findings regarding the competitive impact of the proposed merger and refer those findings to federal and state authorities. 66 Pa.C.S. § 2811(d).

3. The Commission may not approve a merger which could result in the unlawful exercise of market power except upon "such terms and conditions as it finds necessary to preserve the benefits of a properly functioning and competitive retail electricity market." 66 Pa.C.S. § 2811(e)(2).

4. In evaluating the impact of the proposed merger on competition in the Commonwealth, the Commission shall employ the incipiency standard of the Section 7 of the Clayton Act (15 U.S.C. § 18 (2000)) and the analytical framework of the Horizontal Merger Guidelines. Horizontal Merger Guidelines at 1.

5. In the instant case, the relevant product is electric energy, analyzed for different time periods throughout the day and for each seasonal period throughout the year. Accordingly, for each relevant geographic area, ten relevant product markets must be analyzed.

6. The relevant geographic markets are PJM East, PJM Classic, and PJM Pre-2004.

7. The need to redispatch more expensive generation units in PJM Classic due to congestion along the PJM Western Interface and Bedington-Black Oak transmission constraint demonstrates that PJM Classic is a distinct geographic market, and must be analyzed under the Appendix A analysis separate and apart from the PJM Expanded market.

8. Using the HHI index to calculate pre- and post-merger market concentrations, as well as the changes in market concentrations, absent mitigation, the proposed merger would result in an unacceptable increase in concentration, and hence a reduction in competition, in the PJM Classic and PJM East markets, in violation of Section 7 of the Clayton Act and the Horizontal Merger Guidelines.

9. This increase in market concentration and the resulting market screen failures become even more pronounced when the PJM Classic market is properly

considered as a separate market, and imports are allocated based on FTRs in the PJM East market.

10. This lessening of competition in wholesale electricity markets will result in a similar lessening of competition in retail electricity markets, and hence higher prices for retail electricity customers in the Commonwealth – a result that is contrary to Section 2811.

11. Structural remedies are more effective for mitigating market power concerns than conduct remedies, which are difficult to design, cumbersome, costly to administer, and easier to circumvent than structural remedies. *DOJ Merger Remedies Guide* at 8; *see also* Kalt Direct Testimony at p. 20.

12. The Joint Applicants' virtual divestiture proposal will require expanded regulatory intervention into the Commonwealth's electricity markets (*see* FERC Merger Order at PP 134-135, and Ordering Paragraph H), which is antithetical to principles of market-based competition.

13. The Commission should only accept actual, physical divestiture as effective mitigation. *See DOJ Merger Remedies Guide* at 8.

14. The Proposed Settlement does nothing to mitigate the post-merger market concentration or restrain the merged entity's incentive and ability to exercise market power, and thus does not provide the type of robust and thorough relief needed to ensure the long-term restoration of competition envisioned by the antitrust principles and incorporated into Section 2811. 66 Pa.C.S. § 2811.

15. Should the Commission assert jurisdiction over the proposed merger, any approval thereof must be conditioned on the Joint Applicants' acceptance of significant, critical modifications to their proposed mitigation plan to address the anticompetitive concerns created by the concentration of market power in the merged entity. These conditions include, but are not necessarily limited to: (1) conversion of the Joint Applicants' virtual divestiture proposal to a definitive plan for the actual transfer of ownership of the baseload generation; (2) additional, actual divestiture to cure the market screen failures identified in the PJM Classic market when this market is considered separately, and to remedy the screen failures in the PJM East market when FTR ownership is considered in measuring market shares; (3) identification of the specific units to be divested; and (4) additional Commission proceedings to fully consider the effectiveness of the Joint Applicants' revised mitigation plan.

16. The Commission must refer to the Attorney General of Pennsylvania, DOJ, and FERC the investigation of the proposed merger, and certify the evidentiary record so accumulated, including its findings that the proposed transaction presents a serious threat to competition in wholesale and retail electricity markets in the Commonwealth, notwithstanding the mitigation proposed by the Joint Applicants.

## ORDERING PARAGRAPHS SPECIFICALLY IDENTIFYING THE RELIEF SOUGHT

Based upon the foregoing findings of fact and conclusions of law, the PPL Companies submit the following ordering paragraphs for the Commission's consideration.

**IT IS HEREBY ORDERED,** that

PECO Energy Company and Public Service Electric and Gas Company have failed to meet their burden of establishing that the proposed merger of Public Service Enterprise Group Incorporated with and into Exelon Corporation is in the public interest and will not have anticompetitive effects on the wholesale and retail energy markets in the Commonwealth;

**IT IS FURTHER ORDERED,** that

A. the Joint Application of PECO Energy Company and Public Service Electric and Gas Company is denied;

B. pursuant to 66 Pa.C.S. § 2811(d)(1), the Commission's Findings of Fact and Conclusions of Law are referred to the Attorney General of the Commonwealth, the United States Department of Justice, the Federal Energy Regulatory Commission, and the New Jersey Board of Public Utilities and the Secretary is directed to certify the full evidentiary record of the proceedings in this matter along with the Commission's Findings of Fact and Conclusions of Law to the aforesaid agencies.

**BEFORE THE**
**PENNSYLVANIA PUBLIC UTILITY 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** |

## CERTIFICATE OF SERVICE

I hereby certify that, on this 14th day of October 2005, I served a copy of the foregoing Main Brief of the PPL Companies upon the parties listed below by electronic delivery and overnight mail:

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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 are the original and nine (9) copies of the Main Brief on behalf of the Office of Small Business Advocate in the above-docketed proceeding. As evidenced by the enclosed certificate of service, two copies have been served on all active parties in this case.

If you have any questions, please do not hesitate to contact me.

Sincerely,

Carol F. Pennington
Assistant Small Business Advocate

Enclosures

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ORIGINAL

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

| | | |
|---|---|---|
| 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 |

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MAIN BRIEF
ON BEHALF OF THE
OFFICE OF SMALL BUSINESS ADVOCATE

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DOCUMENT
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For: William R. Lloyd, Jr.
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## I. PROCEDURAL HISTORY

The Office of Small Business Advocate ("OSBA") is an agency of the Commonwealth of Pennsylvania authorized by the Small Business Advocate Act (Act 181 of 1988, 73 P.S. §§ 399.41 - 399.50) to represent the interest of small business consumers as a party in proceedings before the Pennsylvania Public Utility Commission ("Commission").

On February 4, 2005, PECO Energy Company ("PECO")[1] and Public Service Electric and Gas Company ("PSE&G") (collectively, "Joint Applicants") filed with the Commission their Joint Application for Approval of the Merger of Public Service Enterprise Group ("PSEG") with and into Exelon Corporation ("Exelon"). By their Joint Application, PECO and PSE&G requested the Commission's approval of the Proposed Merger under Chapters 11, 22, and 28 of the Public Utility Code, 66 Pa. C.S. Ch. 11, 22, and 28. In the alternative, the Joint Applicants requested a declaratory order to the effect that the Commission's approval of the Proposed Merger is not required.

On March 2, 2005, the OSBA filed a Notice of Intervention and Protest ("Protest") with respect to the Joint Application. In its Protest, the OSBA identified several issues of concern, including the following:

a. Whether the Proposed Merger would "affirmatively promote the 'service, accommodation, convenience, or safety of the public' in some substantial way," as required by *City of York v. Pennsylvania*

[1] PECO is a "public utility," a "natural gas distribution company" and an "electric distribution company" as those terms are defined, respectively, in Sections 102, 2202, 2803 of the Public Utility Code, 66 Pa.C.S. §§ 102, 2202, and 2803, and, therefore, is subject to regulation by the Commission. Application, Par. 5, p. 2.

*Public Utility Commission*, 449 Pa. 136, 141, 295 A.2d 825, 828 (Pa. 1972);

b. Whether the Proposed Merger would impede the development of the electric retail market, thereby negatively impacting the price ratepayers must pay for electricity; and

c. Whether the Proposed Merger would impede competition in the wholesale market for electricity, thereby negatively impacting the retail price ratepayers must pay for electricity acquired by the default service provider pursuant to Section 2807(e)(3) of the Public Utility Code, 66 Pa. C.S. § 2807(e)(3).

In addition to the OSBA, the active parties are PECO and PSE&G ("Joint Applicants"); the Office of Consumer Advocate ("OCA"); the Office of Trial Staff ("OTS"); the Philadelphia Area Industrial Users Group ("PAIEUG"); Citizens for Pennsylvania's Future, Joy Bergey and Lisa Z. Leighton ("PennFuture"); the Department of Environmental Protection ("DEP"); the Energy Coordinating Agency ("ECA"); Exelon Utility Coordinated Council, Locals 614 and 777 of the International Brotherhood of Electrical Workers and Frank Kuders ("Labor Parties"); PPL Electric Utilities Corporation, PPL EnergyPlus, PPL Brunner Island, PPL Hollwood, PPL Martins Creek, PPL Montour, PPL University Park, Lower Mount Bethel Energy, and PPL Susquehanna (collectively, "PPL"); the City of Philadelphia ("Philadelphia"); Metropolitan Edison Company, Pennsylvania Electric Company, Pennsylvania Power Company and FirstEnergy Solutions, Corp. (collectively, "FirstEnergy"); Action Alliance of Senior Citizens of Greater Philadelphia, Association of Community Organizations for Reform

Now and Tenants' Action Group ("Action Alliance"); The Reinvestment Fund, through its Sustainable Development Fund ("TRF"); Senator Anthony Williams ("Senator Williams"); and Philadelphia Gas Works ("PGW").

The OSBA filed the direct, rebuttal, surrebuttal, and supplemental testimony of OSBA witness Brian Kalcic. *See*, respectively, OSBA St. No. 1, OSBA St. No. 2, OSBA St. No. 3, and OSBA St. No. 4. Each of these statements was admitted into the record of this proceeding with the exceptions of certain redacted portions pursuant to an agreement with the other parties. The OSBA actively participated in the negotiations which led to the filing, on September 12, 2005, of the Joint Petition for Settlement ("Settlement").

The signatories to the Settlement are the Joint Applicants; the OSBA; the OTS; the OCA; the DEP; PennFuture; Action Alliance; the ECA; PIEUG; TRF; and Senator Williams (collectively, the "Joint Petitioners"). The parties not joining in the Settlement are FirstEnergy, PPL, Philadelphia, PGW and the Labor Parties. The Labor Parties indicated that they would not oppose the Settlement. PPL, PGW and Philadelphia stated their opposition to the Settlement and proceeded to continue litigation of their respective issues at the evidentiary hearings held in Philadelphia on September 22, 23 and 26, 2005.

## II. SUMMARY OF ARGUMENT

The Settlement sets forth a comprehensive list of issues which were resolved through the negotiation process. This brief discusses the OSBA's specific reasons for joining in this Settlement. The following settlement provisions were of particular significance to the OSBA in concluding that the Settlement is in the best interests of small business customers.

First, the Settlement provides rate relief to PECO's customers, thereby affording "affirmative public benefits," as required by *City of York v. Pennsylvania Public Utility Commission*, 449 Pa. 136, 141, 295 A.2d 825, 828 (Pa. 1972) ("*York*"). As filed, the Joint Application did not propose to flow any merger savings directly through to PECO's ratepayers. Instead, the Joint Application offered only the vague assertion that economies of scale resulting from the Proposed Merger "may give rise, over time, to lower rates than would otherwise be the case." PECO Statement No. 1, at 10. In contrast, the Settlement provides $120 million in distribution rate reductions. The Settlement also caps PECO's transmission and distribution rates through December 31, 2010, at the level in effect as of January 1, 2006. In its electric restructuring proceeding at Docket No. R-00973953, PECO filed a cost of service study indicating that its small business class (Rate GS-General Service) was providing a rate of return of 11.18% in comparison to a system average rate of return of only 9.44%. Through the interclass allocation of the $120 million in distribution rate reductions, the Settlement mitigates the size of the subsidy provided by Rate GS customers.

Second, by facilitating the Commission's work and acknowledging the Parties' rights under Section 2811 of the Public Utility Code, 66 Pa. C.S. § 2811, the Settlement

addresses concerns expressed in the OSBA's Protest regarding the potential effect of the Proposed Merger on electric generation rates. Section 2811(a) requires the Commission to "monitor the market for the supply and distribution of electricity to retail customers and take steps . . . to prevent anticompetitive or discriminatory conduct and the unlawful exercise of market power." Section 2811(b) provides for the Commission to "conduct an investigation of the impact on the proper functioning of a fully competitive retail electricity market, including the effect of mergers, . . . and anticompetitive or discriminatory conduct affecting the retail distribution of electricity."

The Settlement explicitly recognizes the right of any party (including the OSBA) to request a Commission investigation when the party "reasonably believes that PECO's affiliated generation company (or any other affiliated entity) has unlawfully exercised market power in any PJM market, or for any other reason as set forth in 66 Pa. C.S. § 2811." The Settlement also requires PECO to "file . . . annually for each of the years 2007, 2008, 2009, 2010, 2011 and 2012 a report addressing wholesale market prices and price trends in the Pennsylvania-New Jersey-Maryland Interconnection ('PJM') markets." That report is to include "information regarding price differentials between PJM East and other PJM regions" as well as "other information necessary to assess prices and price trends in the PJM markets." The OSBA anticipates that the report will assist the Commission in fulfilling the monitoring responsibility under Section 2811(a) and will assist the OSBA in determining whether to request a Commission investigation under Section 2811(b).

By resolving the issues of principal concern to the OSBA, the Settlement enables the OSBA to conserve its resources and avoid the uncertainties inherent in fully litigating those issues.

## III. ARGUMENT

### A. Scope of Review

Section 1102(a) of the Public Utility Code, 66 Pa. C.S. § 1102(a), provides that a proposed merger may not be consummated unless the Commission first issues a certificate of public convenience.

When a certificate of public convenience is required, Section 1103(a) of the Public Utility Code, 66 Pa. C.S. § 1103(a), allows the Commission to issue the certificate only upon a finding or determination that the granting of such certificate is "necessary or proper for the service, accommodation, convenience, or safety of the public." According to the Pennsylvania Supreme Court, satisfying this standard requires the Commission to find that a proposed merger would "affirmatively promote the 'service, accommodation, convenience, or safety of the public' in some substantial way." *York* at 449 Pa. 136, 141; 295 A.2d 825, 828. "Further, when the 'public interest' is considered, it is contemplated that the benefits and detriments of the acquisition be measured as they impact on *all affected parties*, and not merely on one particular group . . . ." *Middletown Township v. Pennsylvania Public Utility Commission*, 482 A.2d 674, 682 (Pa. Cmwlth. 1984). [Emphasis in original.] In addition, Section 1103(a) allows the Commission to impose upon its issuance of a certificate of public convenience "such conditions as it may deem to be just and reasonable."

In accordance with Sections 1102(a)(3) and 1103(a) of the Public Utility Code, the Commission may not grant a certificate of public convenience with respect to the Proposed Merger unless the Commission determines that the Proposed Merger is "necessary or proper for the service, accommodation, convenience, or safety of the

public." As noted above, satisfying this standard requires the Commission to find that the Proposed Merger would "affirmatively promote the 'service, accommodation, convenience, or safety of the public' in some substantial way." *York*, 449 Pa. at 141, 295 A.2d at 828.

"The Commission encourages parties to seek negotiated settlements of contested proceedings in lieu of incurring the time, expense and uncertainty of litigation." 52 Pa. Code § 69.391(a). Therefore, settlement of this proceeding is appropriate because the Settlement provides the affirmative public benefits required by *York* and satisfies the applicable statutory requirements in the Public Utility Code.

**B. Jurisdiction**

By their Application, the Joint Applicants requested the Commission's approval of the Proposed Merger, if such approval is required, under Chapters 11, 22, and 28 of the Public Utility Code, 66 Pa. C.S. Ch. 11, 22, and 28. In the alternative, if the Commission determined that Commission approval of the Proposed Merger was not required, the Joint Applicants requested that the Commission issue a declaratory order setting forth that determination. The Joint Applicants based their argument that Commission approval of the Joint Application was not required on their interpretation of The Statement of Policy at 52 Pa. Code § 69.901.

In contrast, the OSBA took the position (beginning with its Notice of Intervention and Protest) that the approval of the Proposed Merger does come under the Commission's jurisdiction. Section 1102(a) of the Public Utility Code, 66 Pa. C.S. § 1102(a), permits a public utility to undertake certain actions only upon Commission

approval evidenced by a certificate of public convenience. Among the activities that require Commission approval is the following:

> (3) For any public utility or an affiliated interest of a public utility . . . to acquire from, or to transfer to, any person or corporation . . . by any method or device whatsoever, including the sale or transfer of stock and including a consolidation, merger, sale or lease, the title to, or the possession or use of, any tangible or intangible property used or useful in the public service.

66 Pa. C.S. § 1102(a)(3).

Exelon is an "affiliated interest" of PECO under Section 2101 of the Public Utility Code, 66 Pa. C.S. § 2101, in that Exelon is a "corporation . . . owning or holding directly or indirectly 5% or more of the voting securities of such public utility [PECO]."[2] PSE&G's natural gas and electric service territories border PECO's natural gas and electric service territories. PSE&G had a license to use, and could again obtain a license to use, its property for the purpose of providing natural gas, electricity, or both to retail customers in the PECO service territories. Therefore, because Exelon would acquire property of PSEG that is useful in the public service, Commission approval of the Proposed Merger is required under Section 1102(a)(3).

Even though the Joint Applicants alleged that the Commission has no jurisdiction over the Proposed Merger, they "surrendered" to the Commission's jurisdiction for purposes of settlement. *See* Joint Application, Vol. 1, Par. 18-20; Settlement, p. 26, Par.

[2] PECO became a wholly-owned subsidiary of Exelon as part of a transaction approved by the Commission's Order entered June 22, 2000, at Docket No. A-00110550F0147. Concurrent with that transaction, Unicom Corporation, the parent of Commonwealth Edison Company ("ComEd") was merged with and into Exelon. Subsequent to a corporate alignment, PECO and ComEd transferred their generation assets, other non-regulated enterprises and business service functions to separate corporations that also became wholly-owned subsidiaries of Exelon. Currently, PECO and ComEd are second tier subsidiaries of Exelon through their immediate parent, Exelon Energy Delivery Company, LLC. Joint Application, Vol. 1, Par. 6, p. 3.

45. As a result, the Settlement avoids the expense and uncertainty involved in litigating the issue of jurisdiction.

### C. Amount of Merger Savings

#### 1. The Claims in the Application

The Application, as filed, did not demonstrate that the Proposed Merger would result in an affirmative public benefit, as required under Section 1103(a) of the Public Utility Code, 66 Pa. C.S. § 1103(a), and under *York*, 449 Pa. at 141, 295 A.2d at 828. Specifically, the Joint Applicants did not propose to flow merger savings through to ratepayers in any meaningful way. The Joint Applicants estimated only a meager $155 million of net merger savings, in aggregate, for their regulated businesses over the four-year period of 2006-2009, and allocated only $46 million of these savings to Pennsylvania operations. PECO St. No. 2 at 4 and WDA Exhibit 6. Moreover, the Joint Applicants did not propose to flow any of these merger savings directly through to their ratepayers. Rather, the Joint Applicants offered only the vague assertion that economies of scale resulting from the Proposed Merger "may give rise, over time, to lower rates than would otherwise be the case." PECO St. No. 1, p. 10.

Therefore, central to this investigation of the Proposed Merger was a determination of the reasonableness of the Joint Applicants' estimate of $155 million of net merger savings to the Joint Applicants' regulated businesses as well as the reasonableness of the Joint Applicants' methodology for allocating merger savings among their regulated and unregulated businesses and among the various states in which the Joint Applicants do business. Additionally, the fashioning of an appropriate plan for

the direct sharing of the net merger savings with the ratepayers has been crucial to a resolution of this proceeding.

### 2. The OSBA's Analysis of Merger Savings

In its direct testimony, the OSBA recommended that the Commission require: (1) that a sharing of the merger savings from both the regulated and non-regulated business segments as a necessary condition of approval of the merger; (2) that the shared merger savings from the regulated electric business be used to mitigate the electric distribution subsidies currently provided by six PECO energy rate classes; and (3) that 50% of Pennsylvania's share of all generation-related savings derived from the non-regulated business be used to mitigate the generation-related rate increases scheduled to be paid by PECO electric customers beginning in 2006 and 2007. OSBA St. No. 1, p. 2.

During the course of the proceeding, the Joint Applicants admitted to four year generation-related savings of $1,030 million after costs-to-achieve, but they claimed that those savings belonged to stockholders because PECO no longer owns the generating plants. OSBA St. No. 3, p. 8. The OSBA testified that about $9.7 million in annual electric distribution-related savings and $1.7 million in annual gas distribution-related savings should be flowed through to ratepayers each year until PECO's next rate case. OSBA also testified that ratepayers should receive 50 % of Pennsylvania's share of the generation-related savings (or $43 million per year) through the end of the recovery of the Competitive Transition Charge ("CTC"). OSBA St. No. 3, p. 10.

### 3. The Merger Savings in the Settlement

Settlements are generally the result of a certain amount of compromise on the part of all the parties involved. This Settlement provides $120 million in rate reductions to

PECO's customers in comparison to the $217.6 million to which the OSBA testified.[3] However, the Settlement also provides for $43.6 million in other quantifiable ratepayer benefits. *See* Settlement, Par. 14, 33, 35a, 35c, 38, 50 and 52. Therefore, the total amount of shared merger savings under the Settlement is at least $163.6 million. The Settlement also provides some unquantifiable benefits, such as rate cap extensions. When all of the Settlement benefits are considered, the total is within range of the $217.6 million to which the OSBA testified. As a result, the OSBA is satisfied that this Settlement is in the best interests of PECO's small business customers.

### D. Mitigation of the Distribution Rate Subsidy Paid by Business Customers

PECO's electric distribution rates were established in its 1998 Electric Restructuring Case at Docket No. R-00973953. As a result of the PECO/Unicom Merger, PECO's distribution rates were reduced on an across-the-board basis over a four year period. These reductions will expire on January 1, 2006, when PECO's distribution rates return to their original restructuring level. The OSBA testified that the distribution-related merger benefits should be used to mitigate the distribution subsidies existing under current rates. OSBA St. No. 1, pp. 9-10. The subsidy paid by the Rate GS class is about $8 million per year under current distribution rates. *See* OSBA Exh. No. 1.

The OSBA also testified that the generation-related savings should be allocated among the rate classes on the basis of the CTC. OSBA St. No. 1, pp. 13-14. The OSBA's position was contrary to the positions of the OCA and the OTS, which both recommended the allocation of generation-related savings among rate classes on the basis

[3] OSBA witness Brian Kalcic recommended rate reductions of $217.6 million. ( ($43million + $9.7 million + $1.7 million) x 4 years). OSBA St. No. 3, pp. 8-10.

of existing distribution rates. Under the OCA and OTS approaches, Rate GS customers would have received no relief with respect to the distribution subsidy. OSBA St. No. 1, pp. 9-10.

Under the Settlement, the subsidy paid by Rate GS customers is mitigated. The table below illustrates the difference in the Rate GS customers' share of the $120 million distribution rate reduction under the OSBA recommendation, the OTS/OCA recommendations and the Settlement.

| **Rate Reductions** | **OSBA** | **OCA/OTS** | **Settlement** |
|---|---|---|---|
| GS - % Share Litigation Position | 26.43% Sch. BK-3,4, OSBA Exh. No. 1 | 16.70% Sch. BK-1R, OSBA Exh. No.2 | 24.64% Appendix A of Stipulation |
| GS $ Share ( % x $120 million) | $31.7 million | $20.0 million | $29.6 million |

As can be seen in this table, the Rate GS class realized significant relief from its subsidy under the Settlement. The result for the Rate GS class is very close to the result the GS class would have realized if the OSBA had prevailed after full litigation of this issue.

### E. Market Power

The issue of market power did not settle. However, the OSBA believes that no party was prejudiced by this because all parties have had the opportunity to litigate this issue. By facilitating the Commission's work and acknowledging the Parties' rights under Section 2811 of the Public Utility Code, 66 Pa. C.S. § 2811, the Settlement addresses concerns expressed in the OSBA's Protest regarding the effect of the Proposed Merger on electric rates.

Section 2811(a) requires the Commission to "monitor the market for the supply and distribution of electricity to retail customers and take steps . . . to prevent anticompetitive or discriminatory conduct and the unlawful exercise of market power." Section 2811(b) provides for the Commission to "conduct an investigation of the impact on the proper functioning of a fully competitive retail electricity market, including the effect of mergers, . . . and anticompetitive or discriminatory conduct affecting the retail distribution of electricity." The Settlement explicitly recognizes the right of any party (including the OSBA) to request a Commission investigation when the party "reasonably believes that PECO's affiliated generation company (or any other affiliated entity) has unlawfully exercised market power in any PJM market, or for any other reason as set forth in 66 Pa. C.S. § 2811."

The Settlement also requires PECO to "file . . . annually for each of the years 2007, 2008, 2009, 2010, 2011 and 2012 a report addressing wholesale market prices and price trends in the Pennsylvania-New Jersey-Maryland Interconnection ('PJM') markets." That report is to include "information regarding price differentials between PJM East and other PJM regions" as well as "other information necessary to assess prices and price trends in the PJM markets." The OSBA anticipates that the report will assist the Commission in fulfilling the monitoring responsibility under Section 2811(a) and will assist the OSBA in determining whether to request a Commission investigation under Section 2811(b).

Section 2811(b) does not explicitly recognize manipulation in the *wholesale* market as grounds for Commission action. However, the Settlement recognizes that manipulation in both the retail and wholesale markets are grounds for a party to seek a

Commission investigation. *See* Settlement, Par. 53a, p. 29. Combined with the recognition by Joint Applicants' witness Hieronymus that wholesale prices drive retail prices, the Settlement could simplify any request for an investigation of market power and, hence, provides additional benefit to ratepayers. Joint Applicants St. No. 3, pp. 8-9.

## IV. PROPOSED FINDINGS OF FACT

1. The Joint Applicants estimated $155 million of net merger savings for their regulated businesses over the four-year period of 2006-2009, and allocated $46 million of these savings to Pennsylvania operations. PECO St. No. 2 at 4 and WDA Exhibit 6 (attached to PECO St. No. 2.)

2. In their direct case, the Joint Applicants did not propose to flow any of the net merger savings from the regulated business directly through to their ratepayers. PECO St. No. 1, p. 10; OSBA St. No. 1, p. 5.

3. In their direct case, the Joint Applicants did not offer to share any of the merger savings from the non-regulated business with Pennsylvania ratepayers. OSBA St. No. 1, p. 5.

4. The generation-related merger savings over four years amounts to $1,030 million after costs-to-achieve. OSBA St. No. 3, p. 8.

5. PECO's electric distribution rates were established in its 1998 Electric Restructuring Case at Docket No. R-00973953. OSBA St. No. 1, p. 10.

6. As a result of the PECO/Unicom Merger, PECO's distribution rates were reduced on an across-the-board basis over a four year period. These reductions will expire on January 1, 2006, when PECO's distribution rates return to their original restructuring level. OSBA St. No. 1, p. 10.

7. PECO's small business customers are members of the Rate GS class, which is currently providing a distribution subsidy on PECO's electric system. OSBA St. No. 1, p. 10. The amount of the Rate GS subsidy in current distribution rates is approximately $8 million per year. OSBA Exh. No. 1, Sch. BK-2, page 1 of 2.

8. The Settlement provides $120 million in rate reductions to PECO's customers in addition to $43.6 million in other quantifiable ratepayer benefits for a total amount of shared merger savings of at least $163.6 million. Settlement, Par. 14, 33, 35a, 35c, 38, 50 and 52.

9. Under the Settlement, the 24.64% or $29.6 million in rate relief received by the Rate GS class over the next four years results in mitigation of the subsidy paid by the Rate GS class under current distribution rates. Settlement, Appendix A (2006 Unbundled Revenue).

10. Under the Settlement, any party has the right to request a Commission investigation when the party reasonably believes that PECO's affiliated generation company (or any other affiliated entity) has unlawfully exercised market power in any PJM market, or for any other reason as set forth in 66 Pa. C.S. § 2811. Settlement, Par. 53b.

11. The Settlement requires PECO to "file . . . annually for each of the years 2007, 2008, 2009, 2010, 2011 and 2012 a report addressing wholesale market prices and price trends in the Pennsylvania-New Jersey-Maryland Interconnection ('PJM') markets." That report is to include "information regarding price differentials between PJM East and other PJM regions" as well as "other information necessary to assess prices and price trends in the PJM markets." Settlement, Par. 53a.

## V. PROPOSED CONCLUSIONS OF LAW

1. PECO is a "public utility," a "natural gas distribution company" and an "electric distribution company" as those terms are defined, respectively, in Sections 102, 2202, 2803 of the Public Utility Code, 66 Pa.C.S. §§ 102, 2202, and 2803, and, therefore, is subject to regulation by the Commission. Application, Vol. 1, Par. 5, p. 2.

2. Section 1102(a)(3) of the Public Utility Code, 66 Pa. C.S. § 1102(a)(3), requires the Joint Applicants to obtain a certificate of public convenience before they consummate the Proposed Merger in Pennsylvania.

3. Section 1103(a) of the Public Utility Code, 66 Pa. C.S. § 1103(a), allows the Commission to issue a certificate of public convenience for the Proposed Merger only if the Commission finds or determines that granting the certificate is "necessary or proper for the service, accommodation, convenience, or safety of the public."

4. Section 1103(a) allows the Commission to impose upon its issuance of a certificate of public convenience for the Proposed Merger "such conditions as it may deem to be just and reasonable."

5. Under *City of York v. Pennsylvania Public Utility Commission*, 449 Pa. 136, 142, 295 A.2d 825, 827 (Pa. 1972), the Commission may issue a certificate of public convenience for the Proposed Merger only if the Commission determines that the Proposed Merger will "affirmatively promote the 'service, accommodation, convenience, or safety of the public' in some substantial way."

6. Under *York*, 449 Pa. at 143-144, 295 A.2d at 829, the Proposed Merger's effect on rates can justify the issuance of a certificate of public convenience for the

Proposed Merger only if that effect will be "beneficial," *i.e.*, will result in lower rates than without the Proposed Merger.

7. The Application, as filed, did not demonstrate that the Proposed Merger would result in an affirmative public benefit, as required under Section 1103(a) of the Public Utility Code, 66 Pa. C.S. § 1103(a), and under *York*, 449 Pa. at 141, 295 A.2d at 828, because the Joint Applicants did not contemplate the sharing of merger savings with ratepayers in any meaningful way.

8. The rate relief of $120 million and the additional $43.6 million in quantifiable benefits proposed in the Settlement provide substantial benefit to PECO's ratepayers.

9. The share of rate relief allocated to the Rate GS class under the Settlement mitigates the subsidy that the Rate GS class pays under current rates and is, therefore, a substantial benefit to PECO's small business customers.

10. Section 2811(a) of the Public Utility Code, 66 Pa. C.S. § 2811(a), requires the Commission to "monitor the market for the supply and distribution of electricity to retail customers and take steps . . . to prevent anticompetitive or discriminatory conduct and the unlawful exercise of market power."

11. Section 2811(b) of the Public Utility Code, 66 Pa. C.S. § 2811(b), provides for the Commission to "conduct an investigation of the impact on the proper functioning of a fully competitive retail electricity market, including the effect of mergers, . . . and anticompetitive or discriminatory conduct affecting the retail distribution of electricity."

12. The reports that PECO will file with the Commission pursuant to Paragraph 53a of the Settlement are beneficial to the public interest because these reports will assist the Commission in fulfilling its monitoring responsibility under Section 2811(a) and will assist the Parties in determining whether or not to seek Commission action under Section 2811(b).

## VI. PROPOSED ORDERING PARAGRAPHS

1. In that the Settlement assures that the Proposed Merger will "affirmatively promote the 'service, accommodation, convenience, or safety of the public' in some substantial way," the Settlement is in the public interest and is hereby approved without modification.

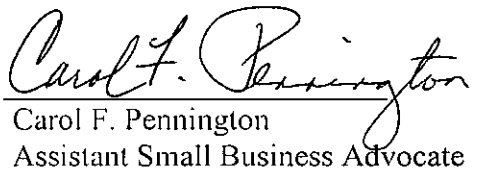
2. In that the Settlement assures that the Proposed Merger will "affirmatively promote the 'service, accommodation, convenience, or safety of the public' in some substantial way," the Proposed Merger is hereby approved and a certificate of public convenience is hereby granted, subject to the conditions set forth in the Settlement.

3. The proceeding at Docket No. A-110550F0160 shall be marked closed.

## VII. CONCLUSION

For the reasons stated herein, the OSBA respectfully requests that the ALJ and the Commission approve the Settlement without modification. Furthermore, if the Settlement is approved without modification, the OSBA respectfully requests that the ALJ and the Commission approve the Proposed Merger and issue a certificate of public convenience subject to the conditions set forth in the Settlement.

Respectfully submitted,



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Dated: October 14, 2005

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SECRETARY'S BUREAU

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

| | | |
|---|---|---|
| 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 |

**CERTIFICATE OF SERVICE**

I certify that I am serving two copies of the Main Brief on behalf of the Office of Small Business Advocate, by e-mail and first class mail (unless otherwise indicated) upon the persons addressed below:

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