

# ORIGINAL



October 21, 2005

Reply to Philadelphia Office


James J. McNulty, Secretary  
Pennsylvania Public Utility Commission  
P.O. Box 3265  
Harrisburg, Pennsylvania 17105-3265

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

Dear Secretary McNulty:

Please be advised that the PennFuture Parties will not be filing a Reply Brief in  
the above-captioned proceeding. Copies of this letter have been served on the parties as  
set forth in the Certificate of Service.

Sincerely,

  
Charles McPhedran  
Senior Attorney

cc: Hon. Marlane R. Chestnut  
Certificate of Service

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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  
WITH AND INTO EXELON  
CORPORATION

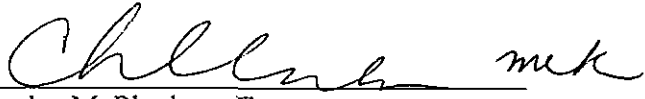
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DOCKET NO. A-110550F0160

CERTIFICATE OF SERVICE

I hereby certify that I have this day served copies of the letter dated October 21, 2005 upon the following persons in accordance with the requirements of § 1.54 (relating to service by a participant).

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**VIA HAND DELIVERY**

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

Dear Secretary McNulty:

Please be advised that the Philadelphia Area Industrial Energy Users Group ("PAIEUG") will not be submitting a Reply Brief in the above-referenced proceeding. Although PAIEUG did not submit a Main Brief or Reply Brief in this proceeding, PAIEUG reserves the right to file Exceptions or Reply Exceptions, as necessary.

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

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Very truly yours,

McNEES WALLACE & NURICK LLC

By *Charis Mincavage*  
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Counsel to Philadelphia Area Industrial  
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CM/lhe  
Enclosures

c: Honorable Marlane Chestnut, Administrative Law Judge (via e-mail and first class mail)  
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32

**CERTIFICATE OF SERVICE**

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

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**Docket No. A-110550F0160**

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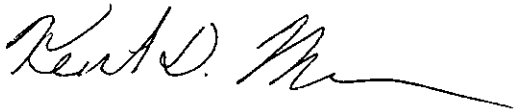
**RE: Joint Application of PECO Energy Company and Public Service  
Electric And Gas Company for Approval of the Merger of Public  
Service Enterprise Group Incorporated with and into Exelon Corporation  
Docket No. A-110550F0160**

Dear Secretary McNulty:

Please find enclosed and original and nine copies of the Reply Brief of Joint Applicants, PECO Energy Company and Public Service Electric and Gas Company, in the above-captioned proceeding.

I am enclosing a copy of this letter to be date-stamped and returned in the self-addressed stamped envelope.

Sincerely,



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cc: Honorable Marlane R. Chestnut (via Hand Delivery)  
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BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION

OCT 21 2005

PA PUBLIC UTILITY COMMISSION  
SECRETARY'S BUREAU

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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Date: October 21, 2005

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66 Pa. C.S. § 2811(e)(1).....20

## I. INTRODUCTORY STATEMENT

The Joint Applicants, PECO Energy Company (PECO) and Public Service Electric and Gas Company (PSE&G), file this Reply Brief in response to the Main Briefs of the City of Philadelphia (City), the FirstEnergy Companies (FirstEnergy), the Philadelphia Gas Works (PGW) and the PPL Companies (PPL), each of which has recommended that the Merger proposed herein not be approved unless conditions in addition to those set forth in the Settlement are imposed.<sup>1</sup> Most of the arguments advanced by the opposing parties in their Briefs were anticipated and fully addressed by the Joint Applicants in their Initial Brief, dated October 14, 2005, and, consequently, a point-by-point rebuttal is unnecessary. Several key areas will be revisited, however, if only to eliminate any confusion over the evidence and regulatory principles that should guide the Commission's action in this case.

Preliminarily, the Joint Applicants offer some general observations regarding the opposing parties' Briefs. First, several parties seriously misconstrue and misapply the legal standards against which the Merger must be measured. For example, the City implies that the "affirmative public benefit" test enunciated in the *York* case<sup>2</sup> can only be met if each and every stakeholder's "wish list" is fully satisfied. Indeed, the City's principal complaint is not that the Settlement will fail to generate substantial benefits, but rather that (1) the Settlement does not

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<sup>1</sup> The Office of Trial Staff (OTS), Office of Consumer Advocate (OCA), Office of Small Business Advocate (OSBA), Citizens for Pennsylvania's Future, *et al.* (PennFuture) and The Reinvestment Fund/Sustainable Development Fund (TRF) filed Main Briefs with attached findings and conclusions that support the Settlement and the Merger. The Pennsylvania Department of Environmental Protection (DEP), Action Alliance of Senior Citizens of Greater Philadelphia (Action Alliance) for itself and on behalf of the Association of Community Organizations for Reform Now (ACORN) and the Tenant's Action Group (TAG) (collectively, Action Alliance) filed proposed findings of fact and conclusions of law in support of the Settlement and the Merger. Additionally, on September 13, 2005, the Exelon Utility Coordinating Council, International Brotherhood of Electrical Workers Locals 614 and 777 and Frank Kuders (collectively, the Labor Parties) filed a letter with the Administrative Law Judge (ALJ) and the Commission's Secretary stating they do not oppose the Joint Petition.

<sup>2</sup> *York v. Pa. P.U.C.*, 449 Pa. 136, 295 A.2d 825 (1972).

give the City all that it wants and (2) certain concessions made by PECO do not extend beyond 2010. Yet, as the Commission has made clear on numerous occasions, most recently in the *SBC/AT&T* case,<sup>3</sup> the *York* test does not require merging parties to demonstrate that all aspects of their operations will be enhanced. Furthermore, the Joint Applicants are unaware of any instance in which the Commission rejected a settlement because its terms did not remain in place indefinitely.

In like fashion, PPL, PGW and FirstEnergy contend that the Merger - - even after the unprecedented mitigation to which the Joint Applicants have committed - - **may** lead to the **opportunity** to exercise market power or, alternatively, **may** create a **perception** that the merging parties have the ability to exercise market power. That, however, is not the legal standard. To the contrary, Sections 2210 and 2811 authorize the Commission to impose conditions only if it concludes that a merger is **likely** to result in anticompetitive or discriminatory conduct (66 Pa. C.S. §§2210 (a)(1) and 2811 (e)(1)). No such showing was made in this case.

Second, the opposing parties do not allege that the Merger will have a direct adverse effect on competitive retail electric and natural gas markets in Pennsylvania (*e.g.*, through the elimination of a potential supplier). Instead, they speculate that the exercise of market power in wholesale markets might have an indirect impact on retail prices. This is an important distinction because the opposing parties essentially restate here, in virtually identical language, the same concerns that were presented to and rejected by the FERC earlier this year. In fact, the only new idea floated in the opposing parties' Briefs is PPL's suggestion that the Commission

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<sup>3</sup> *Joint Application of SBC Communications, Inc. and AT&T Corp.*, Docket Nos. A-31163F0006, A-310213F0008 and A-310258F0005 (October 6, 2005).

“certify” its record and findings to the FERC, the U.S. Department of Justice, the Attorney General of Pennsylvania and the New Jersey Board of Public Utilities. The Joint Applicants question whether the proposed “certification” would serve any useful purpose and/or would even be accepted by those other agencies.<sup>4</sup> More to the point, since the FERC has already completed its market power investigation, it surely would make more sense for the Commission to take notice of and give considerable weight to the FERC’s findings, not vice versa.

Finally, it appears that all parties, including the City and PGW, concur that the possible consolidation of the PECO, PSE&G and PGW gas operations, as posed in Directed Question No. 5, should not be addressed in this case, but rather should be referred to a separate fact-finding proceeding. Although the City would like to launch that proceeding shortly after the conclusion of this one, there is no justification for beginning that inquiry until the Merger has been consummated. Stated differently, the Settlement provides that its terms will not be implemented and enforceable until the Merger closing and there is no basis for carving out this particular feature of the Settlement for differential treatment.

For the reasons set forth in their Initial Brief and hereinafter, the Joint Applicants believe that the application of the correct legal standards to the evidence presented leads to the inescapable conclusion that the Merger will affirmatively benefit the public in a substantial way. The Settlement and Merger should, therefore, be approved.

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<sup>4</sup> It is certainly conceivable that parties to the FERC and NJBPU proceedings would object to the introduction into their cases of an evidentiary record created in another jurisdiction without their participation.

## II. ARGUMENT

### A. The Opposing Parties Misconstrue And Misapply The Applicable Legal Standards

There is general agreement that the standard for approval of a merger or acquisition is set forth in 66 Pa. C.S. § 1103(a), as interpreted by *York*. However, the City's interpretation and application of that standard to the facts of this case are erroneous and represent a marked departure from prior Commission and appellate court precedent. Specifically, the City implicitly assumes that *York's* affirmative benefit test requires the Commission to find, or mandate, that a proposed merger provide individualized benefits to each party that claims to be affected by the transaction. Based on that errant assumption, the City contends that the Merger should not be approved absent requirements that the Joint Applicants concede, or the Commission direct, that the City receive a host of additional "benefits" (e.g., a larger share of economic development funds, higher levels of charitable giving, no reduction in employee positions located in Philadelphia) (*see* Section II. B., *infra*).

Arguments like those advanced by the City have been rejected by appellate courts and the Commission. Thus, in *Middletown Township v. Pa. P.U.C.*, 482 A.2d 674, 682 (Pa. Cmwlth. 1984), the Commonwealth Court, in addressing the standards for Commission approval of an acquisition, held:

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 or geographic subdivision as might have occurred in this case. (Emphasis in original.)

Similarly, this Commission has held that, once it is determined that a merger will, overall, produce substantial, affirmative public benefits, there is no basis for attaching conditions to its approval in order to assure specific benefits to particular parties. *See Joint Application of*

*Pennsylvania-American Water Company And Thames Water Aqua Holdings* (Initial Decision of Administrative Law Judge Wayne L. Weismandel), 2002 Pa. PUC LEXIS 32 (2002) affirmed 221 P.U.R. 4th 487 (2002) (Because the joint applicants established that the merger overall produced affirmative benefits, conditions proposed by opposing parties addressed to their particular interests were rejected.) *See also Joint Application Of SBC Communications, Inc. And AT&T Corp. supra* (Order at 27) and Jt. App. Initial Brief at 8-9.

In like fashion, there is general agreement that 66 Pa. C.S. §§ 2210 and 2811(e) require the Commission to consider the impact of a proposed merger or acquisition on the competitive retail markets for natural gas and electricity, respectively. Nonetheless, the legal standard incorporated in the opposing parties' arguments on market power issues is far different from what the law demands.

Both Sections 2210 and 2811(e) authorize the Commission to condition or withhold approval only if a transaction "is *likely* to result in anticompetitive or discriminatory conduct" (emphasis added). However, the opposing parties that substantively addressed market power issues ask the Commission to withhold approval based on the mere possibility that the Merger could raise market power concerns.<sup>5</sup> Obviously, that is not the standard established by the Public Utility Code, and for good reason. A merger or acquisition should not be disapproved simply because someone can conceive of a set of facts that might raise a market power concern. In short, mere speculation about future events is not a rational basis for regulatory action (*see* Section II. B., *infra*).

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<sup>5</sup> For example, PGW argues that the legal standard is whether the Merger "*provides the opportunity* for anticompetitive or discriminatory conduct" (PGW Brief at 11) (emphasis added)). Such a purported standard is, on its face, at odds with the relevant statutory language ("likely to result . . ."), as explained above. Although the Joint Applicants have demonstrated that, with mitigation, the Merger will not even "provide the opportunity" for the exercise of market power in either retail or wholesale markets, the fact remains that PGW's arguments are based upon a clearly erroneous interpretation of the applicable law.

Finally, the City challenges the Joint Applicants' position that the Merger is not a change-in-control as defined in the Commission's Policy Statement at 52 Pa. Code § 69.901 (*see* City Brief at 5). This issue will be academic if the Commission approves the Settlement, as the Joint Applicants firmly believe the Commission should. Nonetheless, the City's position is not correct.

The City's argument hinges on the language of Section 1102(a)(3) referring to "an affiliated interest of a public utility." Apparently, the City contends that since Exelon is an affiliated interest of PECO, Exelon's merger with PSEG represents an acquisition of PSE&G property that is "used or useful in the public service." The obvious flaw in this argument is that it assumes, incorrectly, that the phrase "property used or useful in the public service" is broad enough to encompass property that is not owned by a Pennsylvania public utility and is not subject to regulation by the PUC. That cannot be the case. Section 1102(a)(3) cannot be interpreted or applied to give it an extra-territorial, non-Pennsylvania reach.<sup>6</sup> Such an interpretation, in addition to conflicting with a sound statutory construction of Section 1102(a)(3), would raise serious Commerce Clause issues. Furthermore, the Commission's Policy Statement on change-in-control transactions makes it clear that approval is necessary only when a transaction effects a change-in-control of a **Pennsylvania** utility (52 Pa. Code § 69.901(b)(1)).

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<sup>6</sup> For example, under the City's interpretation, the parent of a Pennsylvania utility would need to obtain approval under Section 1102(a)(3) to acquire the stock of a company that provides only FERC jurisdictional service, since the property of the acquired company is indisputably "used or useful in the public service" – although not in Pennsylvania retail service.

**B. The City Mischaracterizes Important Elements Of The Proposed Settlement**

The City contends that the Joint Applicants have failed to satisfy the “affirmative benefit” test for Commission approval delineated in *York, supra*. As explained in Section II.A., *supra*, this argument misconstrues the applicable law and, as discussed below, is based on a serious mischaracterization of the relevant facts surrounding the terms of the Settlement and the benefits the Merger and Settlement will produce for PECO’s customers and the public in general.

The City urges the Commission to either (1) unilaterally attach “additional, enforceable commitments” to its approval of the Merger or (2) “hold in abeyance any ruling on the Settlement while the Applicants and intervening parties renegotiate additional commitments” beyond those already set forth in the Settlement (City Brief at 3). The first alternative is clearly unworkable because the “additional, enforceable commitments” alluded to by the City have not been spelled out either in the testimony of its witness or in its Main Brief.<sup>7</sup>

The City’s second alternative relief request is unprecedented, unauthorized and unwarranted and is simply an effort to get a “second bite at the apple.” The City had a full and fair opportunity to participate in the negotiations that led to the Settlement and did so. It also had a full and fair opportunity to litigate its positions in accordance with the procedural schedule to which the parties agreed and did so. The City’s proposal that the proceeding be held “in abeyance” is a transparent attempt to hold the Merger hostage until the City’s subjective demands are met. The City’s effort to derail this proceeding, wherein a broad group of

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<sup>7</sup> E.g., City Brief at 15 (the Settlement’s low income provisions should be revised “to expand the benefits beyond 2010”), 16 (“substantial and verifiable reliability and customer service measures” should be adopted that “ensure an improvement in these services beyond that already required under the Public Utility Code”), 24 (finding fault with commitments to protect PECO customers from the risks of Exelon’s unregulated businesses without offering an alternative), 26-28 (disparaging PECO’s commitments to maintain the current levels of its field work force and limit reductions in other positions in accordance with specified criteria without offering an alternative).

stakeholders worked diligently to achieve a balanced and reasonable result, should be forcefully rejected.

At pages 4-12 of its Brief, the City contends that the Merger, as initially presented in the Joint Application, does not meet the requirements for Commission approval under the *York* test. This argument is wrong and, in light of the Settlement, irrelevant.

Contrary to the City's contentions, the combination of Exelon and PSEG is in the public interest and will produce substantial public benefits. The Merger will create economies of scale and scope and generate opportunities for meaningful cost savings within the regulated distribution businesses of Exelon and PSEG (PECO St. 1 at 6-8). It will also increase the financial strength and flexibility of the combined entity, thereby enhancing the ability of Exelon and PSEG and their distribution subsidiaries to obtain access to capital at favorable rates (*Id.*). These efficiency gains will permit PECO to contain cost increases in its regulated operations, maintain the capacity to provide safe and adequate service while operating under rate caps, and mitigate any post-cap distribution rate increases (*Id.*). The Merger will also allow the sharing of best practices, which will enhance the already high-quality service that PECO provides.

The beneficial consequences of the Merger outlined in the Joint Application and supporting testimony (PECO Sts. 1 and 2) are exactly the kind of merger-related benefits that the Pennsylvania Supreme Court, in *York*, held "will affirmatively promote the 'service, accommodation, convenience, or safety of the public' in some substantial way." 295 A.2d at 828. (*See* Jt. App. Initial Brief at 7-8). This Commission also has repeatedly held that such factors constitute substantial public benefits that meet the legal standard for approval of a merger or acquisition. *E.g., Joint Application Of Pennsylvania-American Water Company And Thames Water Aqua Holdings*, 221 P.U.R. 4th 487, 495-96 (2002) (The combination of American Water

Works and RWE/Thames would produce a financially stronger company, provide better access to capital at favorable rates and increase the combined entity's capability in research and development and the deployment of new technology). *See also* Jt. App. Initial Brief at 8, note 8.

The Commission recently reaffirmed the position it expressed in earlier decisions. In *Joint Application of SBC Communications, Inc. And AT&T Corp., supra*, the Commission found that the *York* test was satisfied by evidence that a proposed merger would create a financially stronger competitor; would better equip the new entity to offer innovative, high quality telecommunications services; would result in savings of fixed and variable costs by eliminating duplicative facilities and overlapping staffs and functions; and would produce efficiencies from standardizing business processes (Order at 10-13, 23-24). In that case, the Commission rejected proposals to attach "conditions" to its merger approval to reduce or cap rates or require a minimum level of capital expenditures despite the fact that SBC estimated combined synergies of \$2 billion per year when fully integrated with AT&T in 2008 (Order at 8, 27, 49-50, 57-61). In summary, the City's contention that the Merger, as presented in the Joint Application, does not produce substantial public benefits is contrary to the prior holdings of this Commission and Pennsylvania's appellate courts.

Furthermore, in contending that the Merger as filed does not satisfy the *York* test (City Brief at 3-12), the City is simply knocking down a straw man because its arguments ignore the effect of the Settlement. While the Joint Applicants are convinced that the Merger, as initially presented in their Joint Application, is in the public interest and provides substantial public benefits, they agreed to significant concessions and conditions as set forth in the Joint Petition for Settlement (Joint Petition) to eliminate any controversy on that score (Jt. App. Initial Brief at

1-2, 11-14). As a consequence, virtually all of the City's criticisms of the Merger – while presenting no valid basis for disapproval – were, nonetheless, addressed by the Settlement.

Beginning at page 12 of its Brief, the City asserts that the Settlement also fails to provide benefits sufficient to pass the *York* test. Central to the City's argument is its contention that the Merger would create "market power" in the merged entity (City Brief at 3, 9-12). While acknowledging that the Settlement would, in fact, create benefits for PECO's customers and the public generally (City Brief at 3 and 16), the City nonetheless asserts that those benefits are insufficient to outweigh the alleged harm that Exelon's post-merger "market power" would produce (City Brief at 12). The City is wrong on all counts.

First, the City presented no testimony or other evidence on market power issues and did not participate actively in that aspect of the case. Its arguments that the Merger would create horizontal and vertical market power simply assume that the testimony presented by PGW's witness, Dr. Carpenter, has "dispositive" probative value and do not engage the testimony of the Joint Applicants' experts, which thoroughly discredited Dr. Carpenter's assumptions and conclusions.<sup>8</sup> Astonishingly, the City never mentions that the FERC rejected claims of market power identical to those raised here by Dr. Carpenter. *See Exelon Corp.*, 112 FERC ¶61,011 (July 1, 2005) at 62-64. As explained in the Joint Applicants' Initial Brief (at 37-48) and in Section II. C., *infra*, the City's market power contentions are not supported by the facts, are contrary to sound economic theory and, therefore, were properly rejected by the FERC. *Id.*

Second, the City's disparagement of the Settlement as "vague and illusory promises from PECO that will not ensure ratepayer benefit" bears no resemblance to the actual terms of the

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<sup>8</sup> The City's attempt to address the testimony of Joint Applicants' witness, Dr. Morris, ignores his written rebuttal testimony entirely (PECO St. 11-R) and seriously misstates the substance of his oral rejoinder (City Brief at 20, note 8).

Joint Petition. Indeed, the City's characterization is totally undercut by the support of the Settlement offered by its signatories, which include representatives of the residential, commercial and industrial customer classes, the Commonwealth of Pennsylvania through DEP and OTS, advocacy groups for senior citizens and low-income customers, and organizations dedicated to environmental protection and community and economic development. Simply stated, there are a host of parties, representing a broad array of diverse interests, that firmly believe the Settlement will produce substantial public benefits for PECO's customers, for the economy of Southeastern Pennsylvania and for the public overall.

Moreover, the City's criticisms of the specific terms of the Settlement misstate and/or misconstrue what the Joint Petition actually says. And, in all instances, the City offers nothing more than unsubstantiated and unrealistic assertions that, while the Settlement will produce benefits (*see* City Brief at 16), they should be larger, should last longer and should direct greater largess to the City. None of these criticisms is valid, as explained below.

**Rate Reductions And Rate Caps (City Brief at 13-14).** The Settlement provides for \$120 million in electric rate reductions over four years and establishes caps on PECO's T&D charges until January 1, 2011, thereby ensuring a period of T&D rate stability of over 20 years since the conclusion of PECO's last electric base rate case in 1990 (Joint Petition at ¶¶ 14-18). The City contends that these concessions are not substantial because the duration of the rate reductions and rate caps (four years and approximately five years, respectively) renders only a "short-term benefit." That characterization is simply wrong since no one would reasonably conclude that a four or five-year duration is "short-term."

Implicit in the City's criticism is the assumption that rate reductions and rate caps must be indefinite in duration in order to be substantial. Certainly that is not the case. Indeed, an

indefinite moratorium on rate relief could seriously harm the financial health of a utility, eventually compromise its ability to meet its service obligations and, therefore, would be inconsistent with the Commission's duty to regulate utilities in a manner that assures both "just and reasonable rates" and the continued provision of safe and reliable service (66 Pa. C.S. §§ 1301 and 1501). Given the significant upward pressure on the costs being incurred by PECO in many areas, including health care, pensions, retiree medical benefits, and critical materials (PECO St. 1-R at 43-44), rate reductions and rate caps of indefinite duration, as envisioned by the City, should not be considered and, more importantly, would be contrary to the public interest.

**Universal Service/Customer Assistance Programs (CAP) (City Brief at 14-15).**

PECO has agreed to a comprehensive package of enhancements to its universal service and CAP Rate Program (Jt. App. Initial Brief at 12-13; Joint Petition at ¶¶ 33-37). The City claims that these enhancements do not rise to the level of "substantial benefits" because they "expire in 2010." That is simply not correct. The most significant changes to which PECO agreed were to substantially increase the monthly usage levels eligible for discounts under its CAP rates and to provide additional payment arrangements to CAP customers that become delinquent (Joint Petition at ¶ 34). Those are changes that will be embodied in PECO's tariff and **will not expire in 2010** (*Id.*). PECO has also made a number of monetary commitments (*see* Joint Petition at ¶ 35). Here, again, the City simply asserts that an indefinite funding commitment is the only concession that should be considered "substantial."

**Economic Development (City Brief at 15-16).** PECO has committed to contribute \$8.0 million to the Pennsylvania Energy Development Authority (PEDA) to be used for energy-related economic development projects and initiatives of benefit to PECO's service territory

(Joint Petition at ¶ 52). The City disputes the substantiality of this commitment because PECO's contribution is being made to a State agency rather than being targeted for use within Philadelphia (City Brief at 15). In addition, the City contends that, in lieu of a cash contribution, a portion of the "virtually divested" generation should be appropriated for economic development within the City to be used at the City's discretion (*see* City St. 1-S at 2-6). Neither of these criticisms is valid and neither forms any valid basis for rejecting the Settlement.

In approving a merger, the Commission must consider the public interest – not just the parochial interest of a particular party or geographic area. *See Middletown Township v. Pa. P.U.C.*, 482 A.2d 674, 682 (Pa. Cmwlth. 1984). Certainly, there is no reason to presume, as the City clearly does, that PEDDA – an agency of the Commonwealth – will neglect its duty to act in the public interest. While the City's desire to maximize its share of the economic development pie is understandable, the City's self-interest cannot be equated with the public interest.

The City's insistence that a "set aside" of virtually divested generation is the only way to achieve a substantial benefit in the area of economic development is also wrong. Obviously, it should make little difference to a business whether economic development assistance were to come in the form of reduced electric rates or a more direct subsidy. In fact, since the latter provides the recipient greater operational flexibility, a business contemplating moving to, or expanding in, the service territory would likely prefer it. Just as important, the City ignores the serious problems that the set aside program would confront.

Initially, it is worth noting that the generation in question is not owned by PECO, is sold in interstate commerce and such sales are subject to the exclusive regulatory jurisdiction of the FERC. Therefore, dictating the use or disposition of any of the "virtually divested" generation is outside the jurisdiction and authority of this Commission. In addition, attempts to appropriate

the use of that generation without just compensation – or to withhold approval of the Merger to achieve the same result – would run afoul of the “takings” provisions of the Federal and State Constitutions (PECO St. 12-DQ at 9-11). U.S. Const. amend. V and XIV; *Brooks-Scanlon Co. v. Railroad Comm. of Louisiana*, 251 U.S. 396 (1920). Other constitutional prohibitions are implicated by the set-aside program because its use of government power to intrude on the operation of the interstate market for wholesale electric power in order to garner disproportionate benefits for Pennsylvania raises serious Commerce Clause issues (PECO St. 12-DQ at 11-12). *See New England Power Co. v. New Hampshire*; 455 U.S. 331 (1982). The set-aside proposal is also problematic because in order to comply with the FERC-approved mitigation plan, a state agency or its surrogate would have to become a participant (*i.e.*, a buyer and seller) in the wholesale market for electric power, would have to meet PJM requirements to function in that role, and would be subject to market price risks (PECO St. 3-DQ at 1-7). That kind of governmental intrusion into the operation of the wholesale power market is contrary to the legislative intent underlying the Electricity Generation Customer Choice and Competition Act (PECO St. 12-DQ at 14-16) and would likely raise the price of electric power for others in PJM (PECO St. 3-DQ at 8). In summary, upon close examination, serious legal and practical problems emerge with respect to the set aside program. Moreover, it is not, at this point, supported by any party other than the City. In contrast, many parties fully support the contribution to PEDA as an appropriate way to foster economic development.

**Reliability And Customer Service (City Brief at 16-18).** In the Settlement, PECO has agreed to a comprehensive and detailed Quality of Service Plan (QSP) to maintain and improve reliability and customer service (Joint Petition at ¶¶ 20-32; Jt. App. Initial Brief at 12). The City denies that this commitment is a substantial public benefit because it claims the QSP does not

require improvements beyond existing standards and has no “enforcement mechanisms” (City Brief at 16-17). Neither contention is correct.

First, the City misperceives the performance thresholds that the QSP would establish, which are considerably more stringent than the standards that would otherwise apply to PECO. For example, starting January 1, 2006, PECO will be subject to Commission imposed 12-month performance thresholds of 1.48 for “SAIFI” and 134 for “CAIDI” (PECO St. 8-R at 9, column B; *Amended Reliability Benchmarks and Standards for the Electric Distribution Companies*, 233 P.U.R. 4th 447 (2004) (Appendix B, column D). However, under the performance thresholds imposed by the QSP, those metrics are 1.28 and 125, respectively (Joint Petition at 12). As their names imply, SAIFI (System Average Interruption Frequency Index) and CAIDI (Customer Average Interruption Duration Index) are measures of the frequency and duration, respectively, of interruptions. *See* 52 Pa. Code §57.192. Therefore, the lower the performance threshold, the more stringent the standard.

Second, the Settlement contains specific, detailed enforcement procedures that provide for mandatory initiation of a Commission proceeding in the event PECO fails to satisfy a performance threshold under the QSP and place the burden of proof on PECO to justify its performance (Joint Petition at ¶ 26). The City seems to think that “enforcement” must be equated with the automatic imposition of “monetary penalties” (City Brief at 17-18). Clearly, that is not the case. As the Settlement makes clear – and as the settling parties recognize – the goal of any reliability enhancement should be to assure safe and reasonable service, which is what the QSP is designed to achieve.

**Investigation Of The Potential For Consolidation Of Gas Operations (City Brief at 22-23).** This portion of the City’s Brief is addressed in Section II.D., *infra*, in the discussion of

parties' responses to Directed Question No. 5. It is sufficient to note here that the City agrees with the settling parties' conclusion that the potential for combining the gas operations of PECO, PSE&G and PGW cannot be assessed without considerable additional study and that process should take place in a separate investigation. The Settlement incorporates an agreement by the settling parties that would enable just such a proceeding to be initiated by the Commission.

**Corporate Structure Protections (City Brief at 23-24).** The Settlement contains provisions to protect customers from the risks associated with unregulated affiliates and cross-subsidization (Joint Petition at ¶¶ 40-48). The City claims that the protections are inadequate to protect customers and cites the testimony of OTS witness Kevan Deardorff to support its position. However, the corporate structure protections in the Settlement incorporate the principal elements of Mr. Deardorff's proposal, and, significantly, the OTS is a signatory and supporter of the Settlement. Additionally, and contrary to the City's assertions (City Brief at 24), the Settlement (1) precludes PECO from seeking a rate cap exception based on a claim that "increases in the price of purchased power are outside the control of PECO simply because the purchase is from Exelon Generating Company, LLC, or another affiliate" (Joint Petition at ¶ 44); and (2) restricts the use of PECO's assets and credit for non-regulated affiliates (Joint Petition ¶ at 41).

**Corporate Presence/Corporate Headquarters (City Brief at 25-26).** PECO has committed to maintaining the headquarters for its distribution business in Philadelphia through at least December 31, 2010 (Joint Petition at ¶ 49). The City wants the commitment to last through 2014 because, as the recipient of ancillary benefits from the employment and corporate presence that attend a Philadelphia-based office location, the longer the commitment the better from the City's perspective. While PECO has no plans to move its headquarters, tying its hands for the

next nine years in the fashion City proposes would be improper, would unreasonably restrict the flexibility PECO needs to operate its business efficiently and could interfere with PECO's duty to provide reasonable service to customers.

Moreover, the Commission does not have the authority to micromanage any utility's business in the manner the City proposes because the appellate courts of Pennsylvania have repeatedly ruled that utilities themselves, not the Commission, have the right to make such business decisions in the first instance. *Northern Pennsylvania Power Company v. Pa. P.U.C.*, 333 Pa. 265, 268, 5 A.2d 133, 134-135 ("The Public Utility Commission is not a super board of directors for the public utility companies of the State and it has no right of management over them."). *Accord Metropolitan Edison Company v. Pa. P.U.C.*, 62 Pa. Cmwlth. 460, 466-67, 437 A.2d 76, 80 (1981); *NAACP v. Pa. P.U.C.*, 5 Pa. Cmwlth. 312, 319, 290 A.2d 704, 708 (1972). In other words, PECO's commitment to maintain its headquarters in Philadelphia is a concession that can be provided only by the Settlement, since the Commission lacks the authority to impose such a condition to its Merger approval.<sup>9</sup>

**Charitable Giving (City Brief at 25).** PECO has committed to fund charitable giving and sponsorships at a level of at least \$3.0 million per year in each of the years 2007 through 2010 (Joint Petition at ¶ 50). The City contends that this commitment simply maintains the "status quo," and the Commission should direct PECO to increase its commitment and extend it "through at least 2014." Initially, it can hardly be suggested that PECO's commitment to charitable giving of at least \$12.0 million over a four-year period is not a substantial benefit. Furthermore, currently, PECO is under no commitment to make any charitable contributions, and

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<sup>9</sup> See, e.g., *Western Pennsylvania Water Co. v. Pa. P.U.C.*, 471 Pa. 347, 370 A.2d 337 (1977) (Since the Commission lacks the authority to order a utility to extend its service territory involuntarily, it cannot exercise equivalent authority by attaching a condition to a certificate of public convenience).

its agreement to undertake such a commitment for four years is, therefore, a substantial benefit over the “status quo.” The City’s desire to get more, while an expression of self-interest, is no reason to find that the Settlement fails to produce substantial public benefits. Finally, and most importantly, the City overlooks the fact the Commission does not have the authority to direct PECO to either make or increase charitable contributions. *Pa. P.U.C. v. Pennsylvania-American Water Company*, 231 P.U.R. 4th 277, 316 (2004) (“Quite simply, the Commission is without authority to require PAWC, or any public utility, to either make or increase charitable contributions derived solely from shareholder funds and kept entirely ‘below-the-line’ for rate making purposes.”)

**Staffing Levels (City Brief at 26-28).** PECO has made significant commitments to maintain staffing levels following the Merger. First, PECO agreed not to make any reductions in field forces levels prior to January 1, 2011 (Joint Petition at ¶ 51). Second, PECO agreed not to make reductions in certain specified categories as a result of the Merger beyond those reductions heretofore identified in this proceeding (*Id.*). The City disapproves of this aspect of the Settlement on the grounds that any reduction in PECO’s employment within Philadelphia will “harm” the City, and, therefore, the Commission should impose a condition that would force PECO to “maintain the current total of full- and part-time employees within the City,” apparently for an indefinite period (City Brief at 29).

This is another instance where the City seeks to equate its self-interest with the public interest. As Mr. Arndt explained, in connection with the study he performed of Merger-related synergies, a substantial portion of the cost savings PECO will realize will come from the elimination of positions that become duplicative after the Merger (PECO St. 2 at 17; PECO Exh. WDA-2). Maintaining unnecessary and duplicative positions in order to pump up the City’s

wage tax revenue may be perceived as a benefit to the City, but it certainly does not represent a benefit to PECO's customers or to the public interest generally. Additionally, like the issue of mandating the location of PECO's headquarters, decisions about staffing levels are within the discretion of utility management, and the Commission is not authorized to override a utility's judgment in such matters. *See Northern Pennsylvania Power Company v. Pa. P.U.C., supra*<sup>10</sup>.

Lastly, the City's attempt to calculate the wage tax effect of the force reductions should be rejected for several reasons. First, it is based upon facts (tax rates, assumptions about compensation levels and location of employees) and computations that are not in the record. If the City wished to introduce such evidence, it should have done so during the evidentiary phase of the proceeding, when PECO would have had the opportunity to cross-examine a witness about it and present evidence of its own on the subject. Second, it is clear that the City's assumptions are unreasonable and erroneous. For example, the City simply assumes that workers whose positions are eliminated will **never** be reemployed. There is no evidence to support that assumption, and it is unreasonable on its face. Even if it were assumed that it would take those workers a period of time to find new jobs, they will receive severance compensation and other benefits while they transition to other employment (PECO St. 2-R at 8). Third, the number of positions within Philadelphia that would be affected is less than that used in the City's calculation. The City began with 250 positions and assumed half would be located within Philadelphia. However, only approximately 100 PECO positions would be affected by the Merger (PECO St. 2-R at 2, 6), and it is unlikely that all of those are located within the City.

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<sup>10</sup> This is another area where PECO's commitment is a concession that could be obtained only through the Settlement because, being outside the authority of the Commission, it could not legally be attached, unilaterally, as a condition to the Merger approval.

In summary, the City's claim that the Merger and Settlement would not provide substantial public benefits sufficient to warrant approval under the *York* test is wrong.

**C. No Party Has Demonstrated That The Merger Is Likely To Have An Adverse Impact On Competitive Retail Markets**

**1. The Legal Standard Applicable To Market Power Issues Is Whether The Merger Is Likely To Have An Adverse Impact On Competitive Retail Markets**

As explained in the Joint Applicants' Initial Brief (at 17-19) and Section II.A. *supra*, the legal standard applicable to market power issues is whether a merger "is *likely* to result in anticompetitive or discriminatory conduct" affecting the competitive *retail* electric and natural gas markets in Pennsylvania. 66 Pa. C.S. §§ 2811(e)(1), 2210(a)(1) (emphasis added). As explained below, none of the opposing parties has demonstrated that the Merger would violate this standard.

***The Commission Should Not Revisit FERC's Rulings Regarding Wholesale Competition***

Not a single party raising market power issues asserts that that the Merger will have a direct impact on competitive *retail* markets. Instead, their allegations all go to claims that the Merger will adversely affect *wholesale* markets. This in turn, they allege, will have negative implications for the retail markets subject to the Commission's jurisdiction.

Given this emphasis on the impact of the Merger on wholesale markets, it is striking that the parties raising market power issues pay scant attention to the fact that FERC issued a 75 page decision that addresses in detail all issues regarding wholesale market power, and concluded that the Merger would not adversely impact competition in those markets. *See Exelon Corp.*, 112 FERC ¶ 61,011 at P 10 (2005) ("we will approve the proposed merger as consistent with the public interest and find that it will not adversely affect competition."). At most, these parties

mention this decision in passing. Nowhere, however, do they even attempt to explain why the Commission should ignore FERC's holdings.

On one level, it is perhaps not surprising that the parties raising market power issues do not want to acknowledge the FERC decision. After all, as the following chart reveals, FERC rejected every wholesale market power argument that they raise in their briefs here.

<b>Arguments Raised by PPL, PGW, FirstEnergy, and the City</b>	<b>Location in Initial Briefs of PPL, PGW, First Energy, and the City</b>	<b>Location in FERC Decision (Paragraph No.)</b>
Claim that PJM Classic should be evaluated as a separate geographic market	PPL Initial Brief at 25-30	P 123
Claim that PJM East transmission import capacity should not be allocated on a pro rata basis, but instead should be allocated based on FTR holdings	PPL Initial Brief at 32-37 City Initial Brief at 11	PP 112, 129
Claim that virtual divestiture is not an appropriate form of mitigation	PPL Initial Brief at 37-46 FirstEnergy Brief at 18 City Initial Brief at 11	PP 134-38
Claim that virtual divestiture amount should not be reduced when nuclear plants are retired	PPL Initial Brief at 46-47	P 143
Claim that the Joint Applicants must identify the plants that will be divested	PPL Initial Brief at 47-49 FirstEnergy Brief at 18	PP 141-42
Claim that the amount of divestiture proposed by the Joint Applicants is insufficient	FirstEnergy Brief at 17-18	P 133
Claim that the post-merger market for delivered gas in PJM will be highly concentrated	PGW Initial Brief at 13-15 City Initial Brief at 19-21	P 200
Claim that it is appropriate to exclude gas transportation capacity controlled by third parties with New York delivery points from the PJM East natural gas market power analysis, but that it is appropriate to include in the same analysis PSEG's gas transportation capacity with New York delivery points	PGW Initial Brief at 31-32	P 200

FERC has exclusive jurisdiction over wholesale electric and natural gas markets. As a result, FERC's decisions regarding the impact of the Merger on those wholesale markets are entitled, at the very least, to great deference from the Commission. *See ARIPPA v. Pa. P.U.C.*, 792 A.2d 636, 657-658 (Pa. Cmwlth. 2002) (relying on the fact that "FERC had found that the merger would not have any anti-competitive effects" in rejecting arguments that merger would adversely impact retail competition).

It would be especially inappropriate to second-guess FERC here, given that the arguments raised are essentially that the wholesale market power analyses performed by the Joint Applicants do not conform to FERC's merger regulations and merger precedent. The parties raising these arguments in essence are asking the Commission to hold that it is in a better position than FERC to conduct FERC's own review of the impact of the Merger on wholesale markets. While it is correct that the legislature has directed the Commission to satisfy itself that the Merger will not impact retail markets in Pennsylvania, that cannot mean that the legislature intended for the Commission to overrule FERC decisions with respect to the applicability of FERC's own merger market power requirements.<sup>11</sup>

PPL asserts in passing that "FERC approved the proposed merger without the benefit of discovery or hearings in which the witnesses were cross-examined" (PPL Initial Brief at 55). It is difficult to rely on this distinction as a reason to ignore FERC's decision, however. For one thing, such a ruling would constitute a direct attack on FERC's choice of procedures, and the

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<sup>11</sup> Moreover, there are serious questions as to whether this Commission could make holdings that conflict with FERC's analysis of the impact of the Merger on wholesale competition. *See, e.g. Free v. Bland*, 369 U.S. 663 (1962) (outright conflict between federal and state law); *Florida Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132 (1962) (compliance with both federal and state law is not possible); *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218 (1947) (federal law occupies the field of regulation).

Commission should not second-guess FERC's procedures any more than it should second-guess its substantive rulings.

Moreover, the hearing conducted by the Commission here did not uncover any material information that was not considered by FERC. At the hearing, PECO's market power witnesses were subjected to only a perfunctory cross-examination. Dr. Hieronymus was cross-examined for less than an hour. The cross-examinations of Mr. Crowley and Dr. Morris took less than one full page of the transcript each (*see* Tr. at 442-43; 513-14). PPL was the only party to cite to the hearing transcript in its Brief, and none of its cites go to any central point that PPL makes. The hearing that was conducted here cannot justify ignoring FERC's rulings.

***The Joint Applicants Do Not Have To Make Any Showings With Respect To The Perceptions Of Market Participants***

FirstEnergy argues, based on the testimony of Mr. Byrd, that the *perceptions* of the wholesale market participants must be taken into account (FirstEnergy Brief at 12-13). The Commission should not apply such a standard. For one thing, nothing in the statutory language requires the Commission to address perceptions rather than actual market power impacts. Moreover, this would be an impossible standard for the Commission to apply. FERC and the antitrust agencies have developed quantitative measures of market power, such as HHI statistics, with which to measure market power. There is no way, however, to evaluate how a merger will alter market perceptions in a way that is different from actual market power. Certainly FirstEnergy, which has presented nothing more than the bare unsupported assertions of Mr. Byrd regarding market perceptions, has made no demonstration that the Merger "is likely to" adversely impact competitive electric retail markets.

*There Is No Need For The Commission To Make Any Referrals To Other Agencies*

In a curious argument, PPL goes on at length about the need under 66 Pa. C.S. § 2811(d) for the Commission to make findings regarding market power and then refer those findings to other agencies, including FERC, the Department of Justice, and the New Jersey Board of Public Utilities (NJBPU) (PPL Brief at 54-57). There is no need, however, for the Commission to take this step. FERC has already reviewed and approved the Merger and the Department of Justice and NJBPU are reviewing it.<sup>12</sup> Referring the matter to them would be superfluous. Indeed, because FERC has already made extensive findings regarding the wholesale market power issues that have been raised here, the Commission should give deference to FERC's findings.

More importantly, in order to make a referral, the Commission first must conclude that there is some threat to competition. However, as the Joint Applicants have demonstrated, the Merger presents no such threat. There is, as a result, nothing to refer.<sup>13</sup>

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<sup>12</sup> Of course, nothing in Section 2811(d) provides for the Commission making any referral to the NJBPU.

<sup>13</sup> The Commission also should reject PPL's argument that the Commission should use the "incipiency" standard of the federal Clayton Act, which applies to the federal antitrust agencies' review of potential anticompetitive behavior (PPL Brief at 18-21). In so arguing, PPL apparently wants the Commission not only to perform the functions of FERC in analyzing the impacts of the Merger on wholesale markets, but also to perform the functions of the Department of Justice in performing its pre-merger antitrust review under the Hart-Scott-Rodino Act. The Pennsylvania legislature has established the standards that it wants the Commission to apply to its review of mergers potentially affecting competitive retail electric and natural gas markets. Nowhere has the legislature indicated that it also intends for the Commission to enforce the provisions of the Clayton Act.

**2. The Joint Applicants Have Demonstrated That The Merger Is Not Likely To Adversely Impact Competitive Retail Electric Markets**

The Joint Applicants demonstrated in their Initial Brief that the proposed Merger will not adversely impact competitive retail electric markets (Jt. App. Initial Brief at 19-36). Nothing in the Briefs submitted by PPL, FirstEnergy or the City<sup>14</sup> should cause the Commission to conclude otherwise.

**a. There Is No Need To Analyze PJM Classic As A Separate Relevant Geographic Market**

The Joint Applicants already explained in detail in their Initial Brief why there is no need to analyze PJM Classic as a separate relevant geographic market (Jt. App. Initial Brief at 24-28). The arguments advanced by PPL in its Initial Brief suffer from the same defects as the arguments raised by Dr. Kalt that the Joint Applicants addressed in their Initial Brief.<sup>15</sup>

***Overstatement Of Impact Of Issue***

Like Dr. Kalt, PPL overstates the impact of this issue on the question of whether the Merger will have an adverse impact on wholesale competition. According to PPL, when the PJM Classic market is analyzed as a separate relevant geographic market, “the Merging Parties’ opportunities to exert market power become readily apparent, as numerous market screen failures are observed” (PPL Brief at 27).

As the Joint Applicants explained, however, the Merger causes screen failures in the PJM Classic market only if it is assumed that all of the divested fossil units are purchased by the four largest market participants, including PPL, and even then the screen failures are relatively minor

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<sup>14</sup> The City presented no evidence on the market power issue, and its discussion in its Brief contains nothing more than terse references to evidence submitted by other parties that provides no independent analysis of the market power issues.

<sup>15</sup> The City makes reference to this issue in its Brief, but adds nothing to the argument advanced by PPL (see City Brief at 11).

(Jt. App. Initial Brief at 26-27). When this assumption is removed, the screen failures go away (*Id.*). PPL thus is arguing that the Merger should be disapproved because a hypothetical distribution of the Joint Applicants' divested generation assets would lead to minor screen failures in a "market" that FERC already has found not to exist.

***Ignoring Price Data Inconsistent With Theory***

As the Joint Applicants discussed in their Initial Brief, Dr. Kalt's relevant geographic market analysis focuses entirely on price differences between the Allegheny Power (AP) and Pepco systems without looking at other price differences that bear on the issue of how the geographic markets should be defined (Jt. App. Initial Brief at 27-28). When all the price data are reviewed, however, a different story emerges. The following three tables, each of which is based on the price data that appear in PPL Exhibit JPK-2 – Dr. Kalt's own exhibit – highlight why there is no rational basis for separating the AP system from the other three systems that PPL would include in a PJM Classic market.

<b>PRICE DIFFERENCES BETWEEN AP SYSTEM AND PJM CLASSIC SYSTEMS</b>		
<b>AP/FE Penelec Difference</b>	<b>AP/PPL Difference</b>	<b>AP/Pepco Difference</b>
\$0.04	\$1.73	\$3.27

As this table shows, there is almost no price difference between AP and FE Penelec, and the price difference between AP and PPL is only \$1.73. PPL's focus on the \$3.27 price difference between AP and Pepco ignores these lower price differences that exist between AP and the other PJM Classic systems. These other price differences do not imply that the systems are in a different geographic market from AP (*see* PECO St. 3-R at 23-24).

In evaluating PPL's claim, it also is helpful to look at price differences within the PJM Classic market that PPL claims should be evaluated as a single market. These internal PJM Classic price differences are shown on the following table:

<b>INTERNAL PRICE DIFFERENCES BETWEEN PJM CLASSIC SYSTEMS</b>		
<b>FE Penelec/ PPL Difference</b>	<b>PPL/Peppo Difference</b>	<b>FE Penelec /Peppo Difference</b>
\$1.77	\$1.54	\$3.31

These price differences within PJM Classic are very similar to the price differences between these systems and AP. Certainly there is no rational way to compare these internal PJM Classic price differences with the price differences between AP and the PJM Classic systems and conclude that FE Penelec, PPL and Peppo – but not AP – should be in one relevant geographic market together.

Finally, it also is helpful to look at price differences within PJM East. No one has suggested that PJM East should be divided into separate geographic markets between the northern and southern systems, yet price differences between the systems in the northern and southern part of PJM East are greater than the price difference between AP and Peppo relied upon by PPL, as the following table illustrates:

<b>PRICE DIFFERENCES BETWEEN NORTHERN AND SOUTHERN SYSTEMS IN PJM EAST</b>				
<b>System</b>	<b>Difference to AECO</b>	<b>Difference to FE JCPL</b>	<b>Difference to NJ Hub</b>	<b>Difference to PSEG</b>
<b>PECO</b>	\$3.81	\$4.59	\$4.42	\$4.69
<b>DPL</b>	\$3.25	\$4.03	\$3.86	\$4.13
<b>East Hub</b>	\$3.16	\$3.84	\$3.67	\$3.94

Given these average price differences in the \$3-\$4 range between the northern and southern systems in PJM East, there is no basis for concluding that a \$3.27 average price difference between the AP and Pepco systems requires separating AP out of the PJM Pre-2004 market, particularly given the much closer price spreads between AP and the FE Penelec and PPL systems.

PPL does not address these price difference data directly, but attempts to dismiss them by referring to them as “price differentials in other markets” (PPL Brief at 29). The Commission should not accept this effort to dismiss a problem through the use of semantics. The Joint Applicants are not relying on price differences in “other markets.” Instead, they are relying on price differences within *the PJM Classic market* that PPL wants to use as a separate geographic market.

PPL also attempts to avoid the implications of these data by referring to them as “average price data,” and referring to the monthly price differences between AP and Pepco that Dr. Kalt presented in PPL Exhibit JPK-3 (PPL Brief at 29-30). However, Dr. Kalt did not present similar monthly price differences between AP and the other PJM Classic systems or between the other systems in the PJM Classic or PJM East markets. Dr. Kalt thus failed to demonstrate that the AP-Pepco monthly price differences are significant when compared to monthly price differences between other systems within the PJM Classic or PJM East markets. This omission underscores the lack of meaningful support for his analysis.

#### ***Use of Wrong Congestion Data***

PPL relies extensively on data regarding congestion on the Bedington-Black Oak line to argue that congestion on the West Interface that connects AP to the PJM Classic market separates AP and PJM Classic into two separate markets (*see* PPL Brief at 26-29). However, as

the Joint Applicants explained in their Initial Brief, the Bedington-Black Oak line is *not* part of the West Interface, but is part of a transmission path between AP and Pepco (Jt. App. Initial Brief at 28). Moreover, data regarding the West Interface show minimal congestion on that interface in 2004 – less than 100 hours for the entire year (*Id.*).

***Ignoring The Effect Of Redispatch On Congestion***

Finally, PPL dismisses the fact that, even when there is congestion on the West Interface, transactions across that interface can be made possible through redispatch of generation. According to PPL, because redispatch requires the running of higher-cost generation on the east side of the interface, this means that markets on the two sides of the interface have separated (PPL Brief at 27-29).

PPL's argument should be rejected. There always is a cost to combining what previously had been two markets into one. That cost can come in the form either of transmission expansion or in generation redispatch. The point is that, once the cost is incurred, additional transactions between the two markets are now possible and the markets are joined. PPL's argument ignores this vital effect of redispatch on the question of geographic market definition.

**b. PJM East Import Capacity Should Not Be Allocated Based On FTRs**

Again, the Joint Applicants demonstrated in their Initial Brief why Dr. Hieronymus' decision to allocate capacity on a pro rata basis was appropriate and consistent with FERC requirements and why Dr. Kalt's proposal to allocate capacity based on FTR ownership should

be rejected (Jt. App. Initial Brief at 28-32). The Joint Applicants will not repeat the points made in its Initial Brief, but respond to two points made in PPL's Brief.<sup>16</sup>

***PPL's FTR Example Does Not Support Its Argument***

The example provided by PPL of how FTRs work (PPL Brief at 33) actually provides a good framework for understanding why FTRs are not related to import allocation and why it makes no sense to pretend that imports are allocated in accordance with FTR ownership. In PPL's example, PECO holds FTRs between the Three Mile Island and Peach Bottom nuclear unit buses outside of PJM East and PECO's service territory inside PJM East. PPL then postulates a transaction where PECO schedules an injection of power at the Three Mile Island and Peach Bottom buses and the simultaneous withdrawal of an equal amount of power in its service territory. As PPL notes, the economic effect of this transaction on PECO is neutral - - PECO pays the same amount for the power that it withdraws in its service territory as it receives for the power injected at Three Mile Island and Peach Bottom plus its FTR revenues (*Id.*).

That fact, while interesting, has absolutely no relevance to the Appendix A analysis that Dr. Hieronymus conducted of market power in PJM East. As Dr. Hieronymus explains, the delivered price test conducted under the Appendix A analysis looks to see how much generation can be delivered to a market at the prevailing market price plus five percent (PECO Exh. WHH-1, Exh. J-1 at 25). Imports are allocated ratably to generation owners located outside of a market who can meet the delivered price test to determine how much of their generation is deemed to be deliverable into the market for purposes of developing the market concentration statistics (*Id.* at 37-38).

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<sup>16</sup> The City again makes reference to this issue in its Brief without providing any substantive discussion (City Brief at 11).

Turning back to PPL's example, the question under an Appendix A analysis is, does the fact that PECO owns FTRs have any impact on how much generation, whether owned by the Joint Applicants or by third parties, can be delivered into PJM East at the prevailing market price plus five percent? The answer to that question is clearly no. Certainly, the fact that PECO receives FTR payments has absolutely no impact on the question of whether third party generation can meet the delivered price test – the cost of third party generation is completely unaffected by PECO's FTRs. Nor do the FTRs have any impact on the ability of the Joint Applicants' generation to meet the delivered price test – either that generation costs less than the market price plus 5 percent or it does not and FTR revenues do not play into that calculation. Third, the FTRs do not provide PECO any rights to use import capacity, as PPL admits in its example (PPL Brief at 33) (“there is no physical right or path whereby the power is necessarily delivered over the transmission system to PECO's service territory”). Finally, FTRs do not give PECO any ability to foreclose third parties' use of import capacity (PECO St. 3-R at 21).

As a result, the fact that PECO owns FTRs simply does not provide any useful information in deciding which generation located outside of PJM East can be delivered into PJM East at the prevailing market price plus five percent. PPL's argument that imports should be allocated in accordance with FTRs bears no relationship to what FTRs are or how they work, and should be rejected.

***PPL Cannot Explain Away the Offsetting Incentive Effect of Load on the Joint Applicants' Incentives***

Dr. Kalt presented a new rationale in his surrebuttal testimony for performing an analysis that allocates imports based on FTRs. Under this new theory, Dr. Kalt abandons his claim that FTRs reflect the use of imports, but instead argues that FTRs create an incentive to increase

prices in PJM East, and that use of an analysis that allocates imports based on FTRs is as good a way as any to analyze this incentive (*see* PPL St. No. 1-SR at 17-18).

The Joint Applicants explained in their Initial Brief that, while it is correct that FTRs viewed in isolation do create an incentive to increase prices, it is not appropriate to evaluate this incentive in isolation. Instead, it also is important to consider the obligation to serve load, which creates an equal and offsetting incentive to reduce prices. Therefore, to the extent that the Commission believes it appropriate to analyze the incentives created by FTR ownership, it also is necessary to take into account the offsetting incentives created by load (Jt. App. Initial Brief at 31-32). PPL presents three counter arguments in its Brief, none of which has any merit.

PPL first simply restates the incentives created by FTRs: “[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” (PPL Brief at 36). While this statement is true as far as it goes, the fact that FTRs give an incentive to increase prices does not justify ignoring the offsetting incentive to reduce prices created by load obligations. To the contrary, to the extent that one type of incentive is taken into account, other offsetting incentives also need to be taken into account to achieve an accurate picture of the incentives involved.

PPL’s second argument is that Dr. Kalt performed an Economic Capacity analysis, and that under FERC’s regulations, the incentives created by load are not supposed to be included in an Economic Capacity analysis (PPL Brief at 36-37). Again, while it is true that load is not factored into an Economic Capacity analysis, it also is true that FERC’s regulations do not call for factoring FTR ownership into the analysis – the Economic Capacity analysis is supposed to look solely at ownership of generation capacity (PECO Exh. WHH-1, Exh. J-1 at 25). To the

extent that PPL wants to layer in FTR ownership on top of the Economic Capacity analysis, it would be inappropriate to do so without also factoring in the offsetting incentives created by load responsibilities, especially since the access to “grandfathered” FTRs relied upon by PPL is based on load obligations and not ownership of generation (Jt. App. Initial Brief at 32; Tr. at 384-85).

Finally, PPL argues that “even assuming that the Merging Parties’ load is accounted for in the analysis, the incentive to withhold generation still exists” (PPL Brief at 37). Pointing to Dr. Hieronymus’ Exhibit J-19 (PECO Exh. WHH-1a, Exh. J-19), PPL argues that the Joint Applicants have more than enough generation located inside PJM East to meet their loads in PJM East, and that therefore the offsetting incentives created by load will not offset the incentives created by FTR ownership (*Id.*).

As an initial matter, Exhibit J-19 does not support PPL’s contention. As Dr. Hieronymus explains, his results include both generation located inside of PJM East and imports from generation located outside PJM East. (PECO Exh. WHH-1, Exh. J-1 at 32-43). In fact, there is now way to tell from Exhibit J-19 whether there will be enough generation located in PJM East after divestiture to serve all of the Joint Applicants’ loads.

In any event, PPL’s argument does not support the analysis submitted by Dr. Kalt. He attributes both FTRs and generation located inside PJM East to the Joint Applicants without accounting for the offsetting incentives of load in any respect (Tr. at 385). The type of analysis that PPL’s argument would support would involve adding generation located inside of PJM East and FTR ownership and then subtracting out load – an analysis that Dr. Kalt did not perform. Dr. Hieronymus did prepare such an analysis for inclusion in his oral rejoinder, but PPL successfully was able to keep this analysis out of the record (*see* Tr. at 388-95).

**c. Virtual Divestiture Constitutes Acceptable Mitigation**

The Joint Applicants demonstrated in their Initial Brief that their virtual divestiture proposal represents an acceptable form of market power mitigation (Jt. App. Initial Brief at 33-35). PPL raises no arguments in its Brief<sup>17</sup> (PPL Brief at 39-46) that were not already fully addressed by the Joint Applicants in their own Initial Brief. In response, the Joint Applicants therefore simply reiterate the following points on this issue:

- The Joint Applicants must provide the energy under their virtual divestiture contracts regardless of the availability of any particular unit, and therefore cannot withhold their nuclear capacity from the market (Jt. App. Initial Brief at 33).
- Nuclear units are not good candidates for executing a withholding strategy (Jt. App. Initial Brief at 33-34).
- The Joint Applicants will divest fossil units as required to mitigate market power, and therefore will have no ability to execute a strategy of withholding fossil units to increase the prices they receive from their nuclear units (Jt. App. Initial Brief at 34).
- Even if the Joint Applicants could affect near-term market prices, there is no evidence that this would impact the longer term three-year market prices in which their virtual divestiture contracts will be sold (Jt. App. Initial Brief at 34-35).

**d. It Is Appropriate To Reduce The Joint Applicants' Virtual Divestiture Requirement When Nuclear Units Are Retired**

PPL argues that, if the virtual divestiture proposal is accepted, the Joint Applicants should not be permitted to reduce their virtual divestiture amounts when they retire nuclear units. PPL characterizes the retirement of nuclear units as “withholding,” and argues that approval of this aspect of the virtual divestiture proposal would allow the Joint Applicants to withhold capacity in order to artificially inflate prices (PPL Brief at 46-47).

This argument suffers from two defects. First, the Joint Applicants explained in their FERC Application that their proposal to reduce the amount of virtual divestiture by nuclear unit

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<sup>17</sup> Both the City and FirstEnergy raise this issue in their Briefs without presenting any argument (City Brief at 11; FirstEnergy Brief at 18).

retirements was predicated on the requirement that the Joint Applicants first put a unit to be retired up for auction, and that the Joint Applicants be allowed to retire that unit only if they receive no bid in excess of the value of the alternative (non-generation) use of the unit. In other words, the Joint Applicants can retire a unit only if no market participant can run it economically at a value higher than its alternate use. This means that retired units most likely would have been retired even if they had been physically divested to a third party, and in no sense can be deemed “withheld” from the market (see PECO Exh. WHH-1a, Exh. J-17 at 40 (“exactly the same effect would have occurred if Applicants had divested the unit outright and the new owner had retired it.”)).

Second, as Dr. Hieronymus explained, the primary market concern resulting from the ownership of nuclear facilities is not that they will be withheld from the market, but that they will give the Joint Applicants the incentive to use other units to attempt to increase market prices. Retiring a nuclear unit eliminates this incentive just as surely as selling the unit to a third party – in either event the Joint Applicants will not be able to sell power from the unit and reap the benefits of the increased market prices (*Id.*). FERC agreed with Dr. Hieronymus on this point:

Applicants have also made a convincing argument that a decrease in their nuclear capacity, whether through divestiture, de-rating, or unit retirement, would mitigate market power, because the incentive to withhold output is an increasing function of the amount of baseload capacity from which the merged firm could profit due to higher energy prices. Therefore, by reducing the amount of baseload capacity they control, they reduce their incentive to withhold marginal capacity in order to raise the market price.

*Exelon Corp.*, 112 FERC at P 143.

**e. The Joint Applicants Have Sufficiently Identified The Generation Units That They Intend To Divest**

PPL argues that the Joint Applicants have not specifically identified the units that they intend to divest (PPL Brief at 46-49). According to PPL, “[a]llowing 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” (*Id.* at 48).<sup>18</sup>

PPL mischaracterizes the nature of the Joint Applicants’ divestiture commitment, however. The Applicants have done more than establish “a non-specific pool of generators eligible for divestiture.” Instead, they have provided the Commission with a specific list of mitigation-eligible units (PECO Exh. WHH-1 at Exhs. J-3, J-12). They also provided the Commission with a chart that specifies: (1) the market in which generation units must be located; (2) the cost characteristics of the divested generation; and (3) the amount of divested capacity that must fit into each cost characteristic and each location (PECO Exh. WHH-1a, Exh. J-17 at 47). This chart is reproduced below:

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<sup>18</sup> FirstEnergy raises the same issue without providing any argument (FirstEnergy Brief at 18).

Generation Type	PJM East	PJM Pre-2004*	Total
Nuclear	2,400	200	2,600
Coal	550	150	700
Mid-Merit <\$55**	650	550	1,200
Mid-Merit >\$55	900	0	900
Peaking	1,000	200	1,200
Total	5,500	1,100	6,600

\* The additional 1,100 MW of commitment can be delivered anywhere in PJM Pre-2004 including PJM East.

\*\* Mid-Merit generation that is economic within 105% of a market price of \$55/MWh.

This chart provides significantly more detail regarding the required divestiture than PPL suggests. Instead of being able to sell only their least economic units, as PPL argues, the Joint Applicants must sell units with specific cost characteristics that are designed to ensure that the divestiture mitigates their market power (see PECO Exh. WHH-1a, Exh. J-17 at 47-50). Again, FERC agreed that the Joint Applicants had provided sufficient detail:

[U]nder the Commission's Appendix A analysis, we need to know the general location (*i.e.* control area or sub-region of an RTO) and cost characteristics of the generators being divested – not the actual units - in order to calculate the post-merger-and-divestiture HHIs. Applicants have provided that information and shown that, based on reasonable assumptions about the buyers of the assets, the post-merger-and-mitigation HHIs are sufficiently close to the pre-merger HHIs to mitigate the merger-related harm to competition.

*Exelon Corp.*, 112 FERC at P 142.

**f. The Commission Should Not Withhold Its Approval Of The Merger Pending The Joint Applicants' Post-Divestiture Compliance Filing**

Another reason that FERC found that the Joint Applicants do not have to specify exactly which units they will divest at this time is that the Joint Applicants have committed to make a

post-divestiture compliance filing at FERC that specifically identifies both the generation units being divested and the purchasers of those units (*Id.*). Latching on to this commitment, FirstEnergy asserts that FERC withheld its final approval of the Merger until it reviews this post-Merger compliance filing and argues that this Commission do likewise. FirstEnergy asserts that this Commission “simply is in no position to render a judgment about the Proposed Merger’s impact on retail competition” and that, like FERC, the Commission should withhold its approval of the Merger until after it reviews this post-divestiture compliance filing (FirstEnergy Brief at 18-19).

FirstEnergy has mischaracterized the nature of FERC’s action. FERC did not withhold its final approval of the Merger or reserve judgment on whether the Joint Applicants’ mitigation proposal adequately addresses wholesale market power. To the contrary, FERC specifically held at the very beginning of its Order that it “authorizes the merger of Exelon Corporation (Exelon) and Public Service Enterprise Group Incorporated (PSEG Holdings) (collectively, Applicants) to form Exelon Electric & Gas Corporation (EE&G).” *Exelon Corp*, 112 FERC at P 1. FERC also found that “we will approve the proposed merger as consistent with the public interest and find that it will not adversely affect competition” (*Id.* at P 10).

The fact that the Joint Applicants are required by FERC to make a post-divestiture compliance filing regarding wholesale market power does not represent grounds for the Commission to withhold its ruling on retail competition issues any more than it prevented FERC from ruling on the wholesale competition issues. Furthermore, as the Joint Applicants explained in their Initial Brief, there is no point to the Commission requiring a further proceeding to review the very same compliance filing that the Joint Applicants will submit at FERC for the very same wholesale competition issues that FERC will address (*see* Jt. App. Initial Brief at 36).

Moreover, FirstEnergy's suggested approach will place the Joint Applicants in a Catch-22 situation from which they cannot emerge. In order to identify the purchasers of the divested generation and make their compliance filing, the Joint Applicants have to merge, jointly select the units to be divested, and conduct a joint auction of their units. Of course, if the Commission were to withhold its approval of the Merger pending the compliance filing, the Joint Applicants would never be able to merge and thereby auction off their generation units and identify the purchasers, and therefore would never be able to make the required compliance filing. It simply would not be rational decision making for the Commission to put the Joint Applicants in such a position.

To the extent that the Commission has any concern that the Joint Applicants somehow will not conduct their divestiture in a way that mitigates wholesale market power, there is a simple solution to address that concern. The Commission can condition its merger approval on the Joint Applicants making the required compliance filing at FERC and on the Joint Applicants implementing any additional mitigation lawfully required by FERC in a final, nonappealable order in the unlikely event that FERC decides that additional mitigation is required. The Applicants have attached, as Appendix A to this Reply Brief, language that would implement such a condition, which would guarantee that the Joint Applicants take the necessary steps to mitigate any wholesale market power without engaging the Commission in a process that is completely duplicative of the FERC review of the compliance filing or places the Joint Applicants in an impossible Catch-22 situation.

**g. The Market Report Required By the Joint Settlement Will Be Of Use To The Commission**

Finally, under the Joint Settlement, the Joint Applicants have committed, in addition to the extensive mitigation included in their Application, to file an annual report with the

Commission in the years 2007-12, detailing wholesale price trends in PJM markets. According to PPL and PGW, however, the report is of no use because it does not give the Commission any information that it does not already have access to on the PJM web site or that would be useful in determining whether the Joint Applicants are exercising market power in PJM (PPL Brief at 52; PGW Brief at 37-38).

The Joint Applicants do not wish to oversell the benefits of this report. It is not intended to be the sole, or even the primary, mechanism for mitigating any market power that they will obtain as a result of the merger. The primary mechanism is the unprecedented physical and virtual divestiture of 6,600 MW of capacity located in PJM. Furthermore, the primary watchdog of their post-merger market activities will continue to be the PJM MMU.

Nevertheless, the Joint Applicants believe that the annual report that they have committed to file will be useful to the Commission. It will allow the Commission to have access to targeted market information that is of most interest to the Commission, rather than requiring the Commission to glean its information from the several hundred page annual PJM MMU State of the Market report or to navigate the PJM web site. This information will not, by itself, enable the Commission to detect the exercise of market power, but it will be of assistance to the Commission in deciding whether to take a closer look at the Joint Applicants' (and other market participants') market activity. The Joint Applicants' commitment to submit this report, in combination with the rest of the Joint Applicants' mitigation package, should allow the Commission to satisfy itself that the Merger is consistent with the applicable statutory provisions regarding market power in the electric industry.

**3. The Joint Applicants Have Demonstrated That The Merger Is Not Likely To Adversely Impact Competitive Retail Natural Gas Markets**

The Joint Applicants have demonstrated that the Merger is not likely to adversely impact competitive retail natural gas markets, or to confer vertical market power on the Joint Applicants to allow them to increase electric prices by increasing the price of natural gas in PJM East (Jt. App. Initial Brief at 37-48). The only substantive argument against this point was submitted by PGW, although the City references PGW's arguments in its own Brief (City Brief at 19-21).

PGW, however, does little in its Brief other than to summarize the testimony of Dr. Carpenter, its witness on the natural gas market power issues. The Joint Applicants for the most part have fully addressed that testimony in their Initial Brief. Rather than repeat that discussion, the Joint Applicants limit themselves here to a few brief points.

***Areas Of Agreement***

For the most part, PGW and the Joint Applicants agree on the analysis of the impact of the Merger on natural gas markets that should be conducted, and even on many of the underlying facts. The areas of agreement include the following:

- The parties agree that the product market to be analyzed is delivered natural gas (PGW Brief at 13).
- The parties agree that the applicable standard for determining if there is a potential market power problem is that the post-merger market must be highly concentrated, *i.e.* the post-merger HHI must be over 1,800 (PGW Brief at 13-15).
- The parties agree that, on most days of the year, there is no significant separation between natural gas prices in PJM East, New York and New England (PGW Brief at 27-30).
- The parties agree that, if the relevant geographic market includes PJM East, New York and New England, there is no market power problem (PGW Brief at 23-24).
- The parties agree that, even if the relevant geographic market is limited to PJM East, there is no market power problem if PSEG's New York market capacity is not included in the PJM East market concentration calculation (PGW Brief at 31).

### *Significance Of Price Data In Defining Relevant Geographic Markets*

Notwithstanding the agreement of the parties on a significant number of issues, they disagree on the significance of the fact that there is price separation greater than 105% on some days. First, they disagree on how often it occurs. PGW asserts that prices between PJM East and New York separate by more than 105% on 23% of winter days and that prices between PJM East and New England separate by more than 105% on 24% of winter days (PGW Brief at 28). Given that PGW defines winter as the five months starting in November and ending in March, this translates to price separations of more than 105% on from 30 to 40 days of the year, or about 10% of the year.

Dr. Morris accepts this 10% number, but observes that the price separations between PJM East and New York and New England do not necessarily occur concurrently. The data show that prices separate by more than 105% between PJM East and both New York and New England on the same day on only 2% of the days of the year (Tr. at 501), which means that on 98% of all days the market is larger than just PJM East. Furthermore, the price data used in the analysis represent only the midpoint of transactions, and the outer ranges of the prices in the three markets are within 105% of each other on all days of the year (PECO St. 11-R at 31-34).

More important, no matter which view of the frequency of price separations is correct, the evidence is clear that the price separations occur on a sporadic, non-sustained basis. Dr. Morris explained that the antitrust agencies look to an ability to increase prices on a sustained basis, and that the sporadic nature of the price separations here does not warrant limiting the relevant geographic market to PJM East (PECO St. 11-R at 17-18).

PGW, however, asserts that the Department of Justice/Federal Trade Commission *Horizontal Merger Guidelines* require that different geographic markets be analyzed during

different periods of demand. PGW cites to comments by the FTC staff regarding the analysis of *markets for electricity*, in which different *product* markets are defined depending on the prevailing demand level (PGW Brief at 26).

There are two problems with this argument. First, it relies on an analysis of electric markets, not markets for natural gas. As Dr. Carpenter concedes, the same FTC staff comments cited by PGW explain that an important reason for defining a number of electric products based on demand conditions in the electric markets is “that electricity cannot be readily stored for subsequent consumption” (PGW St. 1-SR at 12). Natural gas, however, can be and is stored in times of low demand and then released from storage during peak demand periods. It is telling that PGW is unable to cite to any authority indicating that any antitrust regulator has found that natural gas markets should be treated similar to electric markets:

Moreover, the comments cited by PGW go to the definition of *products*, not *geographic markets*. For example, in the long discussion by the FTC staff quoted by PGW in its Brief, the staff explains that a generator might not be able to supply short term capacity in a distant market if it has an existing supply obligation, but that perhaps that generator could compete to sell intermediate capacity, a different product, in the distant market if its supply obligation expires before the intermediate term (PGW Brief at 26 n. 15). While the FTC staff suggests that “the geographic markets differ *for different product markets*” (*Id.* (emphasis added)), nothing in these comments suggests that the geographic markets differ *for the same product*, such as short term capacity, during different demand periods.

Here, PGW has identified only one product – delivered natural gas – to be at issue in the market power analysis (PGW Brief at 13-14). PGW cannot rely on the *Horizontal Merger Guidelines* or the FTC staff comments to support its assertion that a standalone PJM East

geographic gas market should be defined to apply to delivered natural gas during those sporadic periods of peak demand when there is price separation in the price of delivered natural gas. The only conclusion that can be reached from the price data submitted on the record is that the relevant geographic market includes PJM East, New York and New England.

***Treatment Of PSEG's Transportation Capacity Deliverable In The New York Market***

Another area of disagreement involves the treatment of PSEG's capacity on Transco that is deliverable into the New York market north of Linden, New Jersey. Dr. Morris explained at the hearing that there is a constraint on the Transco pipeline at Linden, and that gas delivered on the Transco, PSEG or other systems north of Linden in New Jersey is considered to be part of the New York market because it receives the New York price (Tr. at 508-09). He further testified that Gas Daily considers New Jersey deliveries north of Linden to be part of the New York market, and that the gas price transaction data relied upon by Dr. Carpenter also show that New Jersey deliveries north of Linden receive the New York price (*Id.*).

As the Joint Applicants explained in their Initial Brief, even if the Joint Applicants' relevant geographic markets were rejected and PJM East were used as the relevant geographic market, Dr. Carpenter inconsistently included PSEG's capacity that is deliverable into the New York market (i.e., the market north of Linden, New Jersey) in his PJM East market concentration calculation. To be consistent with Dr. Carpenter's own market definition, *all* New York capacity should be excluded from any calculation of the PJM East market, whether controlled by the Joint Applicants or by third parties. When PSEG's New York capacity is removed from the market concentration calculation, there is no market power problem in PJM East (*see* Jt. App. Initial Brief at 42-43). This position was adopted by FERC in its decision approving the Merger. *See Exelon Corp.*, 112 FERC P 200.

PGW raises three arguments as to why PSEG's New York capacity nevertheless should be included in the PJM East market concentration calculation (PGW Brief at 31-32). None of these arguments has any validity.

First, PGW argues that a significant amount of PSEG's New York capacity is needed to serve PSEG's BGSS requirements<sup>19</sup> in PJM East and therefore should be counted as PJM East capacity rather than New York capacity (PGW Brief at 31). As an initial matter, this argument ignores that the BGSS requirements north of Linden are part of the New York market.

Moreover, the argument also ignores that the BGSS obligations are *retail* obligations. PGW's market power allegation is that the Joint Applicants will withhold from the *wholesale market* capacity that is *not needed to serve retail obligations* (see PGW St. 1 at 22). The location of PSEG's retail sales therefore is irrelevant to PGW's allegation, even if those retail sales were not located north of *Linden* in the New York market. Instead, the question relevant to PGW's market power allegations is, where does PSEG (or whatever party obtains PSEG's released capacity) sell gas when it is *not* making retail sales to BGSS customers? The answer to that question is that capacity deliverable to the New York market will be used to make sales in the New York market on the peak days when prices in the New York market are more than 105% of prices in PJM East.

Dr. Carpenter, PGW's own witness, testified that this is the case:

PSEG makes spot sales on the PSE&G system off Transco on many (39 of 67) of the days when New York prices significantly exceed PJM East prices. PSEG receives prices for these sales that significantly exceed the PJM East gas price. *Thus, PJM East capacity does not offer an alternative to PSEG's sales on the PSE&G system on these days.*

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<sup>19</sup> The BGSS service is the competitive retail natural gas service provided in New Jersey.

(PGW St. 1-SR at 18 (emphasis added)). It is precisely because “PJM East capacity does not offer an alternative to PSEG’s sales on these days” that the capacity used to make those New York market sales should not be considered part of the PJM East market on those days.

Second, PGW notes that PSEG’s wholesale sales in New York during periods of price separation average 105 MMcf/d, and never exceed 195 MMcf/d. PGW argues that it therefore is not reasonable to exclude the full 794 MMcf/d of PSEG’s New York capacity from the PJM East market concentration calculation (PGW Brief at 31-32).

This argument again ignores PGW’s market power argument that the Joint Applicants could withhold capacity from the wholesale market that is not used to serve retail loads. As PGW argues in the preceding paragraph of its Brief, the bulk of PSEG’s New York capacity is used to serve its BGSS retail load. It therefore is not surprising that the full 794 MMcf/d of capacity is not being used to make wholesale sales in the New York market – it mostly is being used to satisfy PSEG’s retail obligations.

PGW has not identified *any* wholesale sales by PSEG from its New York capacity into the PJM East market. Indeed, Dr. Morris testified that his review of the sales data shows that “virtually all the sales” are “past the Linden constraint point” (Tr. at 509). Given that the sales data do not indicate that PSEG uses any of its New York capacity to make wholesale sales into the PJM East market, there is no basis for including any of that capacity in the PJM East market concentration analysis.

Finally, PGW argues that PSEG uses its New York capacity to make sales in New Jersey on many of the days that New York prices exceed PJM East prices (PGW Brief at 32). While factually accurate, this argument is misleading in the extreme. The sales in New Jersey to which PGW refers are sales north of the Linden constraint point and are part of the New York pricing

factually accurate, this argument is misleading in the extreme. The sales in New Jersey to which PGW refers are sales north of the Linden constraint point and are part of the New York pricing market (Tr. at 509). Indeed, the Carpenter testimony cited by PGW to support this argument is the very testimony cited above, in which Dr. Carpenter observes that the sales prices significantly exceed the PJM East natural gas price (PGW St. No. 1-SR at 18). The fact that PSEG made sales into that part of New Jersey that is included in the New York pricing market in no way supports including PSEG's New York capacity in a PJM East market calculation unless all New York capacity held by all parties is also included in the calculation.

### ***Remedies***

Finally, PGW asserts that divestiture of the Joint Applicants' natural gas distribution operations would represent "the cleanest, easiest and most effective remedy for the market power problem in this proceeding" (PGW Brief at 20). However, as the Joint Applicants demonstrated in their Initial Brief, the market power problem that PGW asserts, even if credited, has absolutely nothing to do with the Joint Applicants' natural gas distribution operations. This proposed remedy of requiring the divestiture of those assets is too broad – like killing the dog to get at the fleas (Jt. App. Initial Brief at 46-47) – and would cause PECO, PSE&G and their electric and natural gas customers substantial economic harm (\$410 million annually) from the complex task of unwinding the synergies presently benefiting them from being part of the same enterprise (PECO St. 13-DQ at 4-9).

Any concerns the Commission may have regarding natural gas issues are fully addressed by the fact that the Joint Applicants will not be combining the natural gas procurement functions of PECO and PSEG, and thus cannot act in the concerted manner alleged by PGW. Furthermore, the Joint Applicants have committed not to combine their natural gas procurement functions in

the future without the Commission's approval (Jt. App. Initial Brief at 48). This commitment fully mitigates any possible market power in the natural gas markets that the Joint Applicants might otherwise obtain as a result of the Merger.

**D. The Parties Generally Agree On How The Directed Questions Should Be Addressed**

In their Initial Brief (at 48-58), the Joint Applicants explained why the proposed Settlement was responsive to and appropriately addressed the Directed Questions posed by Vice Chairman Cawley and Commissioner Shane. Notably, only the City and, to a lesser extent, PGW take issue with that conclusion.

**1. Directed Questions Nos. 1-4 (Economic Development)**

The City is the only party that favors the "set-aside" of virtually divested generation. The flaws in the City's proposal were addressed in Section II.B., *supra*. As explained in that discussion, there are serious legal and other obstacles to implementing a set-aside program. Moreover, the contribution to PEDA for which the Settlement provides is a more direct and expeditious means of promoting economic development.

**2. Directed Question No. 5 (Consolidation Of PECO, PSE&G And PGW Gas Operations)**

In response to Directed Question No. 5, the parties have proposed that the viability of combining the gas operations of PECO, PSE&G and PGW into a "profitable, shareholder owned, public utility" be taken up in a separate, fact-finding investigation to commence upon consummation of the Merger. As the OCA correctly observes (OCA Brief at 18), such a process "would allow consideration of this issue to continue in a forum where the myriad of issues can be thoroughly explored, where all affected parties can fully participate, and where a reasoned decision can be reached on the issues."

No party disputes the need for a separate proceeding. Indeed, even PGW admits that “a more detailed due diligence type study” is required (PGW Brief at 52). Consequently, the only remaining differences between the parties concern the scope and timing of such further investigation.

With regard to scope, the Settlement provides for an examination of issues “related to a potential consolidation of the operations of PGW with and into the natural gas distribution business of EEG [Exelon]”<sup>20</sup> (Settlement at ¶55). The Joint Applicants believe this is entirely consistent with Directed Question No. 5, which expressly contemplates PGW’s assets combined with PECO’s and PSE&G’s in a “profitable, shareholder owned, public utility.” In addition, as Mr. O’Brien made clear (PECO St. 1-DQ at 14), Exelon has no intention of spinning off its natural gas operations and would vigorously contest any such directive.

PGW predictably would like to expand the scope of the separate investigation to include consideration of its “state authority” model under which PECO’s gas assets would be appropriated (PGW Brief at 42, 52). For the reasons previously stated, the Joint Applicants oppose that request and believe it would detract from a reasoned assessment of possible solutions to PGW’s problems. Moreover, the Joint Applicants respectfully submit that the evidence presented in this proceeding by Messrs. Arndt and Jirovec, which identified approximately \$410 million of annual diseconomies associated with a spinoff of EEG’s post-Merger gas operations, demonstrates convincingly that pursuit of the “state authority” model would significantly increase the cost of providing both electric and natural gas service and, therefore, would not be in the public interest (*see* Jt. App. Initial Brief at 52).

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<sup>20</sup> Following the Merger, Exelon plans to change its name to Exelon Electric & Gas Corporation (EEG).

As to timing, the City asserts that the Settlement would “impede resolution of this issue” and urges the Commission to place the proposed separate investigation on “an expedited track” to commence upon conclusion of this case (City Brief at 23). The City’s sudden sense of urgency is curious at best, since it was not until the Directed Questions were issued in mid-July (*i.e.*, after the City filed its direct testimony in this case) that the City publicly expressed any interest in disposing of PGW or consolidating those gas operations with PECO’s. In any event, it would make no sense to proceed with an investigation of the consolidation of PGW with EEG’s combined gas operations (as Directed Question No. 5 seems to posit) before the Merger has been completed. Only in the post-Merger environment will it be possible to assemble all of the data needed to fully evaluate the pros and cons of such a combination. Furthermore, the Settlement (at ¶ 56) provides that its terms shall not be implemented and enforceable until the consummation and closing of the Merger.

### III. CONCLUSION

WHEREFORE, for the reasons set forth above and in their Initial Brief, PECO Energy and Public Service Electric and Gas Company request that the Administrative Law Judge approve the Joint Petition For Settlement, filed September 12, 2005, without modification and deny the relief sought by the non-signatory parties.

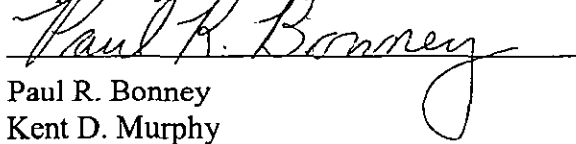


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**APPENDIX A**

**APPENDIX A**

**PROPOSED CONDITION TO  
MERGER APPROVAL**

The Joint Applicants shall make a post-merger compliance filing at FERC detailing the generation units that they intend to divest and identifying the proposed purchasers of those units, as required by FERC's July 1, 2005 Order approving the Merger. If, and to the extent that, FERC issues a final, non-appealable order in response to that compliance filing requiring the Joint Applicants to implement any additional mitigation, the Joint Applicants shall implement such additional mitigation within the time period required by FERC.

**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 : **Docket No. A-110550F0160**  
Group Incorporated with and into Exelon Corporation :

**CERTIFICATE OF SERVICE**

I hereby certify that I have this date served a true copy of the Reply Brief of Joint Applicants, PECO Energy Company and Public Service Electric and Gas Company, via first class mail and e-mail to the following:

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**OCT 21 2005**

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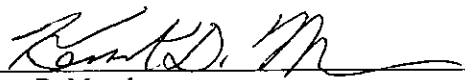
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Date: October 21, 2005

  
Kent D. Murphy  
PECO Energy Company  
2301 Market Street  
Philadelphia, PA 19101-8699  
(215) 841-4941

BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION

ORIGINAL

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

NOTICE OF APPEARANCE

DOCUMENT  
FOLDER

The Office of Small Business Advocate, pursuant to 52 Pa. Code § 1.24, hereby enters the appearance of Sharon E. Webb, replacing Carol F. Pennington, as counsel of record, in the above captioned proceeding.

Documents in this proceeding should now be served on the following:

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Sharon E. Webb, Esquire  
Assistant Small Business Advocate  
Attorney ID No. 73995

For:

William R. Lloyd, Jr.  
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Attorney ID No. 16452

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Dated: October 24, 2005

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OCT 25 2005

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PA PUC

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BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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SECRETARY'S BUREAU

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

CERTIFICATE OF SERVICE

I certify that I am serving copies of the foregoing document, on behalf of the Office of Small Business Advocate, by e-mail and first class mail upon the persons addressed below:

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Attorney ID No. 73995

For:

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Attorney ID No. 16452

Date: October 24, 2005

**WILLIAM B. MORLOK**  
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**ORIGINAL**

Oct 27, 2005

The Pennsylvania Public Utility Commission  
P.O. Box 3265  
Harrisburg, PA 17105-3265

**DOCUMENT  
FOLDER**

Dear Commissioners,

A-110550 FO160

**Subject: Merger between Exelon and Public Service  
Electric and Gas of New Jersey**

**This letter is in support of the Joint Petition for Settlement filed on  
September 12, 2005 by PECO Energy, PSE&G and Others.**

**It is my understanding that the proposal includes \$120,000,000 in rate  
reductions, a rate cap for 4 years, maintaining and improving their  
already excellent efforts in service quality, energy efficiency and  
renewable energy sources, and civic and charitable support.**

**This sounds like a good deal to me, and I urge you to approve the  
proposed settlement.**

Sincerely,



**William B. Morlok**

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35

ORIGINAL

November 5, 2005

Pa Public Utility Commission  
Box 3265  
Harrisburg, Pa 17105-3265

DOCUMENT  
FOLDER

Re: Peco/PSE&G Merger

A-110550 F.O/60

Gentlemen:

I am writing regarding this merger and whether it would be in the best interest of the public. It seems of late that mergers beget higher costs and allow utilities to create a monopoly. Witness the one Natural Gas Co in Pennsylvania.

I am guessing that this merger will go through regardless of what I might say here, but perhaps I can get a pound of flesh out of the deal that will benefit the public and the environment.

I am advised by Peco that I can participate in wind energy if I pay an extra \$5.08 per month. For that Peco will provide 200 kwh of wind energy. I use about 900 kwh, why Can't I have more? Why do I have to pay extra for it? Peco says that the Pocono wind farms produce enough to power 70,000 homes, yet they disclose that currently 17,000 homes are using wind power, and limited to 200kwh per month even if their usage is more.

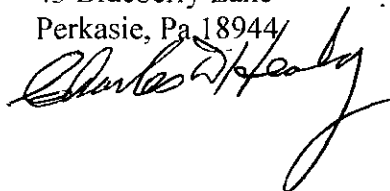
What I don't understand is why do people have to sign up, why do we have to pay extra , and why is it limited to 200kwh?

I am given to believe by the wind energy people like Community Energy, that not all of the wind energy they produce is bought by the Pa utilities. This seems counterproductive to reducing our dependence on fossil fuels and reducing air pollution. The PUC should require the Pa utilities to purchase the wind power as first choice. They should build their own wind farms and shut down some coal plants.

Getting back to the merger, I am advocating that as a condition of merger Peco/PSE&G be required to purchase all available wind power as a first choice in providing electricity, and agree to build their own wind farms and provide a time line for doing so. It seems to me that it has to be less costly to provide electricity from wind power than burning coal or some other fuel.

I hope you will propose this to them and see how receptive they are. In the end, you have the leverage as they came to you for merger approval.

Sincerely,  
Charles D. Healy  
43 Blueberry Lane  
Perkasie, Pa 18944



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2005 NOV -9 AM 9:12  
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15

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November 10, 2005

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James J. McNulty, Secretary  
Pennsylvania Public Utility Commission  
Commonwealth Keystone Building  
400 North Street, 2<sup>nd</sup> Floor  
Harrisburg, Pennsylvania 17120

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:

This firm represents Metropolitan Edison Company, Pennsylvania Electric Company, Pennsylvania Power Company, and FirstEnergy Solutions, Corp. in the above-referenced matter. Pursuant to 52 Pa. Code § 1.53(c), this is to notify the Commission and the other parties to this proceeding of a change in our firm's mailing address. As of November 4, 2005, our new address is 1150 Berkshire Boulevard, Suite 210, Wyomissing, Pennsylvania 19610-1208. Please revise the Commission's service list accordingly. I ask that the other parties to this proceeding please make the same changes to their certificate of service.

**DOCUMENT  
FOLDER**

Respectfully submitted,

RYAN, RUSSELL, OGDEN & SELTZER LLP



W. Edwin Ogden

WEO:jab

c: The Honorable Marlane R. Chestnut  
Per Certificate of Service

**DOCKETED**  
NOV 17 2005

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P.A.P.U.C.  
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 : Docket No. A-110550F0160  
the Merger of Public Service Enterprise :  
Group Incorporated with and into Exelon :  
Corporation :

CERTIFICATE OF SERVICE

I hereby certify that I have this day served true copies of the foregoing letter on behalf of the FirstEnergy Companies upon the persons and in the manner indicated below in accordance with the requirements of 52 Pa. Code § 1.54.

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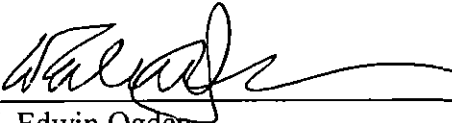
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