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ORIGINAL

October 14, 2005

VIA FEDERAL EXPRESS

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

Please find enclosed an original and nine copies of the Initial 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.

Respectfully submitted,

Paul R. Bonney

cc: Honorable Marlane R. Chestnut (via Hand Delivery)
Official Service List

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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

INITIAL BRIEF OF JOINT APPLICANTS, PECO ENERGY COMPANY AND PUBLIC SERVICE ELECTRIC AND GAS COMPANY

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I. INTRODUCTION

A. Statement Of The Case

On December 20, 2004, Exelon Corporation (Exelon), the parent of PECO Energy Company (PECO), entered into an Agreement and Plan of Merger (Merger Agreement) with Public Service Enterprise Group Incorporated (PSEG), the parent of Public Service Electric and Gas Company (PSE&G). Pursuant to the terms of the Merger Agreement, PSEG would merge with, and into, Exelon (the Merger). In order to obtain the approval of the Pennsylvania Public Utility Commission (PUC or Commission), if such approval is required, PECO and PSE&G (collectively, Joint Applicants), on February 4, 2005, filed the *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* (Joint Application). In the course of the ensuing proceeding, all but four active parties entered into a Joint Petition for Settlement (Joint Petition) or withdrew their opposition to the Merger. An overview of the Merger, the Joint Application and the procedural history of this case are provided in Joint Applicants' Proposed Findings of Fact, which are attached as Appendix A.

B. The Joint Petition For Settlement

The Joint Petition has been executed and submitted by the following parties to this proceeding: PECO, PSE&G, the Office of Trial Staff (OTS), the Office of Consumer Advocate (OCA), the Office of Small Business Advocate (OSBA), the Department of Environmental Protection (DEP), Citizens for Pennsylvania's Future and the two named individuals that joined in its Protest and Petition to Intervene (PennFuture), the Action Alliance of Senior Citizens of

Greater Philadelphia, *et al.* (Action Alliance)[1], the Energy Coordinating Agency of Philadelphia, Inc. (ECA), the Philadelphia Area Industrial Energy Users Group (PAIEUG), The Reinvestment Fund/Sustainable Development Fund (TRF), and State Senator Anthony H. Williams (collectively, Joint Petitioners). In addition, by letter dated September 13, 2005, the Exelon Utility Coordinating Council, International Brotherhood of Electrical Workers Locals 614 and 777 and Frank Kuders (collectively, Labor Parties) submitted a letter to the ALJ and the Commission's Secretary stating that they do not oppose the Joint Petition.

PECO and PSE&G remain convinced that the Merger, as presented in their Joint Application, is in the public interest and provides substantial affirmative benefits. However, in order to eliminate controversy on that score, the Joint Applicants have agreed to significant concessions and conditions as set forth in the Joint Petition. In particular, PECO has agreed to substantial rate reductions; caps on retail electric transmission and distribution (T&D) charges; and commitments to implement enhancements in a variety of areas, including reliability, customer service, universal service, the environment and economic development, as more fully explained in Section V. *infra*.

The intervenors and protestants that executed the Joint Petition have agreed that the Settlement resolves all of their objections to the Joint Application and to the granting of the various approvals the Joint Applicants have requested. They also agreed, subject to certain limited exceptions and qualifications, to withdraw all actions, interventions or protests filed in all proceedings involving or related to the Merger and related transactions and to terminate all other participation in those proceedings. In addition, the Joint Petitioners have expressed their full support for the Settlement, as evidenced by the statements of support each has filed.

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[1] Action Alliance refers collectively to the Action Alliance of Senior Citizens of Greater Philadelphia, the Association of Community Organizations for Reform Now (ACORN) and the Tenants' Action Group (TAG), which are represented by common counsel and submitted a joint protest.

C. The Non-Settling Parties

Among the parties with active status, four have not joined in the Settlement and contend that the Commission should not approve the Merger unless additional conditions are imposed. The PPL Companies (PPL)[2] and the FirstEnergy Companies (FirstEnergy)[3] urge the Commission to withhold its approval because, notwithstanding the Federal Energy Regulatory Commission's (FERC) findings to the contrary (*see* Section VI. B., *infra* and *Exelon Corp.*, 112 FERC ¶ 61,011 (2005)), they still contend that the Merger will give Exelon "market power" within the wholesale power market. PGW has similar objections and also contends that the Merger will create market power in the market for delivered natural gas. On September 19, 2005, the City of Philadelphia (City) filed a statement in opposition to the Joint Petition in which it echoes PGW's market power concerns and contends that the various concessions to which PECO agreed should be greater. The arguments of the non-settling parties are addressed in Section VI., *infra*.

II. STATEMENT OF THE QUESTIONS PRESENTED

1. Whether the Merger, implemented in accordance with the terms and conditions set forth in the Joint Petition for Settlement, satisfies the requirements, if applicable, of Section 1103(a) of the Public Utility Code?

2. Whether the Merger, implemented in accordance with the terms and conditions set forth in the Joint Petition for Settlement and the FERC's Order approving the Merger, including the FERC-approved market power mitigation plan, satisfies the requirements, if applicable, of Sections 2210(a) and 2811(e) of the Public Utility Code?

The questions presented should be answered in the affirmative.

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[2] The PPL Companies consist of PPL Electric Utilities Corporation, PPL Energy Plus and various affiliated limited liability companies that own generation in PJM.

[3] The FirstEnergy Companies consist of Metropolitan Edison Company, Pennsylvania Electric Company, Pennsylvania Power Company and FirstEnergy Solutions Corp.

III. OVERVIEW AND SUMMARY OF ARGUMENT

Although the Merger is not a "change in control" as defined in the Commission's Statement of Policy interpreting 66 Pa. C.S. §1102(a)(3), the Joint Application was filed to confirm that fact and/or obtain the Commission's approval under 66 Pa. C.S. §1103. The Joint Applicants presented substantial evidence establishing that the Merger, as proposed in the Joint Application, satisfies the "affirmative benefit" test for Commission approval delineated in *York v. Pa. P.U.C.* 449 Pa. 136, 295 A.2d 825 (1972) (*York*). In addition, the Joint Applicants and most of the active parties in this case have agreed to a Settlement that provides the means for many of the Merger benefits to have further immediate positive effects on PECO's customers, the economy of PECO's service area, and the Commonwealth overall. These further benefits include: rate reductions; the extension of rate caps; enhancements to reliability, customer service and universal service; funding of environmental and economic development initiatives; corporate structure protections; and commitments to employees, local communities and PECO's corporate presence.

The Joint Applicants also presented substantial evidence demonstrating that the Merger will not create market power in either electric or natural gas markets. Consequently, even if Sections 2210 and 2811(e) were applicable to the Merger, there is no basis for the Commission to find that the Merger would result in anti-competitive or discriminatory conduct, would lead to the unlawful exercise of market power, or would prevent customers from obtaining the benefits of properly functioning and workable retail natural gas and electricity markets. The FERC found that the Merger was in the public interest and rejected the arguments advanced by PGW, PPL and FirstEnergy in this proceeding. The record evidence demonstrates that those arguments are meritless.

IV. LEGAL STANDARD

A. Section 1102(a) And The Commission's Statement Of Policy On "Change In Control" Transactions

Section 1102(a)(3) of the Public Utility Code (66 Pa. C.S. §1102(a)(3)) provides that the Commission's prior approval, evidenced by a certificate of public convenience, is required:

> For any public utility ... to acquire from, or transfer to, any person or corporation ... by any method or device whatsoever, including the sale or transfer of stock and including a consolidation, merger, sale or lease, the title to, or the possession or use of, any tangible or intangible property used or useful in the public service.

Until 1993, the Commission consistently held that Section 1102(a)(3) did not apply to the transfer of stock constituting a controlling interest in a corporation that held a public utility as a subsidiary because only the transfer of stock in the utility itself effected a transfer of property "used or useful in the public interest" as contemplated by Section 1102(a)(3). *Application of MCI Airsignal of Pennsylvania, Inc.*, Docket No. A-330035 (July 15, 1986) (*MCI Airsignal)*; *Application of Airsignal International of Pittsburgh, Pennsylvania, Inc.*, Docket No. A-101365 (January 14, 1980) (*Airsignal)*. However, the Commission revisited the issue of stock transfers in *Joint Application of Commonwealth Telephone Company, et al.*, Docket No. A-310800F0006 (October 22, 1993), where it overruled *Airsignal* and *MCI Airsignal, supra*, and held that Section 1102(a)(3) would thereafter be extended to the transfer of stock of "a utility or of its parent or grandparent affiliates, regardless of the remoteness of the transaction" if the transfer effected a "transfer of control of the utility."[4]

To provide direction for future applicants, the Commission issued a Statement of Policy on October 22, 1994 "to establish clear standards regarding what transfer of voting interest

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[4] *See also Joint Application of Paging Network of Pittsburgh, Inc. and Paging Network of Philadelphia, Inc.*, Docket No. A-33013F0005 (October 29, 1993). (A 32.6% interest held by a single stockholder constituted "*de facto* control" of the parent of two jurisdictional public utilities and, therefore, a transfer by that shareholder of its stock in the parent required prior approval under Section 1102(a)(3)).

constitutes a change in *de facto* control of the utility" (52 Pa. Code § 69.901). The Statement of Policy provides, in pertinent part, as follows:

> (1) A transaction or series of transactions resulting in a new controlling interest is jurisdictional when the transaction or transactions result in a different entity becoming the beneficial holder of the largest voting interest in the utility or parent, regardless of the tier. A transaction or series of transactions resulting in the elimination of a controlling interest is jurisdictional when the transaction or transactions result in the dissipation of the largest voting interest in the utility or parent, regardless of the tier.
>
> (2) For purposes of this section, a controlling interest is an interest, held by a person or a group acting in concert, which enables the beneficial holders to control at least 20% of the voting interest in the utility or its parent, regardless of the remoteness of the transaction. In determining whether a controlling interest is present, voting power arising from a contingent right shall be disregarded.

Applying the standards set forth in the Statement of Policy, the Merger will not result in a "change in control" of PECO. Following the Merger, the common stock of PECO will continue to be held by Exelon Energy Delivery which, in turn, will continue to be a wholly owned, first-tier subsidiary of Exelon. Moreover, the Merger will not effect a change in control of Exelon since no controlling interest, as defined in the Statement of Policy (i.e., a person or group acting in concert controlling at least 20% of the voting interest), currently exists in Exelon nor will any new controlling interest be created as a result of the Merger.[5] Although the Merger will effect a change in control of PSE&G, that company is not a "public utility" for Pennsylvania regulatory

[5] The current public shareholders of Exelon, in aggregate, do not constitute a "controlling interest" since they are not a "group acting in concert." Moreover, even if, contrary to the terms of the Statement of Policy, the current public shareholders of Exelon were considered a "controlling interest," they would represent the "largest voting interest" in Exelon both before (100%) and after (68%) the Merger.

purposes because it is not anticipated to serve, and does not serve, any customers in Pennsylvania.[6]

A statement of policy, unlike a regulation, does not have the force and effect of law but, instead, is an announcement to the public of the policy, which the agency hopes to implement in future rulemakings or adjudications. *See Pennsylvania Human Relations Commission v. Norristown Area School District*, 473 Pa. 334, 350, 374 A.2d 671 (1977). Because a statement of policy, unlike a regulation, does not bind the agency that adopted it, the Joint Applicants filed the Joint Application to obtain a definitive determination by the Commission that its approval of the Merger under Section 1102(a)(3) is not required or, if it is, that such approval should be granted.

Section 1103(a) of the Public Utility Code provides that a certificate of public convenience evidencing the Commission's approval under Section 1102 shall issue only upon a showing that granting such approval is "necessary or proper for the service, accommodation, convenience, or safety of the public" (66 Pa. C.S. § 1103(a)). In *York*, 295 A.2d at 828 (1972), the Pennsylvania Supreme Court held that those seeking approval of a utility merger[7] must demonstrate that the merger "will affirmatively promote the 'service, accommodation, convenience, or safety of the public' in some substantial way." Evidence deemed sufficient to

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[6] As a consequence of its fractional ownership interest in an electric transmission line that runs from the Conemaugh Generating Station to the Maryland border, PSE&G holds a certificate of public convenience that was issued on April 24, 1968 at Docket No. 94234 and specifically provides that PSE&G "shall confine and restrict its operations to the construction, maintenance, repair, replacement, and removal of the proposed electric transmission line." This Commission has previously held that the holder of such a certificate is not a "public utility." *Application Of New York State Electric & Gas Corporation; Request For Abandonment Of Electric Service*, Docket Nos. A-93538, A-110001, F.200 (January 17, 1991) ("NYSEG has never requested or been granted authority to serve any Pennsylvania customer. [Its] transmission line is utilized solely to transmit electricity out-of-state – a FERC regulated activity ... Clearly, NYSEG is not a public utility in Pennsylvania in that it does not provide electric service 'for the public for compensation.' 66 Pa. C.S. §102.") *See also Drexelbrook Associates v. Pa. P.U.C.*, 418 Pa. 430, 212 A.2d 237 (1965).

[7] *York* involved the merger of public utilities themselves, not the merger or change in control of the parent or grandparent of a utility.

satisfy this standard has included testimony that the merger would produce a stronger company; that investors would be more attracted to a larger enterprise; that certain duplicative tasks would be eliminated; that service would be improved; that economies of scale or scope would result in lower costs and could give rise to lower rates in the future than would otherwise be the case; and that the merged entities could improve their operations by sharing best practices. *York, supra*; *Joint Application Of Pennsylvania-American Water Company And Thames Water Aqua Holdings*, 221 P.U.R. 4th 487 (2002).[8] In the Commission's recent decision approving the merger of SBC Communications, Inc. (SBC) and AT&T Corporation (AT&T), it held that the *York* test does not require the merging parties to demonstrate quantifiable benefits in every aspect of their operations but, rather, can be satisfied by showing that a merger will, overall, generate affirmative public benefits:

> When we view the Merger in context, we would agree with the Joint Applicants that the standards of the *City of York* need not only be addressed by a quantification of the specific effects of alleged savings, particularly a specific level of capital investment by the merged entity in Pennsylvania. (*See* Joint App. MB at 10). Rather, we must view the public interest benefits in the context of the telecommunications industry in Pennsylvania, as a whole.

Joint Application of SBC Communications, Inc. and AT&T Corp., Docket Nos. A-31163F0006, A-310213F0008 and A-310258F0005 (October 6, 2005) (p. 27). *See also ARIPPA v. Pa. P.U.C.*, 792 A.2d 636, 654-658 (Pa. Comwlth. 2002) (*ARIPPA*). As explained in Section V., *infra,* the Merger will produce substantial affirmative benefits that clearly satisfy the *York* test.

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[8] *See also Joint Application for a Certificate of Public Convenience Evidencing Approval Under Section 1102(a)(3) of the Public Utility Code, of the Transfer, By Merger, of a Controlling Interest in Three Operating Water Utilities From Consumers Water Company to Philadelphia Suburban Corporation*, Docket Nos. A-212370F0048, *et al.* (December 17, 1998) (adopting the Initial Decision of Chief Administrative Law Judge Robert A. Christianson); *Joint Application of Pennsylvania-American Water Company and Citizens Utilities Water Company of Pennsylvania*, Docket Nos. A-212285F0074 and A-211070F2000 (January 24, 2001); *Application of United Water Pennsylvania, Inc. (United) for Approval of the Acquisition by Lyonnaise American Holding, Inc. (Lyonnaise) of the Remaining Outstanding Shares of United's Parent, United Water Resources, Inc.*, Docket Nos. A-310013F0014 and A-230077F0003 (January 27, 2000).

B. Sections 2210 And 2811(e)

Chapters 22 (Natural Gas Choice and Competition Act) and 28 (Electricity Generation Customer Choice and Competition Act) contain parallel provisions that require the Commission to consider the potential anti-competitive effects of a merger or combination "in the exercise of *authority the commission otherwise may have* to approve mergers or consolidations" (emphasis added) involving natural gas distribution companies and electric utilities (66 Pa. C.S. §§2210(a) and 2811(e)(1)). Sections 2210 and 2811 do not confer any authority upon the Commission to approve mergers or consolidations of public utilities or a change in control of a public utility beyond the authority the Commission otherwise possesses under Chapter 11 of the Public Utility Code. Thus, if the Commission finds that the Merger does not require prior approval under Section 1102(a)(3), then Sections 2210 and 2811 are not applicable to the transaction. In any event, even if Sections 2210 and 2811 were to be applied to the Merger, there is no basis for the Commission to find that it would result in anti-competitive or discriminatory conduct, would lead to the unlawful exercise of market power, or would prevent customers from obtaining the benefits of properly functioning and workable competitive retail natural gas and electricity markets. As explained in detail in PECO Statement Nos. 3 and 3-R, the direct and rebuttal testimony, respectively, of Dr. William H. Hieronymus, and PECO Statement No. 11-R, the rebuttal testimony of Dr. John P. Morris, because of the robust mitigation plan to which the Joint Applicants have committed, the Merger will have no adverse competitive effects on either the wholesale market within the PJM Interconnection LLC (PJM) or Pennsylvania's retail energy markets and, indeed, will likely promote increased retail competition.

V. THE JOINT APPLICANTS HAVE SATISFIED THE LEGAL STANDARD FOR ANY NECESSARY COMMISSION APPROVAL OF A CHANGE-IN-CONTROL TRANSACTION

Even if Section 1102(a)(3) were applicable to the Merger, it is abundantly clear that the transaction satisfies the "affirmative benefit" test laid down in *York, supra*. Those benefits were set out in detail in the Joint Application (pp. 16-20) and summarized in the direct testimony of PECO's President, Mr. O'Brien (PECO St. 1, pp. 6-8), as follows:

> **Increased Scale, Scope and Operational Diversity**. The Merger of Exelon and PSEG will increase the scale and scope of the combined entity's energy delivery and generation businesses. For retail utility operations, this means a larger geographic "footprint" and, as a result, a more diverse customer base. For the generation business, it means the combined company's larger portfolio of generation assets will enable it to capture economies of scale and will provide more balance and diversification in terms of geographic location, fuel mix, dispatch and load-service capacity. In addition, EEG's overall operations will be more balanced, with approximately half its earnings and cash flow coming from its three regulated utilities and approximately half from the generation business. The greater scale, scope and diversification of the combined company's operations should provide more stable cash flows and greater earnings predictability, which, in turn, should allow EEG to maintain a strong balance sheet and continued access to capital at favorable rates.
>
> **Financial Strength and Flexibility**. The Merger will provide continued financial strength and flexibility associated with a company with a strong balance sheet. Following the Merger, EEG will have approximately $70 billion in assets, a market capitalization of approximately $40 billion, annual revenues of approximately $26 billion and annual net income of approximately $2.6 billion. The PECO Energy balance sheet will not change as a result of the Merger.
>
> **Commitment to High-Quality Service; Sharing of Best Practices**. Exelon is committed to maintaining and, where possible, enhancing the high-quality service it provides. As a result of the merger, PECO will benefit from the opportunity to share best practices with PSE&G, which has an outstanding record of reliability and customer service in terms of both its electric and natural gas delivery functions.
>
> **Synergies**. The Merger will create the opportunity to achieve meaningful cost savings not only through the sharing of best practices, as mentioned above, but also through the elimination of duplicative functions, improved operating efficiencies in nuclear and other generation operations and

supply-chain benefits from improved sourcing. William Arndt, Exelon's Senior Vice President, Financial Operations, in his testimony, describes both the anticipated synergies and the costs that will have to be incurred to achieve those synergies.

Commitment to Competition. Exelon and PSEG have been strong advocates of competition in retail and wholesale markets for both electricity and natural gas. This shared vision will allow EEG to be even more active in promoting competitive markets and developing energy-related services. In addition, we anticipate that the knowledge and experience of each company will enhance EEG's ability to manage the transition to competition, which will provide benefits for customers and shareholders. We also recognize that combining the generation assets of the two companies raises certain market concentration concerns. To address those concerns, as part of our Application to the Federal Energy Regulatory Commission (FERC) for approval of the Merger, we are proposing a mitigation plan that entails divesting certain generating assets and selling entitlements to nuclear generation. Dr. William H. Hieronymus, PECO's witness on competitive markets, analyzes the market concentration issues and describes the proposed generation mitigation plan in his testimony.

In addition to the affirmative public benefits inherent in the combination of Exelon and PSEG, the Settlement ensures that many of those benefits will have further immediate positive impacts on PECO's customers, the economy of PECO's service area and the Commonwealth overall, as explained in the Joint Petition (pp. 8-33) and PECO Statement No. 1-S, and summarized below:

Rates Will Be Reduced. The Settlement provides for $120 million of rate reductions over a four-year period commencing approximately one month after the Merger is consummated. These reductions are made possible, in substantial part, by the projected synergies the Merger is expected to produce within PECO's regulated operations.

T&D Charges Will Be Capped For An Additional Four Years. The Settlement caps PECO's T&D charges until December 31, 2010 thus guaranteeing that PECO's customers will enjoy at least a 20-year period with no base rate increases (last case was 1990). In addition, PECO agrees that expenses attributable to achieving Merger-related synergies will be amortized

by the end of the T&D rate cap period and will not be deferred or claimed in a subsequent rate case.

Post-Cap Distribution Rate Increases Will Be Mitigated. The Merger will create the opportunity to achieve cost savings in PECO's regulated operations through the sharing of best practices, purchasing economies and the elimination of duplicative functions which, in turn, will mitigate future distribution rate increases.

Sharing Of Increases In Nuclear Decommissioning Costs Will Continue. The Settlement provides that provisions of the 2000 Unicom Merger Settlement for sharing the risk of future increases in the costs of decommissioning PECO's pre-existing nuclear units will remain in effect and reaffirms PECO's commitment not to seek recovery of decommissioning costs associated with any nuclear units it did not own as of December 31, 1999.

Reliability And Customer Service Will Be Enhanced. As part of the Settlement, PECO commits to a Quality of Service Plan designed to maintain or improve reliability and the quality of customer service provided by PECO during the five-year period from January 1, 2006 through December 31, 2010. The Quality of Service Plan establishes performance thresholds, reporting requirements and enforcement mechanisms for non-compliance. In addition, PECO commits to address issues that may arise in the future involving the implementation of a new common customer information and billing system.

Universal Service Coverage Will Be Expanded. The Settlement provides for a number of substantial enhancements to PECO's universal service programs including: (1) paying $500,000 per year from 2007 through 2010 to the Matching Energy Assistance Fund; (2) increasing to 650 kWh the monthly usage levels eligible for discounts under CAP Rates B, C, D and E; (3) committing to spend $1.2 million on additional CAP enrollment outreach; (4)

enhancing, stream-lining and simplifying the CAP application and recertification process; (5) providing $400,000 to community based organizations (CBOs) for CAP outreach and referrals; and (6) conducting at least four training sessions annually to educate CBOs on the availability and operation of the CAP Rate Program.

The Environment Will Benefit. The Settlement provides that PECO will: (1) contribute $12.0 million to the Pennsylvania Energy Development Authority (PEDA) to fund renewable energy, energy efficiency and energy conservation programs; (2) contribute $7.2 million to the Sustainable Development Fund; and (3) support new customer-friendly net metering and interconnection rules.

Customers Will Be Protected Against Affiliate Risk And Cross-Subsidization. Paragraph Nos. 40-48 of the Joint Petition contain detailed, inter-related provisions designed to protect PECO's customers from risks associated with unregulated affiliates and cross-subsidization. These include provisions on the determination of PECO's cost of capital for ratemaking purposes; limitations on PECO's ability to financially assist unregulated affiliates; notice requirements for dividends and other transfers of retained earnings; accounting controls and procedures for allocating overheads and costs of jointly-used property and personnel; limitations on claiming rate cap exceptions based on increases in affiliates' power costs; and access to books, records, personnel, annual reports and reports to analysts.

A Strong Corporate Presence And Commitment To Employees And Local Communities Is Assured. The Settlement provides that PECO: (1) will maintain the corporate headquarters for its distribution business in Philadelphia through at least December 31, 2010; (2) will fund charitable giving and sponsorships at a level of at least $3.0 million per year for 2007

through 2010; and (3) not reduce field forces and limit reductions in other positions in accordance with specified criteria.

Economic Development Will Be Promoted. The Settlement provides that PECO will contribute $8.0 million over four years to PEDA to be used for energy-related economic development projects and initiatives of benefit to the PECO service territory.

Wholesale Market Conditions Will Be Closely Monitored. The Settlement will create a wholesale electricity market reporting and monitoring mechanism to remain in place through 2012. The market monitoring provisions will give the Commission and Joint Petitioners information regarding price differentials between relevant markets and submarkets within PJM, which they can use to assess price trends and possible market power issues.

As the summary of its terms reveals, the Settlement achieves a fair balance of the interests of a broad and diverse stakeholder coalition that includes the Commonwealth of Pennsylvania, representatives of the residential, commercial and industrial customer classes, CBOs representing low-income customers and senior citizens, and environmental and sustainable energy groups. Additionally, and as previously mentioned, the Labor Parties, while not entering into the Settlement, do not oppose it.

Finally, as explained in detail in Section VI. B., *infra*, the Merger will not result in any anticompetitive or discriminatory conduct. Therefore, the Merger does not raise any issue or concern under either 66 Pa. C.S. § 2210 or § 2811(e).

VI. THE OPPOSING PARTIES HAVE NOT PRESENTED ANY VALID REASON FOR THE COMMISSION TO EITHER WITHHOLD APPROVAL OF THE TRANSACTION OR ATTACH FURTHER CONDITIONS TO ITS APPROVAL

A. The City's Objections Are Meritless

The City did not present testimony opposing the Settlement. Instead, it submitted comments[2] urging the Commission not to approve the Merger "absent further enforceable commitments by PECO and its regulated and unregulated affiliates, or corresponding orders by the Commission ...." In essence, the City's Comments attempt to revisit each of the elements of the Settlement that were carefully and painstakingly negotiated by over a dozen parties to the Settlement over the course of many weeks of discussions. The City offers no real guidance as to how the settling parties could have better balanced the many interests of the Joint Applicants and other stakeholders, except for the bare assertion that the Settlement is a "positive step but is insufficient" (City's Comments, p. 7).

Similarly, as to market power, the City simply echoes the arguments advanced by witnesses for PGW, PPL and FirstEnergy. Contrary to the City's claim that those arguments were "unrefuted" (City's Comments, p. 2), Drs. Hieronymus and Morris demonstrated that the opposing parties' positions are not supported by the facts, are contrary to sound economic theory and, therefore, had properly been rejected by the FERC, as explained in Section VI. B., *infra*. The record demonstrates that the City is the party that failed to introduce any competent testimony, analysis or evidence whatsoever to support its bare assertions. As discussed in detail in Section VII. B., *infra*, concerning Directed Question No. 5, the City's unsubstantiated criticisms of the Merger and Settlement as well as its suggestion that the Merger proceeding be

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[2] The City's comments were filed September 19, 2005 and titled *Statement Of The City Of Philadelphia In Opposition To Approval Of Merger Based Solely On Terms Of Joint Petition For Settlement (City's Comments).*

delayed to study and resolve other issues, all beg the question whether the City's alleged concerns about market power issues have substance or whether the City is opportunistically attempting to use this proceeding to unload PGW, a financially and operationally troubled City-owned gas utility.

As the City itself concedes, the Settlement provides affirmative benefits in a number of significant areas (e.g., rate reductions, heightened reliability and customer service standards, enhanced universal service programs, environmental and economic development initiatives, corporate protections) (City's Comments, pp. 3-5). As explained in Section V. A., *supra*, and as evidenced by the support of a broad and diverse group of stakeholders, the Settlement creates public benefits that are clearly substantial both in absolute terms[10] and by comparison to the terms and conditions on which other major utility mergers were approved.[11] Accordingly, the City's unsubstantiated market power arguments, attempts to revisit the terms of the Settlement, and vague suggestions that the proceeding should be delayed to address PGW's financial problems lack merit and should be rejected.

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10 In this regard, the City acknowledges that the rate reductions to which PECO agreed in the Settlement will yield benefits to the City "in excess of $1 million over four years" (City Comments, p. 3). Thus, the proposed rate reductions alone create a substantial benefit to the City and its residents, which is augmented by other provisions of the Settlement.

11 *See supra, Joint Application of SBC Communications, Inc. and AT&T Corp.* (approving the merger of SBC and AT&T and rejecting conditions proposed by intervenors); *Joint Application For Approval Of The Merger Of GPU, Inc. With FirstEnergy Corp.*, 2001 Pa. PUC LEXIS 16 and 2001 Pa. PUC LEXIS 23 (2001) (approving the merger of GPU, Inc. and FirstEnergy Corp. subject to a three-year extension of rate caps by their Pennsylvania subsidiaries, contributions to sustainable energy funds and renewable energy projects, development of a Demand Side Response program and formation of a reliability monitoring committee); *Re DQE, Inc.*, 186 P.U.R. 4th 39 (1998) (approving the merger of DQE and Allegheny Power System subject to reductions of $15.8 million and $9.1 million, respectively, in the distribution rates of their Pennsylvania subsidiaries, Duquesne Light and West Penn Power); *Joint Application of Pennsylvania-American Water Company And Thames Water Aqua Holdings*, 221 P.U.R. 4th 487 (2002) (approving the merger of American Water Works Company, Inc. and RWE without imposing rate reductions, a "stay-out" provision or various other conditions proposed by opposing parties).

B. After Implementation Of The Proposed Mitigation, The Merger Will Not Raise Market Power Concerns

1. The Commission Should Not Revisit FERC's Rulings On Wholesale Market Power

The legal standards applicable to the Commission's review of market power issues associated with mergers are virtually identical for electric and natural gas issues. Under 66 Pa. C.S. § 2811(e)(1), which applies to electric utility mergers, the Commission is required to determine whether the merger:

> is likely to result in anticompetitive or discriminatory conduct, including the unlawful exercise of market power, which will prevent retail electricity customers in this Commonwealth from obtaining the benefits of *a properly functioning and workable competitive retail electricity market* (emphasis added).

Similarly, 66 Pa. C.S. § 2210(a)(1), which applies to mergers involving natural gas distribution companies, provides that the Commission consider whether the merger:

> is likely to result in anticompetitive or discriminatory conduct, including the unlawful exercise of market power, which will prevent retail gas customers in this Commonwealth from obtaining the benefits of *a properly functioning and effectively competitive retail natural gas market* (emphasis added).

Thus, in both cases, the Commission's market power focus is on whether the proposed merger will disrupt competitive *retail* markets.

In this proceeding, no party submitted any evidence, much less demonstrated, as required by the statutory language, that it "is likely" that the Merger will somehow increase the Joint Applicants' market power in any competitive retail market in Pennsylvania or that the Merger otherwise will prevent competitive retail markets from functioning properly. Nor could they. No one disputed Dr. Hieronymus' testimony that PECO's retail electric and gas operations are limited to Pennsylvania and PSE&G's retail electric and gas operations are in New Jersey (PECO Exh. WHH-1 at Exh. J-1, pages 19-22). Nor did any party dispute Dr. Hieronymus'

testimony that the Merger will not eliminate any competitor in retail markets because Exelon's retail marketing affiliate is not active in PJM East while PSE&G does not even engage in competitive retail marketing (*Id.* at page 14).

Instead, the parties raising market power issues assert that the Merger will confer market power on the Joint Applicants in the wholesale electric and natural gas markets and that the exercise of market power in these wholesale markets will have an indirect impact on prices in the retail markets. In making their arguments regarding wholesale markets, these parties either ignore or barely acknowledge that the very same issues that they raise here were also raised before FERC, which has exclusive jurisdiction over wholesale electric and natural gas markets. FERC considered the very same arguments raised here, and found that the Merger does not adversely impact competition in the wholesale 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.")

In this regard, the Commonwealth Court's decision in the GPU Energy – FirstEnergy merger is instructive. *See ARIPPA*, 792 A.2d at 657-58. In upholding the Commission's finding that the merger would not adversely impact retail electric competition, the Court first addressed the evidence regarding the impact on retail competitors, noting that there would be over 50 retail marketers even after the merger and that GPU Energy was not in the retail market before the merger (*Id.* at 658). With respect to arguments that impacts on wholesale markets might have adverse impacts on competitive retail markets, the Court relied on the fact that FERC had reviewed the merger and found that it would not have any anticompetitive effects (*Id.).*

The parties raising market power issues in this proceeding, however, do not focus on how their allegations affect the Pennsylvania retail markets or raise any issues that are unique to the

Pennsylvania markets. Instead, they have viewed this proceeding as an opportunity to get a second bite at the apple regarding the arguments that FERC rejected. Every issue raised by PPL witness Kalt, for example, was included in the testimony that Dr. Kalt filed at FERC. FirstEnergy witness Frayer did not even bother to draft new testimony in this proceeding addressing Dr. Hieronymus' market power analysis, but merely attached the testimony that she filed at FERC. Dr. Carpenter's testimony for PGW was not filed until a few days before FERC's decision and was not specifically addressed in FERC's order. However, it makes the same essential points that were made in other testimony considered and rejected by FERC. Because the issues raised by PPL, FirstEnergy and PGW already were considered and rejected by FERC, the Commission should not revisit their arguments here.

2. The Joint Applicants Have Demonstrated That, With Mitigation, The Merger Will Not Raise Market Power Concerns In Electric Markets

a. Overview of FERC Appendix A Analysis

Dr. Hieronymus presented what is known as an "Appendix A" analysis of the impact of the Merger prepared in accordance with FERC's regulations and merger precedents. *See* 18 C.F.R. § 33.3. This analysis applies a "delivered price test," which is described in FERC's regulations and is intended to comport with the Department of Justice's Merger Guidelines that are used to evaluate mergers under the Hart-Scott-Rodino Act (PECO Exh. WHH-1, Exh. J-1 at 24-25). This test is intended to determine the extent to which a merger will enhance merger applicants' ability to exercise market power, which is defined as the ability to increase market prices for a sustained period of time (*Id.* at 23).

The delivered price test requires a determination of how much generation capacity can be delivered in a particular market during various seasons (summer, winter, shoulder) and at various load conditions (off-peak, peak, super peak) at the prevailing market price, plus five percent. It then uses market shares and the Herfindahl-Hirschman Index ("HHI") to compare market concentration before and after the merger.[12] If the post-merger increase in market concentration exceeds certain levels, FERC will conclude that there is a "screen failure" that requires a more detailed look at that market.

Under FERC's Appendix A analysis, the significance of the HHI increase depends on the total HHI in a market subsequent to the merger. If the post-merger HHI is below 1,000, then the market is deemed to be unconcentrated and FERC does not find a problem regardless of total increase in HHI caused by the merger (PECO Exh. WHH-I, Exh. J-1 at 24 n. 35). If the post-merger HHI is between 1,000 and 1,800, then the market is deemed to be moderately concentrated. If the merger-related HHI increase in a moderately concentrated market is above 100, then the screen is considered to be violated and further examination is required – while an increase below 100 indicates that there are no adverse impacts on competition (*Id.*). If the post-merger HHI is above 1,800, then the market is deemed to be highly concentrated and the threshold for a screen failure drops to an increase of 50 (*Id.*).

Under FERC's regulations, a screen failure (*i.e.* an HHI increase of above 100 for a moderately concentrated market or an HHI increase of above 50 for a highly concentrated market) does not necessarily mean that there is a competitive problem. Rather, a screen violation indicates a need for a more detailed consideration of whether there may be a competitive

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[12] The HHI is calculated by adding together the square of each company's market share. For example, if five companies each had a 20% market share, each company's 20% share would be squared, and then added together. Since 20 squared is 400, the HHI would equal five times 400, or 2,000.

problem. Mergers that present no or few screen violations routinely are approved without a hearing (PECO Exh. WHH-1, Exh. J-1 at 25). Because the HHI screen is a conservative test, it is entirely possible for a merger to produce numerous screen failures and still not present any competitive problems. *See Revised Filing Requirements Under Part 33 of the Commission's Regulations (Revised Filing Requirements)*, FERC Stats. & Regs. ¶ 31,111 at 31,882 (2000) ("Concentration statistics ... *are not the end of the analysis.* We note that *in many cases, the Commission has moved quickly beyond market concentration statistics* in evaluating the competitive effects of proposed mergers.") (emphasis added).

To the extent that FERC finds that there is a competitive problem, then the applicants must propose some form of mitigation. The most common form of mitigation is divestiture of generation assets in an amount necessary to cause HHI increases to be reduced to acceptable levels. However, FERC does not dictate any specific form of mitigation and has stated that it will consider mitigation other than divestiture (*Id.* at 31,900).

b. Dr. Hieronymus' Appendix A Analysis and the Applicants' Proposed Mitigation

In accordance with FERC's regulations, Dr. Hieronymus performed an Appendix A analysis showing the impacts on wholesale energy markets of the Merger. Dr. Hieronymus' analyses showed screen violations resulting from the Merger without mitigation. As a result, the Joint Applicants proposed significant mitigation – described below – to address these screen violations. Dr. Hieronymus included an Appendix A analysis that analyzed the effects of this mitigation, showing that it fully eliminated the screen failures. Later, in response to protests filed at FERC, the Joint Applicants increased the amount of proposed mitigation. Dr.

Hieronymus submitted supplemental testimony that included an additional Appendix A analysis showing the impact of this additional mitigation.[13]

As revised, the Applicants have proposed to divest 6,600 MW of capacity. This is a substantial amount of generation to divest – more than the total generation capacity owned by any other generation owner located in PJM East, and is almost equal to the amount of Exelon's generation located in PJM East before the merger (PECO Exh. WHH-1 at J-9). The Applicants' proposal represents by far the largest amount of generation ever proposed to be divested in connection with a merger.

The Applicants proposed two different forms of divestiture. First, they proposed to physically divest 4,000 MW of fossil-fired generation. This includes low-cost coal fired generation, combined cycle generation, and higher cost peaking facilities. The breakdown of generation types is shown on PECO Exhibit WHH-1a at Exh. J-17, page 47. Second, the Applicants proposed the "virtual divestiture" of 2,600 MW of nuclear capacity. Rather than actually selling nuclear generation facilities, the virtual divestiture consists of the sale of energy on a firm, 24 hours a day, 7 days a week (24/7) basis. The Joint Applicants proposed the virtual divestiture instead of the physical divestiture of their nuclear capacity because one of the expected benefits of the merger is to allow Exelon to apply its nuclear operations expertise to PSEG's nuclear generation fleet. This is expected in turn to result in increased production from those units – which would have a pro-competitive impact because it would increase the amount of energy being sold in the PJM market. The virtual divestiture proposal is described in more detail in PECO Exhibit WHH-1 at Exh. J-1, pages 7-9.

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[13] Dr. Hieronymus' FERC testimony also was submitted to this Commission in support of the Joint Application. Dr. Hieronymus' original FERC testimony was submitted as PECO Exhibit WHH-1. Dr. Hieronymus' supplemental FERC testimony was submitted as PECO Exhibit WHH-1a.

c. The Attacks On The Assumptions Used By Dr. Hieronymus In His Analysis Are Without Merit

PPL and FirstEnergy attack the assumptions used by Dr. Hieronymus in performing his FERC-mandated Appendix A analysis and which were approved by FERC in the face of the exact same attacks.[14] These attacks have no merit.

Energy Market Price Assumptions

Dr. Hieronymus was required to make assumptions about the market price of energy in PJM in 2006 over a range of likely market conditions in order to prepare his Appendix A analysis. These market prices are used to define the generation that can meet the delivered price test, which includes all generation that can be delivered to the market at the market price plus 5%. For example, if the market price assumption is $50/MWh, then all generation which can be delivered into the market at a cost of $52.50/MWh ($50 plus 5%) is included in the market concentration calculation. Dr. Hieronymus used nine different market price assumptions for nine different assumed load conditions. These market prices ranged from $250/MWh for his "S_SP1" (Summer Super Peak –1) load condition, which is the single highest peak hour of the summer, to $20/MWh for the "SH_OP" (Shoulder Off Peak) load condition (PECO Exh. WHH-1a at Exhs. J-27, J-28 and J-29).

Dr. Kalt's direct testimony, as well as Ms. Frayer's FERC testimony, attacks Dr. Hieronymus' price assumptions (PPL St. 1 at 30-32; Met-Ed/Penelec/Penn Power St. No. 3 at Exh. 3-A at 26-30). They assert that actual market prices have been somewhat different, and that

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[14] Almost as striking as the fact that PPL and FirstEnergy are attacking a FERC-approved Appendix A analysis on the grounds that it does not satisfy FERC's requirements is the lack of expertise of the witnesses criticizing the analysis as compared to the expertise of Dr. Hieronymus in performing such analyses. Dr. Hieronymus lists 13 different large utility mergers that he has analyzed, and in addition has worked on a number of smaller transactions (PECO Exh. WHH-1, Exh. J-2). By contrast, Dr. Kalt's statement of qualifications (PPL Exh. JPK-1) shows only two electric utility merger matters before FERC, one in 1994 and one in 1990 – both of which predated FERC's 1996 adoption of the Appendix A analysis requirement in its Merger Policy Statement. Ms. Frayer's statement of qualifications, which appears as Appendix A to Met-Ed/Penelec/Penn Power St. 3, does not list a single FERC merger proceeding.

Dr. Hieronymus' off-peak prices especially are lower than the recent average off-peak prices in PJM.

Dr. Hieronymus responded to these attacks in his Rebuttal Testimony (PECO St. 3-R at 10-12). He testified that he deliberately used a wide range of prices, from a low price that is somewhat lower than average off-peak prices to a high price that is somewhat higher than average peak prices, with a regular distribution in between. These assumptions allow an examination of potential market power over a wide range of possible market conditions, including low load conditions when the Joint Applicants' nuclear capacity represents a high percentage of the market as well as peak load conditions when there are price spikes. As Dr. Hieronymus pointed out, "[t]here are no intentional – and certainly no obvious – price gaps" in the range of market prices that he assumed (*Id.* at 10).

Neither Dr. Kalt nor Ms. Frayer rebutted this testimony, or suggested that the range of prices assumed by Dr. Hieronymus was inappropriate or left out prices that should have been assumed in his analysis. Furthermore, the exact same objections had been raised at and rejected by FERC, which found that "Applicants have adequately addressed the protests concerning the fuel cost and wholesale market price assumptions in their analysis of energy markets." *Exelon Corp.*, 112 FERC ¶ 61,011 at P 125.

Relevant Geographic Market

The relevant geographic market used in an Appendix A analysis is, quite simply, the geographic location of the market that will be the subject of the analysis. All of the generation physically located in this market that can be sold at the assumed market price plus 5 percent, as well as generation that can be imported into the market at that price, will be considered in the market concentration calculations. The definition of the relevant geographic market therefore is

very important to the results of the Appendix A analysis, because it defines which generation is included in the analysis.

In general terms, the relevant geographic market should include all generation facilities that can compete with one another to make sales. As a starting point, Dr. Hieronymus considered all of PJM (which he called "PJM Expanded") as the relevant geographic market (PECO Exh. WHH-1 at Exh. J-1 at 34). This makes practical sense because all of PJM in fact is operated as a single market, subject to the dispatch instructions of PJM, which uses bids to establish the lowest-cost dispatch order for the entire market.

However, Dr. Hieronymus recognized that transmission constraints within PJM sometimes restrict the ability of some generation facilities to respond to price increases on the other side of the constraint. Thus, transmission constraints can cause large price differences, known as price "separation," between different locations in PJM. For example, at certain times there are constraints on a series of transmission facilities known as the "Eastern Interface" that cause prices east of the interface to increase relative to prices west of the interface. When this occurs, generation west of the interface cannot further discipline prices east of the interface. The number of hours that the Eastern Interface is congested is quite limited, only about 275 hours in 2004 (*Id.* at 33), and these hours are spread out throughout the year. As a result, there is a good argument that the constraint does not occur frequently enough to justify dividing PJM up into more than one market. Nevertheless, in order to be conservative, Dr. Hieronymus also conducted an analysis of that part of PJM east of the Eastern Interface, which is known as PJM East (*Id.*).

There also are, at times, price differences between the western systems recently added to PJM – Commonwealth Edison, AEP, Dayton Power & Light and Dominion – and the rest of

PJM (called "PJM Pre-2004," because it includes all of PJM before the expansion of PJM in 2004). As a result, Dr. Hieronymus also analyzed the PJM Pre-2004 market as a separate market (*Id.* at 34). Again, it is not clear that the prices separate frequently enough to require a separate market analysis, but the analysis was included to be conservative.

In total, Dr. Hieronymus analyzed three geographic markets; PJM Expanded, PJM East and PJM Pre-2004. In each market, Dr. Hieronymus found screen failures that could be resolved with the mitigation proposed by the Applicants (PECO Exh. WHH-1a at Exh. J-17 at 46-50; PECO Exh. WHH-1a at Exhs. J-18; J-19, J-27, J-28, and J-29).

Dr. Kalt did not object to Dr. Hieronymus' choice of PJM Expanded and PJM East as markets that should be analyzed. However, Dr. Kalt did attack Dr. Hieronymus' decision to analyze PJM Pre-2004 as a separate market (PPL St. 1 at 16-19). Dr. Kalt argued that, instead, Dr. Hieronymus should have used a market termed as "PJM Classic" to represent the intermediate market between PJM East and PJM Expanded. The only difference between PJM Pre-2004 and PJM Classic is that PJM Pre-2004 includes the Allegheny Power system, which joined PJM in 2002. PJM Classic refers to the original members of PJM prior to Allegheny Power's entry.

As an initial matter, the competition issue does not turn on the resolution of the dispute over whether PJM Classic should be analyzed as a separate market. Dr. Kalt appended to his direct testimony two analyses performed by Dr. Hieronymus of the PJM Classic market, that were produced in discovery (PPL Exh. JPK-11 at 5-6). The first analysis, on page 5 of PPL Exhibit JPK-11, assumes that the generation proposed to be divested by the Applicants is not sold to any of the four largest PJM market participants. The second analysis, on page 6 of PPL Exhibit JPK-11, is based on an assumption that the four largest PJM market participants,

including PPL, purchase the divested capacity. Only the second analysis shows screen violations, and even these screen violations are relatively minor.

As a result, Dr. Kalt has not shown that the Merger would create a competitive problem in the PJM Classic market even if that market were to be accepted as a relevant market. All that Dr. Kalt has shown is that, if PJM Classic were to be deemed a relevant geographic market, the Applicants should not divest to PPL or other large market participants.

Moreover, Dr. Kalt again made the identical argument at FERC that PJM Classic should be treated as a separate market, where it was rejected. *See Exelon Corp.* 112 FERC ¶ 61,011 at P 123 ("We reject arguments that 'PJM-Classic' should be considered a separate relevant geographic market within PJM Pre-2004."). Dr. Kalt makes no attempt in his surrebuttal testimony, which was filed after FERC's Order, to explain the errors in FERC's decision – indeed he does not even acknowledge that FERC has ruled on the issue.

In addition, Dr. Kalt's argument focuses primarily on the Allegheny Power (AP) and Pepco systems. First, Dr. Kalt describes price differences between the AP system and prices in the Pepco system, which is located in PJM Classic (PPL St. 1 at 14-15, 18, and PPL Exhs. JPK-2 and JPK-3). Second, he refers to congestion on the Bedington-Black Oak line, which forms part of the transmission path from the AP system to Pepco and into eastern Virginia (PPL St. 1 at 17-18).

When price and transmission congestion data related to the entire PJM Classic market – instead of just Pepco – are examined, however, a different picture emerges. Although PPL Exhibit JPK-2 highlights the AP-Pepco price difference, it also shows price differences in other zones as well. PECO Exhibit WHH-3 takes that price information and shows the price differences between AP and all of the PJM Classic zones that are not in PJM East. Page 3 of this

exhibit shows that the prices in the AP Zone and the FE Penelec and PPL zones are not nearly so far apart as the difference in prices between the AP and Pepco zones. It also shows that the price differences that do occur are similar to the differences between FE Penelec, PPL and Pepco, all of which are within PJM Classic. There certainly is no basis in the price differences shown on PECO Exhibit WHH-3 for excluding AP from a geographic market that includes FE Penelec, PPL and Pepco.[15]

PPL Exhibit JPK-2 also shows that the primary transmission interface that separates AP from PJM Classic is the West Interface.[16] As Dr. Kalt concedes, the Bedington-Black Oak line that he references is not part of the West Interface (PPL St. 1 at 17). What Dr. Kalt does not reveal, however, is that congestion on the West Interface was limited to only 78 hours in 2004, evidence that even if there were the ability to influence price during congestion, the price increases are not sustainable (PECO Exh. WHH-1 at Exh. J-1 at 33 n. 52). Furthermore, as Dr. Hieronymus testified, congestion on the West interface is controlled by PJM through redispatch (PECO Exh. WHH-1a at Exh.J-17 at 33-34). As a result, when the primary interface separating AP from PJM Classic is considered, the amount of congestion is minimal and in any event can be controlled through redispatch. Again, that dictates against finding that PJM Classic is an appropriate geographic market. Instead PJM Pre-2004, which includes AP, should be used.

Allocation of Import Capacity

Another task in preparing an Appendix A analysis is to determine how much power can be imported into a geographic market. The imports are then added to the amount of generation

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15 Moreover, page 3 of PECO Exhibit WHH-3 shows that price differences between the three bottom zones and four top zones in PJM East are all within the same $3-$4 dollar range as the price difference between AP and Pepco. No one has asserted that PJM East should be divided into two separate geographic markets, and there is no reason to rely on the similar price difference between AP and Pepco to place AP in a different geographic market from Pepco.

16 As PPL Exhibit JPK-2 also shows, portions of the FE Penelec zone also are located west of the West Interface.

located in the market to determine the level of market concentration. For example, up to 7,300 MW of power can be imported into PJM East. Therefore, in calculating market concentration levels in PJM East, it is necessary to add 7,300 MW of imports to the generation physically located in PJM East (PECO Exh. WHH-1 at Exh. J-1 at 38-40.

In addition to determining the amount of imports, it also is necessary to assign the use of that import capacity to specific companies (Id.). For example, if all 7,300 MW of PJM East import capacity were to be assigned to the Joint Applicants, their market shares and the resulting HHI calculations would increase considerably. By contrast, if the 7,300 MW of import capacity were allocated to several companies with no generation located inside of PJM East, the market concentration, and therefore the HHI levels, would be much lower.

It is a simple matter to allocate long-term firm transmission capacity to holders of long-term firm contracts. However, it is more difficult to allocate short-term firm and non-firm transmission capacity. By its very nature, it is not possible to know today who will be using short-term and non-firm transmission capacity in 2006 and beyond.

In his analysis, Dr. Hieronymus used what is called the "pro rata" or "squeeze down" methodology (Id.). This approach allocates import capacity to owners of generation pro rata based on the total amount of capacity that they own outside of the market that can meet the delivered price test (*i.e.* that can deliver energy at the market price plus five percent). For example, if there were 100 MW of import capacity and ten owners of generation located outside of the market meeting the delivered price test, each with 100 MW of such generation, the pro rata approach would allocate 10% of the total import capacity – 10 MW – to each generation owner.

FERC has described the pro rata approach as being preferable to other import allocation approaches. *See Revised Filing Requirements* ("certain methods provide more accurate and reasonable results than others (*i.e.*, pro-rata as opposed to least cost))." FERC Stats. & Regs. ¶ 31,111 at 31,894. As a result, it is not surprising that FERC accepted Dr. Hieronymus' use of the pro rata approach here. *See Exelon Corp.*, 112 FERC ¶ 61,011 at P 129 (2005).

Nevertheless, in an argument that also was presented to FERC, Dr. Kalt asserts that import capacity into PJM East should be allocated based on the ownership of Financial Transmission Rights (FTRs) instead of on a pro rata basis. Because the Joint Applicants own a significant amount of FTRs for 2006, use of Dr. Kalt's approach increases their market shares, and thus the HHI levels, significantly (PPL St. at 28-29).

Dr. Kalt's reasoning as to why his approach should be adopted evolved somewhat as the hearing progressed. In his direct testimony, Dr. Kalt seemed to assert that FTRs represent actual transmission rights (PPL St. 1 at 25 ("the Merging Parties are holders of grandfathered import rights"); 27 ("FTRs allow Exelon and PSEG to 'sink' their lower cost generation into PJM East"); 28 (describing FTR ownership as representing "actual import right ownership."). But, in his surrebuttal testimony, Dr. Kalt retreated from this position, acknowledging in response to Dr. Hieronymus that "I do not claim that FTRs provide physical import rights" (PPL St. 1-SR at 13). Instead, Dr. Kalt asserts that holders of FTRs into PJM East have an "ability to compete effectively in PJM East," while "would-be sellers with resources in the west, but lacking FTRs, are effectively precluded as effective competitors in the east" (PPL St. 1-SR at 14). In addition, Dr. Kalt presented, for the first time, a new theory as to why FTRs should be included in the screening analysis:

> FTRs create a strong incentive for the Merging Parties to withhold, as both their generation and their FTRs will increase in value from such

> withholding. Accounting for this incentive in the competitive screen analysis is essential.

(Id. at 18).

In order to understand the fallacy in Dr. Kalt's assertions, it is important to understand the nature of FTRs. First, as Dr. Kalt concedes in his Surrebuttal Testimony, FTRs do not provide firm transmission rights – they are financial instruments unrelated to the generation or transmission of energy (PPL St. 1-SR at 13); PECO St 3-R at 20-21; Tr. at 383). Indeed, the holder of the FTR does not even need to deliver energy at any point in PJM in order to obtain the benefits of the FTR (PECO St. 3-R at 21).

Instead, FTRs entitle the holder to receive payment from PJM equal to the cost of congestion, which is defined as the difference in the PJM Locational Marginal Price (LMP) between the two points covered by the FTR. For example, if the PJM LMP was $50/MWh at a point in PECO and $49/MWh at a point in PPL, a holder of an FTR between those points would be entitled to a payment of $1. If the prices at the two points were the same, then there would be no payment.

As Dr. Hieronymus testified, "[o]wnership of FTRs provide no right whatsoever to preferential access to scarce transmission, nor do they allow the holder to limit or otherwise control the level of imports into PJM East" (PECO St 3-R at 21). As a result, there simply is no basis for allocating imports into PJM East based on FTR ownership, as Dr. Kalt proposes. Such an allocation would bear no relationship to reality.

Dr. Kalt's alternate theory advanced in his surrebuttal testimony regarding incentives omits important facts about the incentives involved. As Dr. Hieronymus explained, FTRs and load obligations create equal and opposite incentives for market participants to attempt to change market prices (Tr. at 384). Dr. Hieronymus gave an example where an entity owned 1,000 FTRs

into PJM East. To the extent that prices in PJM East increase by $1/MWh, then the FTR holder would benefit by $1,000 – which is the incentive that Dr. Kalt references. However, to the extent that the FTR holder also must serve 1,000 MW of load, the cost to the FTR holder of purchasing power to serve that load also would increase by $1,000, thereby canceling out the FTR holder's incentive to increase prices created as a consequence of its ownership of the FTRs (*Id.*).

The fact that load obligations cancel out incentives created by FTRs is crucial to the question of how those incentives should be modeled in a market power analysis. As Dr. Hieronymus further testified, the "grandfathered" FTRs that Dr. Kalt focuses on in his analysis are allocated to load serving entities based on who now serves the load that existed in 1998. As load moves to other retail providers, the rights to the FTRs automatically move to the new entity that serves the load (Tr. at 384-85). As a result, any analysis that is intended to provide a picture of how FTR ownership affects incentives to exercise market power in PJM East must also factor in the offsetting incentives created by the load obligations of the FTR holders.

This Dr. Kalt failed to do. His analysis, which looked at market concentration levels assuming that imports were allocated in accordance with FTR ownership, completely ignores load obligations (Tr. at 385). Thus, his analysis not only fails to reflect how import allocation works in PJM, but it also fails to provide any useful information about the impact of FTRs on the Applicants' incentives to increase prices in PJM East.[17]

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[17] Of course, Dr. Hieronymus did prepare an analysis after the issue was raised in Dr. Kalt's Surrebuttal Testimony that took both load and FTR ownership into account. However, PPL's counsel successfully objected to the introduction of this exhibit (Tr. at 388-95). He even went to the extent of modifying a question on cross-examination in order to prevent opening the door to Dr. Hieronymus' study (*Id.* at 432-33). Thus, it is PPL's fault that the record is left devoid of any evidence that bears on Dr. Kalt's assertions that FTR ownership will affect the Joint Applicants' incentives to increase prices in PJM East.

d. The Attacks On The Mitigation Proposed By The Joint Applicants Are Without Merit

Virtual Divestiture

One of the most hotly litigated aspects of the FERC proceeding was the efficacy of the Joint Applicants' virtual divestiture proposal. FERC's Order therefore discussed the various objections that were made to that proposal in detail. FERC's ultimate conclusion was that virtual divestiture does represent an appropriate form of mitigation. *See Exelon Corp.*, 112 FERC ¶ 61,011 at PP 134-38.

Dr. Kalt raises two arguments here that were considered and rejected by FERC. First, Dr. Kalt argues that, because the nuclear units subject to virtual divestiture are not being sold to third parties, the Joint Applicants will retain control over their virtually divested capacity. He asserts that this would allow the Joint Applicants to withhold the nuclear capacity from the market through maintenance and related operational decisions (PPL St. 1 at 22).

Dr. Hieronymus responded by observing that, under the virtual divestiture option, the Joint Applicants are obligated to make the energy available on a firm basis twenty-four hours a day, seven days a week. Thus, the energy has to be provided by the Joint Applicants regardless of maintenance decisions with respect to any particular unit (PECO St. 3-R at 36). He further noted that FERC has held on a number of occasions that there is not much risk that nuclear units will be used to execute a withholding strategy because the operating characteristics and regulatory scrutiny over nuclear units makes it almost impossible to withhold them from the market (*Id. at 36-37).* FERC agreed with Dr. Hieronymus' points.

> We have recognized that operational control of generation resources is a key element of market power analysis and mitigation. Here, the virtual divesture effectively transfers control of the output of 2,600 MW of nuclear capacity from the merged firm to the purchasers. That is, the merged firm cannot withhold the energy from the market and the buyer of the firm

> rights, not the seller, determines where and to whom the energy is ultimately sold.

Exelon Corp., 112 FERC ¶ 61,011 at P 134.

Dr. Kalt never responds in his surrebuttal testimony to the points made in this regard by Dr. Hieronymus or to the reasoning in FERC's decision, and appears to concede that withholding the nuclear units is not a realistic danger. Instead, he falls back on his second argument, which is that the Joint Applicants could withhold their fossil units from the near term markets in an effort to drive up the prices that they receive in the virtual divestiture auctions (PPL St. 1-SR at 7-9).

As an initial matter, this argument assumes that the Joint Applicants would have market power that would allow them to impact near-term prices by withholding their fossil units from the market. However, as Dr. Hieronymus testified, the Applicants will have divested 4,000 MW of fossil generation, and their mitigation package as a whole has been found by FERC to mitigate market power resulting from the Merger. As a result, the entire predicate for Dr. Kalt's theory is unfounded (PECO St. 3-R at 38). FERC agreed with this point, stating:

> [B]y giving up control of 6,600 MW of through the divestiture and virtual divestiture, Applicants have adequately mitigated the merger-related increase in market power. Therefore, they would not be able to raise the price of energy by other means, as the previous contracts expire, in order to raise the price they receive for the three-year contracts.

Exelon Corp., 112 FERC ¶ 61,011 at P 137. Dr. Kalt's failure to explain how the Applicants could influence the near-term markets in light of their market power mitigation represents a fatal flaw in his theory.

Furthermore, Dr. Kalt does not explain how raising prices in the *near-term* markets, even if it were possible, would cause prices to increase in the *long-term three year markets* in which the virtual divestiture auctions will take place. These are separate markets, and the factors that influence prices in the near-term markets are different from those that affect the three-year

markets. Purchasers of three-year contracts are looking to expected market conditions over the three-year period, and prices in the near-term markets referenced by Dr. Kalt are not relevant to those long-term market conditions. In this regard, Dr. Hieronymus and FERC both noted that the long-term markets are deemed to be competitive, and thus should not be influenced by any attempted exercise of market power in the short-term and near-term markets (PECO St. 3-R at 38; see *Exelon Corp.*, 112 FERC ¶ 61,011 at P 136 ("the Commission has determined that long-term capacity markets, absent specified entry barriers, are inherently competitive.")).

Any Attempt to Exercise Market Power Would Be Detected by the PJM MMU and the FERC OMOI

Another factor bearing on the Joint Applicants' ability to exercise market power is that the activity of all market participants is closely monitored by the PJM Market Monitor (the "PJM MMU"). As Mr. Crowley explains in detail in his testimony, the PJM MMU takes an active role in reviewing bids and other actions taken by market participants (PECO St. 9-R).[18] The testimony of Mr. Crowley in this regard went unrebutted. Similarly, no one rebutted Dr. Hieronymus' testimony regarding the ability of FERC's Office of Market Oversight and Investigations (OMOI) to detect and address market power abuse (PECO St. 3-R at 43-44).

The consequences of market manipulation being detected by the PJM MMU or OMOI are potentially quite severe. Under the recently enacted Energy Policy Act of 2005, a new Section 222 was added to the Federal Power Act to prohibit market manipulation, and Sections

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[18] The effectiveness of the PJM MMU to promptly identify and correct any inappropriate conduct by market participants was amply demonstrated in 2001 when it detected an unexplained increase in PJM's daily auction prices for installed capacity credits (ICAP) beginning on January 1, 2001. The PJM MMU attributed that aberration to conduct by PPL that, while not unlawful or prohibited by PJM, nonetheless "constituted the exercise of undue market power." Based on the PJM MMU's investigation and report, PJM filed tariff changes that, by April 2001, revised the market structure to prevent such conduct in the future. The PJM MMU notified the PUC of its action, which triggered a comprehensive investigation by this Commission that resulted in referrals to the FERC, the U.S. Department of Justice and the Pennsylvania Attorney General. *Re Investigation Of PJM Installed Capacity Credit Markets*, 218 PUR 4th 149 (Pa. P.U.C. 2002).

306, 316 and 316A of the Federal Power Act were amended to allow FERC to impose civil and criminal fines of up to $1 million/day per violation. *See* Energy Policy Act of 2005, §§ 1283-84. As a result, to the extent that the Joint Applicants were to attempt to exercise market power to increase prices and that attempt was detected by the PJM MMU or OMOI, as any sustained attempt likely would be, the resulting penalties associated with that effort would be quite severe.

e. There Is No Need to Condition Merger Approval On Approval Of The Post-Merger Compliance Filing That The Joint Applicants Will Make at FERC

Finally, in her surrebuttal testimony, Ms. Frayer refers to the fact that the Applicants will be making a post-merger compliance at FERC in which they will detail the exact generation units being divested, as well as the identity of the purchasers. Ms. Frayer notes that FERC will review this filing to ensure that the mitigation implemented by the Joint Applicants satisfies FERC's criteria for determining that there are no adverse impacts on competition in the wholesale markets. She goes on to argue that this Commission should withhold its final approval of the merger pending its own review of the Joint Applicants' compliance filing with respect to the adequacy of the divestiture (Met Ed/Penelec/Penn Power St. 3-S at 4-6).

The Commission should decline this invitation. As described above, the Commission's duty is to ensure that the proposed merger does not impact competition in retail markets, not the wholesale markets subject to FERC's review. Yet the compliance filing that the Applicants committed to make at FERC deals wholly with their market power in the wholesale markets. Nothing about that filing will relate to competition in retail electric markets.

Because there is no reason to believe that FERC's review of the compliance filing will not adequately address all wholesale competition issues, there is no reason for this Commission to duplicate FERC's review of that compliance filing. Such an effort would be a meaningless exercise.

3. The Joint Applicants Have Demonstrated That The Merger Will Not Raise Market Power Issues In The Natural Gas Market

The only party to raise any issues with respect to the impact of the merger on natural gas markets was PGW. Again, PGW made no real claims that the merger would have any direct impact on competition in retail natural gas markets. Instead, PGW's claims go to the wholesale natural gas markets.

As an initial matter, it became clear at the hearing that PGW's claims are far removed from any harm that PGW, its retail sales customers, or any retail sales customers in Pennsylvania might suffer. As Dr. Carpenter conceded on cross-examination, his theory at most goes to the ability of the Joint Applicants to raise natural gas prices in PJM East. PGW has rights to more than enough transportation capacity to move gas to its customers from the gas producing areas that are beyond the asserted reach of the Joint Applicants' market power. PGW and its retail sales customers therefore will never have to pay elevated natural gas prices in the event the Applicants somehow were able to increase natural gas prices in PJM East (Tr. at 472-474). Similarly, because local distribution companies (LDCs) located in PJM generally have sufficient natural gas transportation rights to meet their loads, any attempt by the Joint Applicants to raise natural gas prices in PJM East would have very little impact on retail sales customers of the LDCs, even if the Joint Applicants were successful (Tr. at 474-75).

Dr. Carpenter tried to avoid the implications of this line of questioning by asserting that the higher natural gas prices that were the subject of his testimony would lead in turn to higher electric prices. However, he acknowledged that PECO has an electric rate cap in place through 2010 and that any impact of the Merger thereafter would depend on how the market changes between 2006 and 2010. He therefore had to concede that PGW would not suffer from any increase in electric prices either (Tr. at 474-76). PGW thus has failed, as required by the

controlling statutes, to demonstrate that the merger "is likely" to create competitive problems in either the competitive electric or metal gas retail markets. *See* 66 Pa. C.S. §§ 2811(e)(1) and 2210(a)(1).[19]

In any event, Dr. Carpenter's assertions about the Joint Applicants' post-merger market power are without merit. As was the case with PPL's and FirstEnergy's arguments about market power in the electric industry, FERC already considered and rejected claims that the Joint Applicants would be able to use market power in the natural gas markets to increase wholesale electric prices. Furthermore, Dr. Carpenter's arguments are unsupported by the record in this proceeding.

a. FERC's Methodology for Evaluating Natural Gas Market Power

In addition to establishing a methodology for evaluating market power in the wholesale electric markets, FERC's Merger Regulations set out a methodology for evaluating whether the merger applicants' control over natural gas transportation assets could be used to raise electric prices, which FERC calls "vertical market power." These regulations appear at 18 C.F.R. § 33.4.

Like the Appendix A analysis, FERC's vertical market power analysis requires the calculation of market concentration using the HHI approach. Rather than compare changes between pre and post-merger HHIs, however, FERC looks solely at the post-merger HHI figures, both for upstream (natural gas transportation) and downstream (electric generation served by natural gas pipelines) markets. Only if both the upstream and the downstream markets are highly

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[19] The facts developed in the evidentiary hearings, as summarized above, now make it abundantly clear that PGW lacks standing to raise the issue of horizontal market power in the market for delivered gas because it is fully insulated from any adverse effects of such market power even if it existed. In short, PGW does not have, and cannot credibly assert, any interest that would be adversely affected by the outcome of this issue and, therefore, does not have the "substantial, direct and immediate" interest necessary to establish standing. *William Penn Parking Garage, Inc. v. City of Pittsburgh*, 464 Pa. 168, 346 A.2d 269 (1975); *Mid-Atlantic Power Supply Association v. Pa. P.U.C.*, 746 A.2d 1196, 1200 (Pa. Cmwlth. 2000). *See also Service Employees International Union Local, 686, AFL-CIO v. Philadelphia Gas Works*, Docket No. C-20039160 (Order Denying Interim Emergency Relief) (January 23, 2003).

concentrated after the merger, *i.e.* the HHI is above 1,800, will FERC conclude that there may be a market power problem. *See, e.g., Engage Energy America, LLC*, 98 FERC ¶ 61,207 at 61,750 (2002); *El Paso Energy Corp.*, 92 FERC ¶ 61,076 at 61,332 (2000); *Long Island Lighting Co.*, 80 FERC ¶ 61,035 at 61,079 (1997).

b. Dr. Hieronymus' FERC Natural Gas Market Power Analysis

Dr. Hieronymus presented to FERC, and to this Commission, the vertical market power analysis required by FERC's regulations. Dr. Hieronymus' analysis showed that the post-merger HHI in the PJM East natural gas market is 1,572 (PECO Exh. WHH-1 at Exh. J-16). Because this post-merger HHI is below the 1,800 threshold established by FERC, no vertical market power issues are raised by the merger (PECO Exh. WHH-1 at Exh. J-1 at 71-73). Based on this evidence, FERC concluded: "Applicants have shown that both the upstream and downstream markets are not highly concentrated, thus the horizontal upstream combination will not harm competition in the relevant downstream wholesale electricity markets." *Exelon Corp.*, 112 FERC ¶ 61,011 at P 203.

c. Dr. Carpenter's Attacks On Dr. Hieronymus' Analysis Are Without Merit

Dr. Carpenter's Incorrect Definition of the Geographic Market

Dr. Carpenter raises a number of allegations as to potential actions that the Joint Applicants could take after the Merger to impact natural gas prices, and thereby increase electric prices in PJM East. At bottom, however, all of these allegations depend on the assertion that the Joint Applicants will possess market power in the PJM East delivered natural gas market after the Merger. If they do not possess market power, then they will not be able to influence natural gas prices regardless of the actions they take. As a result, Dr. Carpenter's entire attack rests on

his assertion that the natural gas market is highly concentrated and that the Applicants therefore possess market power.

The assertions in the record regarding the Joint Applicants' market power are diametrically opposed. Dr. Carpenter presented HHI calculations showing a highly concentrated market with an HHI of 1,942 (PGW St. 1 at 17). Dr. Hieronymus presented a revised analysis that corrected for certain errors identified by Dr. Carpenter, which shows an HHI of 1,292, which fits squarely within the definition of a moderately concentrated market and is well below the 1,800 threshold for the definition of a highly concentrated market (PECO St. 3-R at 59). Dr. Morris presented an alternative calculation that shows an HHI of 897, which represents an unconcentrated market (PECO St. 11-R at 24).

The sole difference between Dr. Carpenter's calculations showing a market power problem and Dr. Hieronymus' and Dr. Morris' calculations showing no market power problem is in the definition of the geographic market. Dr. Hieronymus includes transportation capacity that runs through PJM East and which is deliverable in PJM East under the transportation contracts, even when the contracts include primary delivery points that can also serve New York or New England (PECO St. 3-R at 57-59). Dr. Morris includes all transportation capacity deliverable in PJM East, New York and New England (PECO St. 11-R at 23-24). Dr. Carpenter, however, achieves his higher market concentration levels by excluding all transportation contracts, with one significant exception, that have primary delivery points in New York or New England, even if that capacity also is deliverable in PJM East (Tr. 485-87).[20]

The experts agree that the standard for determining whether PJM East is in the same geographic market as New York and New England is to look at prices in the three regions to see

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[20] Dr. Carpenter also excludes contracts with a primary delivery point in PJM East if the shipper has a corresponding contract right to transport its gas on the Algonquin pipeline into New England (*Id.*).

whether there is price separation (PECO St. 11-R at 17-18; PGW St. 1-SR at 12-13). Dr. Morris used a threshold of a 5% difference in prices, which is based on the Department of Justice/FTC *Horizontal Merger Guidelines* (PECO St. 11-R at 17). Although Dr. Carpenter at one point objects to the use of this standard (PGW St. 1-SR at 11-12), he never proposed anything different, and in fact applied the 5% standard to his own analysis (PGW St. 1-SR at 14-15).

The experts also agree that, when there is no price separation between PJM East, New York and New England, these three regions are all part of the same geographic market (PECO St. 11-R at 16-18; Tr. at 487-88). Dr. Carpenter asserts, however, that because prices separate during peak gas usage periods, the three regions should be considered as separate geographic markets during peak periods (PGW St. 1-SR at 16).

It is true that prices between PJM East, New York and New England do separate at times during peak periods. However, in order for price separation to require the establishment of separate geographic markets, that price separation must be sustainable (PECO St. 11-R at 17-18). The uncontested record evidence shows that the price separations occur only on a sporadic, non-sustainable basis. This evidence includes the following:

- Dr. Morris presented detailed information regarding prices in the three regions, showing that the prices follow each other closely, with only sporadic differences in excess of 5% (PECO St. 11-R at 18-21).
- Using this data, Dr. Morris calculated that prices in PJM East are more than 5% below both the New York and the New England prices on only 2% of the days of the days of the year (Tr. at 501).
- The price data that Dr. Morris used is what is called the "mid-point" data, *i.e.* it reflects the mid-point of the sales prices reported for the day – some sales prices that day actually are higher and some are lower than the reported mid-points. Dr. Morris showed that even a 1% increase in prices in PJM East will cause some transactions in New York and New England to be diverted to PJM East on 99% of all days, and a 5% price increase in PJM East will cause transactions to be diverted to PJM East on 100% of the days (PECO St. 11-R at 31-34).

- Even Dr. Carpenter's price data shows that price separation during winter peak demand periods does not always reach the 5% level. His Table 2 on page 15 of his Surrebuttal Testimony shows that the average price separation for the entire winters of 2001/02 and 2002/03 was less than 5% (PGW St. 1-SR at 15; Tr. at 502).

The only conclusion that can be drawn from this uncontested price data is that price separations between PJM East, New York and New England are sporadic and short-lived. Certainly, there is no reason to believe that these price separations would permit sustainable price increases in PJM East without drawing a supply response from New York and New England that would in turn reduce prices in PJM East. As a result, Dr. Carpenter's geographic market is too narrowly drawn. Under an appropriate geographic market, the Joint Applicants will not possess market power after the Merger.

Dr. Carpenter's Inconsistent Application of His Market Definition

Even accepting Dr. Carpenter's flawed geographic market definition, Dr. Carpenter is forced to apply that definition in an inconsistent manner in order to show a market power problem. According to Dr. Carpenter, "pipeline capacity capable of serving New York and New England should be considered to be in a separate geographic market than the capacity contracted to PJM destinations during peak demand periods" (PGW St. 1-SR at 16). Yet, after testifying that New York capacity should not be included in a PJM East market calculation, Dr. Carpenter proceeds to include in his PJM East market calculation 794 MMcf/d of PSEG capacity that has delivery points in the New York market (*Id.* at 17).

As Dr. Morris explained at the hearing, PSEG's capacity on the Transco pipeline with delivery points north of the Linden constraint can command the New York price rather than the PJM East price, a fact that he confirmed by looking at actual PSEG sales data (Tr. at 509). Therefore, if Dr. Carpenter's argument that capacity deliverable to New York and New England

should be excluded from the PJM East market were to be accepted, the 794 MMcf/d of PSEG capacity deliverable north of Linden also would have to be excluded (Tr. at 509-10).

The impact of excluding the PSEG 794 MMcf/d north of Linden capacity from Dr. Carpenter's market concentration is significant. This capacity represents over 15% of the entire 5,112 MMcf/d PJM East market assumed by Dr. Carpenter. Dr. Hieronymus prepared an analysis which shows that, when this capacity is removed from Dr. Carpenter's calculation, the resulting post merger HHI is 1,335, which again is a moderately concentrated market well below the 1,800 threshold for defining a highly concentrated market (PECO St. 3-R at 52, Table 5). As a result, even if Dr. Carpenter's narrow market definition were accepted, which it should not, there would be no market power problem if that definition is applied consistently.

d. Putting HHI Calculations Aside, Dr. Carpenter Has Not Demonstrated a Market Power Problem

As Dr. Morris explains, it is not enough to show a high HHI level in order to demonstrate a market power problem. The HHI analysis is intended to act as a screen to identify situations that require further analysis. Therefore, when a screen violation is found, the next step is to conduct further analysis of the market to determine whether in fact there really is a market power problem (PECO St. 11-R at 15-16). Here, the record demonstrates that there is no market power problem regardless of the HHI calculation.

No Spare Capacity During Peak Periods

Dr. Carpenter's theory as to how the Joint Applicants would exercise market power is that they would "withhold gas transportation capacity from the market by not using or releasing it" (PGW St. 1 at 22; PECO St. 11-R at 14 (market power is exercised by withholding supplies from the market)). Yet, during the peak demand periods when Dr. Carpenter theorizes that the

Joint Applicants will have market power, the Joint Applicants need to use all of their transportation capacity to serve their own loads. They therefore cannot withhold their transportation capacity during peak periods by not using or releasing that capacity (PECO St. 11-R at 21).

While it is correct, as Dr. Carpenter asserts, that there are many days when the Joint Applicants' transportation capacity "greatly exceeds the retail gas demands that the merger entity will be required to meet" (PGW St. 1 at 22), those are the days when demands are not at their peak, and even Dr. Carpenter agrees that the Joint Applicants do not have market power on these days (Tr. at 487-88).

As a result, on those days when Dr. Carpenter asserts the Joint Applicants possess market power, they do not have any ability to withhold capacity from the market, and on those days that the Joint Applicants have the ability to withhold capacity from the market, Dr. Carpenter concedes that they do not have market power. Under either scenario, the Merger cannot create a market power problem in the natural gas market.

Mismatch Between Peak Gas Demand and Peak Electric Demand

Dr. Carpenter's theory is that the Joint Applicants would increase natural gas prices in order to influence the market price for electricity. He asserts that, when natural gas-fired generation is at the margin, an increase in natural gas prices will cause the market price for electricity to increase (PGW St. 1 at 24-25).

A problem with this argument is that there is a mismatch between the times of peak demand for electricity and natural gas. As Dr. Hieronymus demonstrates, electric prices in PJM East peak in the summer when natural gas demand tends to be lower, while natural gas demand peaks in the winter when electric prices tend to be lower. This mismatch makes it less likely that

the strategy hypothesized by Dr. Carpenter would be successful in increasing the market price of electricity (PECO St. 3-R at 50).

Inability to Withhold Under FERC Open-Access Regulations

FERC's open-access regulations in any event would prevent the Joint Applicants from withholding their capacity. As Dr. Carpenter admits, those regulations require interstate natural gas pipelines to offer unused firm capacity on an interruptible basis if it is not used by the shipper that has a firm contract for the capacity (PGW St. 1 at 22). Thus, if the Joint Applicants did not use or release their transportation capacity, that capacity would be made available to third parties on an interruptible basis.

Dr. Carpenter argues, however, that the availability of unused capacity on an interruptible basis does not alleviate market power concerns. According to him, interruptible transportation capacity is viewed by electric generators as a poor substitute for firm transportation capacity (*Id.*).

Dr. Carpenter presents no statements by owners of electric generation to support this assertion. He has no data on use of interruptible transportation in PJM East, whether by electric generators or others. Nor does he explain why a generator that requires firm instead of interruptible service would not already have firm service in place rather than depending on the use of a firm capacity release from the Joint Applicants. Logically, any generator that has chosen not to contract for firm capacity in the hopes that released capacity will be available should be willing to use interruptible transportation if released firm capacity is not available (PECO St. 11-R at 34).

Dr. Carpenter's theory that electric generators do not find interruptible transportation to be an acceptable substitute also ignores the fact that other natural gas customers are willing to

use interruptible transportation. As long as some customer is using the interruptible transportation and the quantity of natural gas reaching the market does not change, then there will be no impact on the price of natural gas in the market regardless of who the interruptible customer might be (PECO St. 11-R at 35).

Market Oversight

Finally, Dr. Carpenter ignores the fact that natural gas markets are subject to oversight from FERC's OMOI, which routinely oversees natural gas markets for evidence of market abuse. Indeed, it was OMOI's predecessor that made the allegations in the El Paso Natural Gas Pipeline case that Dr. Carpenter references in his testimony (PECO St. 11-R at 50). Given that the Energy Policy Act also amended the Natural Gas Act to provide for the same $1 million/day penalties discussed above under the Federal Power Act, the threat that market manipulation will be uncovered by OMOI or other market participants such as PGW itself provides even more of a deterrent today against the type of behavior hypothesized by Dr. Carpenter than in the past.

Similarly, under the Commission's own regulations, PECO submits its purchasing practices for Commission review annually under Section 1307(f) of the Public Utility Code. In this context, PECO must demonstrate that it has maximized the use of its pipeline capacity for the benefit of its customers. Withholding that capacity would run counter to that obligation and would be readily transparent.

e. The Remedies Suggested by Dr. Carpenter Bear No Relationship to the Harm He Alleges

Dr. Carpenter suggests two remedies for the competitive problems that he asserts are created by the merger: (1) divestiture of the Joint Applicants' natural gas distribution assets; and (2) transfer of control over the Joint Applicants' natural gas transportation and storage contracts to an independent third party (PGW St. 1 at 20-31).

The first of these proposed remedies – divestiture – is clearly too broad. As Dr. Morris testified, it is like killing the dog to get at the fleas (Tr. at 510). As Dr. Carpenter conceded, it is the Joint Applicants' contract rights, not their natural gas distribution assets, that cause the market power problems that he asserts (Tr. at 493). Divestiture of the natural gas distribution assets is not necessary to solve a problem that has nothing to do with the ownership of these assets (PECO St. 11-R at 51; Tr. at 510).

The second remedy – the transfer of contract rights to a third party – also represents overkill. As Dr. Morris testified, it makes no sense to transfer contract rights that apply for the whole year to solve a problem that, at most, occurs only during the small number of days in which peak demand conditions cause prices to separate (Tr. at 511).

Dr. Morris suggested that any concerns the Commission conceivably might have are addressed by the fact that the Applicants are not proposing to combine the natural gas procurement functions of PSEG and PECO. This means that PSEG and PECO will not be able to act in the concerted manner necessary to exercise the market power hypothesized by Dr. Carpenter (Tr. at 512).

In his supplemental testimony, Dr. Carpenter concedes that this maintenance of separate gas procurement functions will address the problems he alleges. Dr. Carpenter asserts that the Commission cannot rely on this separation because the Applicants have not committed to maintain the separation in the future (PGW St. 1-S at 3-4). However, as Ms. Crutchfield testifies, the Joint Applicants cannot combine their procurement functions in the future without obtaining the Commission's approval (PECO Statement No. 4-R at 40, 42-43; *see also* 66 Pa. C.S. § 2102 (approval of contracts with affiliated interests); 66 Pa. C.S. § 1102(3) (transfer of tangible or intangible property)).

To clear any lingering concerns on this issue, the Joint Applicants commit that they will not combine their natural gas procurement functions after the merger is closed without obtaining the Commission's approval. As a result, the Commission will retain full control over whether the Joint Applicants will ever be able to combine their gas procurement functions, and can act to prevent such a combination if it determines that it is necessary to do so in order to protect competition.

VII. THE QUESTIONS POSED BY VICE CHAIRMAN CAWLEY AND COMMISSIONER SHANE ARE APPROPRIATELY ADDRESSED BY THE PROPOSED SETTLEMENT

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

Directed Questions Nos. 1-4 inquire into whether the synergies to be unlocked by the Merger could be harnessed to enhance economic development, and they specifically raise the prospect of a set-aside of some portion of the nuclear generation to be "virtually" divested pursuant to the FERC-approved mitigation plan previously discussed.

In his supplemental testimony (PECO St. 1-DQ), Mr. O'Brien described in detail PECO's existing economic development initiatives. He further noted that comparable programs in neighboring states (1) had been implemented on a statewide basis in accordance with legislative or commission mandate and (2) were funded by customers or by the state, either through surcharges to customers' utility bills or through tax credits granted directly to the utilities themselves (*Id.* at p. 10). Dr. Hieronymus, in turn, explained why a set-aside program of the nature apparently envisioned by the Directed Questions could complicate the mitigation plan adopted by the FERC, could have the inadvertent effect of increasing the price of energy sold at the virtual divestiture auction, and could expose the Commonwealth or a designated competitive electric generation supplier to substantial market risk (PECO St. 3-DQ). Finally, Mr. Sidak testified that the set-aside raised serious constitutional "takings" issues if the divested generation

were to be appropriated by the State for less than its fair market value, and, on its face, the set-aside seemed inconsistent with the policy and principles of electric restructuring in Pennsylvania (PECO St. 12-DQ).

To avoid these potential legal and regulatory obstacles, the Settlement (at ¶ 52) provides for PECO to contribute $8.0 million ($2.0 million in each of the years 2007, 2008, 2009, and 2010) to PEDA to be used for energy-related economic development projects and initiatives of benefit to the PECO service territory. PEDA will provide to the Commission and the Joint Petitioners copies of the report it sends annually to the Governor and the General Assembly so that the use of these funds can be monitored. As the DEP observed (Department Of Environmental Protection's Statement In Support Of The Joint Petition For Settlement, p. 3), these dollars, coupled with other funding made available by the Settlement, ".... will promote the use of efficient, clean and diverse energy technologies in Pennsylvania that will contribute to the welfare of Pennsylvania's citizens and to the continued economic prosperity of the Commonwealth."

B. Directed Question No. 5 (Consolidation Of PECO, PSE&G and PGW Gas Operations)

Directed Question No. 5 asks the parties to consider the viability of combining the natural gas operations of PECO, PSE&G and PGW into a "profitable, shareholder owned, public utility, assuming a revenue stream from off system sales from an LNG facility, and separate resolution of the problem of a billion dollar debt."

1. The Settlement Provides A Procedural Mechanism For Exploring The Issues Raised By Vice Chairman Cawley And Commissioner Shane

PECO is cognizant of the financial and operational difficulties faced by PGW and is certainly willing to explore, with the Commission, possible solutions to PGW's problems. At the

same time, and as Mr. O'Brien noted, Directed Question No. 5 cannot be answered "... without extensive further investigation; an understanding of the transaction terms upon which Exelon and PGW would agree; and the regulatory treatment that would be accorded a host of difficult issues" (PECO St. 1-DQ, p. 3).

The Joint Petitioners concurred in Mr. O'Brien's assessment and, for that reason, have recommended in the Settlement (at ¶ 55) that, if the Commission desires to pursue this matter, it do so in the context of a separate fact-finding investigation following the consummation of the Merger. PECO believes that such a proceeding could serve a valuable function in terms of identifying issues and gathering the information needed to determine whether the contemplated combination of gas operations would be in the public interest (PECO St. 1-DQ at p. 16). Moreover, Mr. O'Brien pledged to work with the Commission and all interested parties to define the scope and anticipated timeline of such an investigation (*Id.* at 16).

It is unclear, at this point, whether any party opposes this aspect of the Settlement. On the one hand, the City acknowledged its desire to "create 'facts on the ground' before deciding an issue of great interest to the City and others within PECO's service territory" and stated that "[t]he Settlement, or at least the merger, should not impede consideration of this matter, but should instead provide meaningful progress towards this important potential benefit to the public" (City's Comments at p. 2). PGW witness White similarly opined that the possible consolidation of gas operations warranted "further study" (Tr. 549) to determine **if** it would be "in the best interests of the citizens of southeastern Pennsylvania" (Tr. 588). The separate investigation proposed by the Settlement would seem to meet the needs of both parties.

Yet, on the other hand, both PGW and the City suggest that the Commission should delay this proceeding to allow for study and resolution of the PGW issues (City's Comments at p. 7).

PECO and PSE&G would, of course, vigorously oppose any attempt to delay or condition merger approval upon the resolution of PGW's ongoing problems. While Section 1103(a) of the Code empowers the Commission to "impose such conditions as it may deem to be just and reasonable," Pennsylvania's Appellate Courts have made it clear that the Commission may not exercise that authority to accomplish indirectly that which it cannot do directly. *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). This is relevant because there is no independent or legal basis for the Commission to compel PECO either to acquire PGW or to divest its gas operations.

2. The Record In This Proceeding Confirms That Additional Study Is Required

a. Numerous Issues Have Been Raised by the Parties and the Directed Question Itself That Would Need To Be Addressed

Directed Question No. 5 contemplates a significant, and potentially very complicated, corporate transaction that, under the best of circumstances, would entail months of due diligence, extensive negotiations, and a lengthy regulatory approval process potentially involving many Federal and State agencies. Moreover, entities and people that are not parties to this proceeding, such as PECO's suburban customers and their representatives, likely would want to participate in any proceeding that would, at its heart, require some affiliation with PGW's operations and, therefore, those potentially interested parties should be afforded notice of a proceeding in which such a proposal is being considered in a public forum. For those reasons, most parties appear to agree that the current merger proceeding does not provide an appropriate platform to examine, in a meaningful way, the many issues that would have to be addressed.

PECO has agreed to participate in such a proceeding after the Merger has closed to address the viability of consolidating the gas operations of PECO, PSE&G and PGW into a "profitable, shareholder owned, public utility." Conceptually, the "shareholder owned, public utility" could either be a newly formed and independent corporate entity (the spin-off scenario) or an entity owned and operated by Exelon (the acquisition scenario). PECO asked Mr. Todd J. Jirovec of Booz Allen Hamilton to perform an initial assessment of these two possible deal structures. Based on Mr. Jirovec's uncontested analysis, a spin-off of the PECO and PSE&G gas properties would not be in the public interest, but rather "would create significant diseconomies and cause operating costs to increase relative to the current organizational and cost structures" (PECO St. 13-DQ at p. 7).[21] More specifically, Mr. Jirovec estimated that the revenue requirement of the stand-alone business would increase by approximately $250 million per year and that PECO's and PSE&G's electric divisions would experience lost economies totaling an additional $150 million per year (*Id.* at p. 8). Notably, any synergies that could be achieved by rolling PGW's gas operations into the combined entity could only fall far short of offsetting these cost increases (*Id.* at p. 9). The impact of the lost synergies would be felt by all PECO customers, including PECO's electric customers in the City of Philadelphia as well as suburban Philadelphia.

Under the acquisition scenario, Exelon would purchase the assets and business of PGW and combine them with its post-Merger gas operations. Mr. Jirovec identified a number of areas where he believed savings could be generated, but he also noted possible constraints that would have to be carefully evaluated – e.g., PGW's existing collective bargaining agreements, capital structure and tax differences, and PGW's collection problems (i.e. the uncollectible accounts)

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[21] As Mr. Jirovec explained, the common customer base for gas and electric service allows PECO and PSE&G to achieve economies of scale in the areas of customer service, meter reading, bill processing and field operations (PECO St. 13-DQ, p. 7).

(*Id.* at pp. 10-15). Moreover the viability and potential profitability of the acquisition scenario would depend, in part, on the purchase price that the parties were able to negotiate and the ratemaking treatment accorded thereto. Because of these uncertainties and limitations on the data that was available to him, Mr. Jirovec was unable to offer an opinion as to whether Exelon's acquisition of PGW would be in the public interest.

Similarly, PECO's President, Denis O'Brien, and other witnesses testified concerning the numerous issues that would need to be examined in any evaluation of whether the consolidation of PGW with the gas operations of PECO and PSE&G would be viable (PECO St. 1-DQ at pp. 14-15; OCA St. 1 Supplemental). These issues involve typical due diligence questions that must be examined in the context of any transaction involving the potential acquisition or consolidation of two or more public utilities. Because this proceeding cannot afford a reasonable opportunity to examine those issues, a separate proceeding initiated after the closing of the Exelon–PSEG merger would be a possible, albeit unusual, forum to address those issues.

b. PGW's "Preliminary Analysis" Is Incomplete And Built On Unsupported And Unrealistic Assumptions

PGW sidestepped the hypothetical posed by Directed Question No. 5 – namely, the creation of a "profitable, shareholder owned public utility" to house the gas properties of PECO, PSE&G and PGW. Instead, its witness, Mr. White, suggested the possible consolidation of the PECO and PGW gas operations in a not-for-profit Pennsylvania "state authority or similar entity" (PGW St. 2 at p. 5). On the strength of what he characterized as "a preliminary analysis," Mr. White surmised that such a structure "could be viable" (*Id.* at p. 3).

As an initial matter, the Joint Applicants respectfully submit that Mr. White's testimony should be accorded little, if any, weight. Although Mr. White is, undeniably, a talented and experienced gas system operator, he acknowledged that: he had no expertise when it came to the

purchase or sale of business units or assets (Tr. 527); had never participated in a synergy study involving the merger of formerly separate utilities (Tr. 528); was generally unfamiliar with his suggested "state authority" structure or what it entailed (Tr. 528, 530); and could not speculate as to whether PGW's owner, the City, would politically support the solution through its elected legislative and executive representatives, the City Council and Mayor, let alone whether the State legislature or the Governor would pass and sign the necessary legislation to support the billions of dollars in loans necessary for this solution (Tr. 550). In addition, Mr. White admitted that he was unaware that the Joint Applicants had performed their own synergy study (Tr. 540-41) and that he had not to read the testimony of Messrs. Arndt and Jirovec as it related to a possible divestiture of PECO's gas operations and a consolidation with PGW (Tr. 543).

Beyond these shortcomings, Mr. White's cross-examination revealed that the "preliminary analysis" on which he relied had not been conducted by him or under his supervision or control (Tr. 533) and, in fact, was replete with unsupported and unrealistic assumptions. Most glaringly, the PGW study presumed that PECO would part willingly with its gas assets for between $1.1 and $1.2 billion, a figure barely in excess of their net depreciated book value. Mr. White offered no support for this assumption and, in fact, admitted that PGW had conducted no study of the fair market value of PECO's gas system (Tr. 541; PECO Cross-Exam. Ex. 5). Mr. White did make clear that PGW could not afford to pay fair market value and suggested that PECO accept "appropriate value" instead (Tr. 546):

> Q. Mr. White, you indicated earlier that there was an appropriate market value that would be paid for the PECO Gas assets. Is there a difference between appropriate market value and fair market value in your mind?
>
> A. Obviously we couldn't get into a bidding war because once the price would be at a level that would be so exorbitant that it wouldn't make sense, wouldn't allow us to have 1.5 coverage, that an appropriate level would be a level that would sufficiently compensate PECO for

> the assets and at the same time would allow the authority to function with a 1.5 coverage.

Apparently Mr. White's view of "appropriate value" is the value that PGW can afford to pay and still make the "state authority" structure viable under its "preliminary analysis":

> We have assumed and included a favorable acquisition price for the gas system. The model, as currently developed, does not indicate a great deal of room for a higher price, or the possible impact if the sale becomes the subject of a bidding war.

(PECO Cross-Exam. Ex. 4, p. 7).[22] Plainly, even if PECO decided to sell its gas operations (or was ordered to do so), then it would sell them to the highest bidder and not simply for an amount that would be convenient for PGW.

With regard to the two specific issues alluded to by Directed Question No. 5, namely (l) a possible revenue stream from a new "LNG facility" and (2) PGW's billion dollar debt "problem," Mr. White's responses demonstrated that solutions to these issues were not imminent or easily achievable. Instead, in some respects, Mr. White's testimony could fairly be characterized as equivocal and evasive. For example, Mr. White testified that it would be "premature" to offer any opinion as to the LNG project's political or regulatory viability and that it would, therefore, be equally "premature" to assume that the project would yield any benefits (Tr. 557). In fact, when asked about the project's potential benefits, Mr. White indicated that he was "not at liberty to discuss [them]" and flatly refused to answer any questions about project specifics (Tr. 565). Similarly, Mr. White had little to add concerning the billion dollar debt "problem," other than to note that the "state authority" presumably would have to issue another billion dollars of debt or more to finance the acquisition of PECO's gas operations (Tr. 547-59).

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[22] It goes without saying that what is "favorable" to PGW might well be unacceptable to PECO. As Mr. White agreed (Tr. 547), PECO management undoubtedly would seek to maximize the value received for its gas operations, whether from PGW, the City or some other third party.

In other words, a "state authority" model that includes PECO's gas customers might well convert a billion dollar debt problem into a multi-billion dollar debt problem.[23]

c. On Its Face, Any Affiliation with PGW May Be Contrary To PECO's Duty To It Customers

Putting all these uncertainties aside, one must seriously question why the divestiture of PECO's gas operations and the formation of a "state authority" would be in the best interests of PECO's customers or the public in general.[24]

On the financial side, Mr. White admitted on cross-examination that: PGW once again faces a looming liquidity crisis; that credit agencies rate its bonds at BBB-, just above junk bond status (Tr. 511); and that the rating agencies have not further reduced PGW's rating only because they assume continued repayment forgiveness of tens of millions in City loans and annual payment obligations.

On the operational side, PGW's infrastructure appears to be in an equally tenuous condition. Mr. White conceded that just five months ago he personally testified that (Tr. 573):

> PGW has an aged distribution system comprised primarily of cast iron main. Its supplemental gas facilities are nearing the end of useful life. The fleet is the oldest when benchmarked against other utilities, and many of its basic facilities have been ignored and are in need of repair.[25]

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[23] In terms of timing, Mr. White noted that City Council review and approval of the LNG project would likely not occur until the late winter or early spring of 2006, following which he would anticipate an eighteen-month FERC review process and that the anticipated in-service date for the terminal is 2009 (Tr. 558). PECO further believes that the creation of a "state authority" would require enacting legislation.

[24] While PGW touts the fact that the municipal authority would not have to pay many types of taxes, it ignores that this proposal would strip the Commonwealth of significant tax revenues (*e.g.*, state income taxes, capital stock taxes), which dollars undoubtedly would have to be replaced through other means such as "payments" by the authority or an added burden on other taxpayers (Tr. 588-590).

[25] Under cross-examination, Mr. White initially denied the substance of this quote (Tr. 573). However, when it was pointed out that the words were his own, Mr. White changed course and tried to suggest that recent events made him more optimistic about PGW's situation (Tr. 575-576). Mr. White then pointed to a consultant's report as evidence that PGW's infrastructure was in somewhat better shape than his recent testimony would suggest. The problem with Mr. White's explanation, however, is that the consultant's report that he relies upon pre-dates his March 2005 testimony. Thus, one would assume that Mr. White already considered the report when he testified in March 2005.

PGW's customer service operations also sadly mirror the tenuous condition of its finances and its unhealthy infrastructure. As Mr. White admitted, PGW is under PUC order to answer its customer calls within 30 seconds 80% of the time. Its actual performance never has met this threshold and has hovered at 27% for months at a time. Mr. White testified that PGW deliberately sacrificed its call center performance so that it could increase collections. Mr. White attempted to explain how PGW's customers actually preferred that PGW committed resources to collections over answering their telephone calls (Tr. 581).

PGW's state authority structure offers nothing to PECO customers to compensate them for affiliating with PGW's troubled finances, suspect infrastructure and deficient customer service performance. PGW offers a "possible" rate freeze for three years. However, PECO's gas customers already have enjoyed nearly 20 years of base rate stability since 1987 – a record that Mr. White described as "almost unbelievable" (Tr. 555). In contrast, PGW customers have had multiple base rate increases during that same period, the last of which occurred in 2003 (Tr. 555). Furthermore, PGW's rates are higher across the board than PECO's rates for comparable gas service (PECO St. 13-DQ, p. 15).

To return to the point, while the Commission's directed question is worthy of discussion outside the context of the Merger at issue, the simple truth is that PGW remains a financially marginal enterprise, the basic facilities of which have been – to use Mr. White's own words – "ignored" for years (Tr. 573). The answer to PGW's problem is not to create an even larger problem under a state authority or PGW's leadership. Likewise, the answer is not to try to solve PGW's problems on the backs of PECO and its existing customers by trying to compel PECO to acquire PGW. PGW's and the City's efforts to leverage unwarranted market power claims to force such a fix should not be countenanced.

As Directed Question No. 5 correctly identifies, the LNG and debt issues must be resolved, but have not been. Further, there must be acceptance that any viable combination of these entities likely will require substantial job reductions, other difficult financial decisions by PGW's current owner, a commitment by the new owner to resolve PGW's service quality and operational problems that is aided by a cooperative and supportive attitude by all stakeholders, and potentially a curtailment of some of PGW's present discounted rate programs. Without a solution to these issues and others, PGW, standing alone or in any combination, will continue to falter both financially and operationally, and its customers will continue to suffer from high rates and poor customer service quality.

In conclusion, the answer to PGW's problems lies in real political and regulatory leadership that deals with the difficult labor, financial, rates and LNG issues that must be resolved in order to turn PGW around. As Mr. O'Brien makes clear, PECO does not rule out a possible acquisition of PGW at some point in the future, but there must be, in the first instance, a process to understand and address these problems.[26] Quick fix solutions that avoid these difficult decisions or attempt to foist the problem onto PECO, its customers, or any other company will simply result in larger problems. PECO and the other Joint Petitioners have expressed their willingness to work together with the Commission and PGW to begin to address these questions (Settlement ¶ 55). However, this is not the appropriate proceeding in which to do so.

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[26] Presumably, if PGW's problems were addressed, there would be more buyers interested in PGW, allowing PGW's owner, the City, to obtain the greatest value for these assets.

VIII. CONCLUSION

WHEREFORE, for the reasons set forth above, 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.

Respectfully submitted,

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APPENDIX A

THE JOINT APPLICANTS' PROPOSED FINDINGS OF FACT

1. On December 20, 2004, Exelon Corporation (Exelon), the parent of PECO Energy Company (PECO), entered into an Agreement and Plan of Merger (Merger Agreement) with Public Service Enterprise Group Incorporated (PSEG), the parent of Public Service Electric and Gas Company (PSE&G) (Joint Application, Ex. C).

2. Pursuant to the terms of the Merger Agreement, PSEG would merge with, and into, Exelon (the Merger) (Joint Application, Ex. C).

3. In order to obtain the approval of the Pennsylvania Public Utility Commission (PUC or Commission), if such approval is required, PECO and PSE&G (collectively, Joint Applicants), on February 4, 2005, filed the *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* (Joint Application).

4. PECO is a Pennsylvania corporation that provides electric and natural gas service in Southeastern Pennsylvania (Joint Application, p. 2).

5. PECO is a "public utility," a "natural gas distribution company" (NGDC) and an "electric distribution company" (EDC) as those terms are defined, respectively, in Sections 102, 2202 and 2803 of the Public Utility Code (66 Pa. C.S. §§102, 2202 and 2803) (Joint Application, p. 2).

6. PECO has turned over the operational control of its electric transmission system to the PJM Interconnection, LLC (PJM), which is the Regional Transmission Organization

(RTO) approved by the Federal Energy Regulatory Commission (FERC) for a centrally dispatched control area comprising all or parts of twelve states and the District of Columbia (Joint Application, p. 2).

7. Exelon is a Pennsylvania corporation, and its common stock is publicly traded on the New York Stock Exchange (Joint Application, p. 3).

8. Pursuant to this Commission's Order entered June 22, 2000 at Docket No. A-00110550F0147 (2000 Unicom Merger), PECO became a wholly owned subsidiary of Exelon. Concurrent with that transaction, Unicom Corporation (Unicom), the parent of Commonwealth Edison Company (ComEd), was merged with and into Exelon (Joint Application, p. 3).

9. As a consequence of the PECO-Unicom merger, ComEd became a subsidiary of Exelon. Currently, PECO and ComEd are second tier subsidiaries of Exelon through their immediate parent, Exelon Energy Delivery Company, LLC (Exelon Energy Delivery) (Joint Application, p. 3).

10. As part of the corporate realignment that established the holding company structure, PECO and ComEd transferred their generation assets, other non-regulated enterprises and business service functions, respectively, to separate corporations that also became wholly owned subsidiaries of Exelon (Joint Application, p. 3).

11. Currently, Exelon, through it subsidiaries, operates in three primary business segments, which have been denominated Energy Delivery, Generation, and Enterprises, and, through Exelon Business Services Company, provides business services to the consolidated

group. Enterprises, which is an infrastructure and electrical contracting business, is in the process of winding down (Joint Application, p. 3).

12. Exelon's energy delivery business is conducted through PECO and ComEd (Joint Application, p. 3).

13. ComEd is headquartered in Chicago and provides electric service in Northern Illinois and, through a subsidiary, provides electric transmission service in portions of Indiana (Joint Application, p. 4).

14. ComEd is a "public utility" under the Illinois Public Utilities Act and, therefore, is subject to regulation by the Illinois Commerce Commission (ICC) (Joint Application, p. 4).

15. On April 1, 2003, ComEd received approval from the FERC to transfer operational control of its transmission assets to PJM, which occurred in May 2004 (Joint Application, p. 4).

16. Exelon's generation business consists of (1) electric generating facilities with a total capacity of 34,467 Megawatts (MW) that Exelon Generation Company, LLC (Exelon Generation) owns or has under contract; (2) wholesale energy marketing operations (Power Team); and (3) as of January 1, 2004, the competitive retail sales business of Exelon Energy Company (Joint Application, p. 4-5).

17. The competitive retail sales business of Exelon Energy Company is not in PJM East (PECO Ex. WHH-1 at Ex. J-1 at 14).

18. Exelon Generation has ownership interests in 11 nuclear generating stations, consisting of 19 units with 16,943 MW of capacity, which is the largest fleet of nuclear units in the United States (Joint Application, p. 4).

19. PSE&G is a New Jersey corporation that provides electric and natural gas service (Joint Application, p. 5).

20. PSE&G is headquartered in Newark and, like PECO and ComEd, has turned over operational control of its electric transmission system to PJM (Joint Application, p. 5).

21. PSE&G's service territory comprises a corridor running diagonally across New Jersey from the southwest to the northeast and encompasses most of New Jersey's largest municipalities, including its six largest cities (Joint Application, p. 5).

22. As a consequence of its fractional ownership interest in an electric transmission line that runs from the Conemaugh Generating Station to the Maryland border, PSE&G holds a certificate of public convenience issued by this Commission (Joint Application, p. 5).

23. PSE&G's certificate, which was issued on April 24, 1968 at Docket No. 94234, provides that it "shall confine and restrict its operations to the construction, maintenance, repair, replacement, and removal of the proposed electric transmission line" (Joint Application, p. 5).

24. PSE&G is not authorized to serve, and does not serve, any customers in Pennsylvania (Joint Application, p. 5).

25. PSEG, the parent company of PSE&G, is a New Jersey corporation (Joint Application, p. 6).

26. The common stock of PSEG is publicly traded on the New York Stock Exchange (Joint Application, p. 6).

27. PSEG has four principal first-tier subsidiaries: PSE&G, PSEG Power LLC (PSEG Power), PSEG Energy Holdings LLC (PSEG Energy Holdings), and PSEG Services Corporation (PSEG Services) (Joint Application, p. 6).

28. PSEG Power is a wholesale energy supply company that operates through three principal subsidiaries: PSEG Nuclear LLC (PSEG Nuclear), which owns and operates nuclear generating stations; PSEG Fossil LLC (PSEG Fossil), which develops, owns and operates domestic fossil generating stations; and PSEG Energy Resources & Trade LLC (PSEG ER&T) (Joint Application, p. 6).

29. PSEG Power's generation portfolio consists of approximately 18,000 MW of installed capacity (Joint Application, p. 6).

30. PSEG ER&T purchases virtually all of the capacity and energy produced by PSEG Power and markets electricity, capacity, ancillary services and natural gas products on a wholesale basis (Joint Application, p. 6).

31. No PSEG entity engages in the retail marketing of electricity or natural gas (PECO Ex. WHH-1 at Ex. J-1 at 14).

32. PSEG Energy Holdings has pursued investment opportunities in energy markets through its direct wholly-owned subsidiaries (Joint Application, p. 7).

33. PSEG Services provides management and administrative services to PSEG and its subsidiaries, including legal, human resources, information technology, financial, and corporate governance services (Joint Application, p. 7).

34. Under the terms of the Merger Agreement, PSEG will merge with and into Exelon (Joint Application, Ex. C).

35. Each PSEG shareholder will be entitled to receive 1.225 shares of Exelon common stock for each PSEG share held, with cash paid in lieu of any fractional shares (Joint Application, p. 7).

36. Following the Merger, the existing shareholders of Exelon will represent approximately 68%, and the former shareholders of PSEG will represent approximately 32%, of the shareholders of the post-Merger Exelon (Joint Application, p. 7; PECO St. 6-R, p. 6).

37. Exelon will be the surviving company and, as such, will remain the corporate parent of PECO and all other current Exelon subsidiaries, and will become the ultimate corporate parent of PSE&G and all other PSEG subsidiaries (Joint Application, p. 7; PECO St. 6-R, p. 6).

38. Following the Merger, Exelon will change its name to Exelon Electric & Gas Corporation (EEG) (Joint Application, p. 7). A diagram depicting EEG's post-Merger corporate structure was provided as Exhibit D to the Joint Application.

39. The Merger will not change the ownership of PECO. Both before and after the Merger, all of PECO's common stock will be owned by Exelon Energy Delivery. Both before and after the Merger, all of Exelon Energy Delivery's common stock will be owned by Exelon (Joint Application, pp. 7-9; PECO St. 6-R, pp. 5-6).

40. Prior to the Merger, no person or group acting in concert controls at least 20% of the voting interest in Exelon (Joint Application, pp. 7-9, 11-12; PECO St. 6-R, pp. 5-6).

41. After the Merger, no person or group acting in concert will control at least 20% of the voting interest in Exelon (Joint Application, pp. 7-9, 11-12; PECO St. 6-R, pp. 5-6).

42. Exelon's pre-Merger shareholders will own 68% of the outstanding common stock of EEG (the post-Merger surviving corporation) after the Merger (Joint Application, pp. 7-9, 11-12; PECO St. 6-R, pp. 5-6).

43. Mr. John W. Rowe, the current Chairman, Chief Executive Officer and President of Exelon, will serve as Chief Executive Officer and President of EEG following the Merger (Joint Application, p. 9).

44. Mr. E. James Ferland, the current Chairman, Chief Executive Officer and President of PSEG, will become the non-executive Chairman of the EEG board of directors after the Merger and will serve in that capacity until March 31, 2007 unless he leaves the board sooner. When Mr. Ferland's tenure ends, EEG's Chief Executive Officer will be appointed Chairman (Joint Application, p. 9).

45. Mr. Denis P. O'Brien, the current President of PECO, will remain in that position and will continue to be responsible for PECO's day-to-day operations (Joint Application, p. 9).

46. This proceeding was initiated on February 4, 2005 by the filing of the Joint Application .

47. Along with the Joint Application and its attachments, PECO and PSE&G submitted Statement Nos. 1-3 and accompanying exhibits consisting of the direct testimony of Denis P. O'Brien, President of PECO, William D. Arndt, Senior Vice President, Financial Operations, for Exelon, and William H. Hieronymus PhD., Vice President of Charles River Associates, Incorporated.

48. PECO provided customer and public notice of the filing (Joint Application, p. 24).

49. PECO notified its customers by bill inserts and also served copies of its filing on the Office of Trial Staff (OTS), the Office of Consumer Advocate (OCA), the Office of Small Business Advocate (OSBA) and the Philadelphia Area Industrial Energy Users Group (PAIEUG) (Joint Application, p. 24).

50. PECO also served notice of the filing on all of the active parties to the 2000 Unicom Merger proceeding and all active parties to PECO's natural gas restructuring proceeding at Docket No. R-00994787.

51. As directed by Secretarial Letter dated February 8, 2005, the Joint Applicants published notice of the proposed Merger in the *Philadelphia Inquirer* during the week of February 14, 2005.

52. On February 19, 2005, a notice of the filing of the Joint Application was published in the *Pennsylvania Bulletin*, which allowed interested parties until March 7, 2005 to file protests and petitions to intervene.

53. Twenty-two parties filed protests or petitions to intervene in response to the Commission's Order. In addition, the OTS entered its appearance.

54. The Commission assigned this matter to Administrative Law Judge Marlane R. Chestnut (ALJ) to conduct hearings and issue an Initial Decision.

55. On March 29, 2005, a Prehearing Conference was held in Philadelphia at which various procedural matters were addressed, including the establishment of a schedule for filing testimony, hearings and briefing.

56. The Joint Applicants have responded to approximately 1,000 interrogatories and requests for production of documents.

57. Depositions and informal discovery sessions have been conducted.

58. Public input hearings were held in Philadelphia on June 30, 2005.

59. In addition, thirteen parties filed testimony and related exhibits addressing various aspects of the proposed Merger.

60. By Secretarial Letter dated July 15, 2005, the parties were directed to respond to a series of questions (Directed Questions) posed by Vice Chairman James H. Cawley and Commissioner Bill Shane.

61. The first four Directed Questions inquired into whether the synergies to be unlocked by the Merger could be used to enhance economic development, and they specifically raised the issue of a "set aside" of "virtually divested generation" to be dedicated to that purpose.

62. The fifth Directed Question asked the parties to consider the feasibility of combining the natural gas operations of PECO and PSE&G with the operations of the Philadelphia Gas Works (PGW) in a viable, profitable, shareholder-owned public utility.

63. The procedural schedule was revised to afford the parties an opportunity to respond to the Directed Questions.

64. On July 29, 2005, the Joint Applicants filed the rebuttal testimony and related exhibits of twelve witnesses.

65. Rebuttal statements were also submitted by the OCA and OSBA. On August 26, 2005, surrebuttal testimony and related exhibits were filed by eleven parties.

66. On August 26, 2005, the Joint Applicants and ten other parties filed supplemental testimony and related exhibits responding to the Directed Questions.

67. On September 12, 2005, a Joint Petition for Settlement (Joint Petition) was filed with the Commission containing, *inter alia*, the terms of the settlement (Settlement) reached by PECO, PSE&G, OTS, OCA, OSBA, the Department of Environmental Protection (DEP), Citizens for Pennsylvania's Future and the two named individuals that joined in its Protest and Petition to Intervene (PennFuture), the Action Alliance of Senior Citizens of Greater Philadelphia (Action Alliance), the Association of Community Organizations for Reform Now (ACORN), the Tenants' Action Group (TAG), the Energy Coordinating Agency of Philadelphia, Inc. (ECA), PAIEUG, The Reinvestment Fund/Sustainable Development Fund (TRF) and State Senator Anthony H. Williams (collectively, Joint Petitioners).

68. By letter dated September 13, 2005, the Exelon Utility Coordinating Council, International Brotherhood of Electrical Workers Locals 614 and 777 and Frank Kuders (collectively, Labor Parties) submitted a letter to the ALJ and the Commission's Secretary stating that they do not oppose the Joint Petition.

69. Four parties continued to oppose Commission approval of the Merger absent additional conditions: the PPL Companies (PPL Electric Utilities Corporation, PPL Energy Plus and various affiliated limited liability companies that own generation in PJM), the FirstEnergy Companies (Metropolitan Edison Company, Pennsylvania Electric Company, Pennsylvania Power Company and FirstEnergy Solutions Corp.), the Philadelphia Gas Works (PGW) and the City of Philadelphia (City).

70. Evidentiary hearings were held in Philadelphia on September 22, 23 and 26, 2005.

71. The Merger will create the following affirmative benefits for the customers and employees of PECO and for the public generally, which, individually and in total, are substantial in nature (PECO St. 1, pp. 6-8):

A. The Merger will increase the scale, scope and geographic diversity of the combined entity's energy delivery business, which, in turn should strengthen the balance sheet of EEG and provide continued access to capital at favorable rates.

B. As a result of the Merger, PECO will benefit from sharing best practices with PSE&G.

C. The Merger will create the opportunity to achieve meaningful cost savings through sharing of best practices, elimination of duplicative functions and improved operating efficiencies, which have been quantified in a synergy study presented by the Joint Applicants.

D. The Merger will help to promote competition in retail energy markets.

72. The terms of the Joint Petition ensure that the affirmative public benefits the Merger will achieve will have an immediate beneficial impact on PECO's customers, the

economy of PECO's service area and the Commonwealth in the following principal respects (PECO St. 1-S):

A. The Settlement provides for $120 million of rate reductions over a four-year period commencing approximately one month after the Merger is consummated. These reductions are made possible, in substantial part, by the projected synergies the Merger is expected to produce within PECO's regulated operations.

B. The Settlement caps PECO's transmission and distribution (T&D) charges until December 31, 2010.

C. PECO agrees that expenses attributable to achieving Merger-related synergies will be amortized by the end of the T&D rate cap period and will not be deferred or claimed in a subsequent rate case.

D. The Merger will create the opportunity to achieve cost savings in PECO's regulated operations through the sharing of best practices, purchasing economies and the elimination of duplicative functions which, in turn, will mitigate future distribution rate increases.

E. The Settlement provides that the provisions of the settlement of *Application Of PECO Energy Company Pursuant To Chapters 11, 19, 21, 22 and 28 of the Public Utility Code*, Docket No. A-110550F0147 (June 22, 2000) (2000 Unicom Merger Settlement) for sharing the risk of future increases in the costs of decommissioning PECO's pre-existing nuclear units will remain in effect and reaffirms PECO's commitment not to seek recovery of decommissioning costs associated with any nuclear units it did not own as of December 31, 1999.

F. As part of the Settlement, PECO commits to a Quality of Service Plan designed to maintain or improve reliability and the quality of customer service provided by PECO during the five-year period from January 1, 2006 through December 31, 2010 by establishing performance thresholds, reporting requirements and enforcement mechanisms for non-compliance. In addition, PECO commits to address issues that may arise in the future involving the implementation of a new common customer information and billing system.

G. The Settlement provides for substantial enhancements to PECO's universal service programs including: (1) paying $500,000 per year from 2007 through 2010 to the Matching Energy Assistance Fund; (2) increasing to 650 kWh the monthly usage levels eligible for discounts under CAP Rates B, C, D and E; (3) committing to spend $1.2 million on additional CAP enrollment outreach; (4) enhancing, stream-lining and simplifying the CAP application and recertification process; (5) providing $400,000 to community based organizations (CBOs) for CAP outreach and referrals; and (6) conducting at least four training sessions annually to educate CBOs on the availability and operation of the CAP Rate Program.

H. The Settlement provides that PECO will: (1) contribute $12.0 million to the Pennsylvania Energy Development Authority (PEDA) to fund renewable energy, energy efficiency and energy conservation programs; (2) contribute $7.2 million to the Sustainable Development Fund; and (3) support new customer-friendly net metering and interconnection rules.

I. The Joint Petition contains inter-related provisions designed to protect PECO's customers from risks associated with unregulated affiliates and cross-

subsidization. These include provisions on the determination of PECO's cost of capital for ratemaking purposes; limitations on PECO's ability to financially assist unregulated affiliates; notice requirements for dividends and other transfers of retained earnings; accounting controls and procedures for allocating overheads and costs of jointly-used property and personnel; limitations on claiming rate cap exceptions based on increases in affiliates' power costs; and access to books, records, personnel, annual reports and reports to analysts.

J. The Settlement provides that PECO: (1) will maintain the corporate headquarters for its distribution business in Philadelphia through at least December 31, 2010; (2) will fund charitable giving and sponsorships at a level of at least $3.0 million per year for 2007 through 2010; and (3) will not reduce field forces and limit reductions in other positions in accordance with specified criteria.

K. The Settlement provides that PECO will contribute $8.0 million over four years to PEDA to be used for energy-related economic development projects and initiatives of benefit to the PECO service territory.

L. The Settlement will create a wholesale electricity market reporting and monitoring mechanism to remain in place through 2012. The market monitoring provisions will give the Commission and Joint Petitioners information regarding price differentials between relevant markets and submarkets, which they can use to assess price trends and possible market power issues.

73. The Settlement achieves a fair balance of the interests of a broad and diverse stakeholder coalition that includes the Commonwealth of Pennsylvania, representatives of the residential, commercial and industrial customer classes, community based organizations (CBOs)

representing low-income customers and senior citizens, and environmental and sustainable energy groups (Joint Petition, pp. 2, 31-36).

74. The Merger will have a positive effect on the service and rates of PECO because: (1) The existing management structure of PECO and Exelon will remain intact after the Merger; (2) PECO's T&D rates will be reduced and capped as provided in the Settlement; (3) customer service will be maintained and improved through the implementation of the Quality of Service Plan; and (4) in the post-rate cap period, rate increases will be mitigated because the Merger will create the opportunity to achieve cost savings (Joint Petition, pp. 34-36; PECO St. 1-S).

75. The potential competitive impact of the Merger on electric and gas markets was addressed in the direct testimony and accompanying Exhibits WHH-1 and WHH-1a of Dr. William H. Hieronymous (PECO St. 3) and in the rebuttal testimony of Dr. Hieronymus and Dr. John Morris (PECO Sts. 3-R and 11-R).

76. Dr. Hieronymus testified that PECO's retail electric and gas operations are limited to Pennsylvania and PSE&G's retail electric and gas operations are in New Jersey, and thus there is no overlap between the two retail operations that might create market power (PECO Ex. WHH-1 at Ex. J-1, pp. 19-22).

77. Dr. Hieronymus also testified that the merger will not eliminate any competitor in retail markets because Exelon's retail marketing affiliate is not active in PJM East while PSE&G does not even engage in competitive retail marketing (PECO Ex. WHH-1 at Ex. J-1, p. 14).

78. Dr. Hieronymus analyzed the pre and post-Merger market concentration for the relevant product (energy, capacity and spinning reserves) and geographic (PJM East) markets (PECO St. 3; PECO Ex. WHH-1 and WHH-1a).

79. Dr. Hieronymus employed the FERC's Competitive Analysis Screen as described in Appendix A to the FERC's Merger Policy Statement, which, in turn, comports with the U.S. Department of Justice (DOJ) and Federal Trade Commission (FTC) Horizontal Merger Guidelines (PECO St. 3, p. 2).

80. Dr. Hieronymus' analytic method complies with this Commission's prior directive that FERC's Appendix A Competitive Analysis Screen should be used to assess market power and competitiveness issues for electric utility mergers. *Re DQE, Inc.*, 186 PUR 4th 39 (1998).

81. Dr. Hieronymus made appropriate assumptions in conducting his Appendix A analysis:

A. As FERC found, Dr. Hieronymus made appropriate choices regarding the market prices of energy to use in his analysis. Dr. Hieronymus used an appropriate range of market prices from $20/MWh to $250/MWh, with no obvious gaps in between (PECO St. No. 3-R at 10-12; *Exelon Corp.*, 112 FERC ¶ 61,011 P 125 (2005).

B. As FERC found, it is not necessary to analyze the PJM Classic market as a separate geographic market. Dr. Kalt's contention otherwise is based solely on price differences and transmission congestion between the Allegheny Power and Pepco systems, when prices and transmission between Allegheny Power and PJM Classic are viewed as a whole, it is clear that price differences are not as great and transmission

congestion is low and declining (PECO St. No. 3-R, pp. 22-25; *Exelon Corp.,* 112 FERC ¶ 61,011 at P 123).

C. As FERC found, Dr. Hieronymus appropriately allocated import capacity into PJM East based on a pro rata or "squeeze down" approach rather than in accordance with FTR ownership. Transmission capacity bears no relationship to ownership of FTRs and it would be improper to allocate imports based on FTR ownership. Furthermore, FTR ownership alone does not represent the incentive to raise market prices without also taking load obligations into consideration (PECO St. No. 3-R, pp. 18-22; Tr. at 384;12 FERC ¶ 61,011 at P 129).

82. Dr. Hieronymus' analysis showed that, absent mitigation, the Merger would not pass the Appendix A market screen. Therefore, the Joint Applicants adopted a mitigation plan involving divestiture of 6,600 MW of generation through the outright sale of 4,000 MW of fossil generation and virtual divestiture of 2,600 MW of nuclear generation (PECO Ex. WHH-1a).

83. With the Joint Applicants' mitigation plan, none of the FERC Competitive Analysis Screens are violated and, therefore, the Merger will not create market power (PECO St. 1, PECO Ex. WHH-1a).

84. The fact that the PJM Market Monitor oversees the market activities of the Joint Applicants further mitigates any potential that they would attempt to manipulate the market, particularly in light of recent amemdments to the Federal Power Act increasing the penalties for market manipulation (PECO St. 9-R; Energy Policy Act of 2005, §§ 1283-84).

85. The Merger is not likely to produce any other adverse effect on the Pennsylvania retail market.

86. If, as expected, EEG is able to increase the capacity factors of the Salem and Hope Creek nuclear plants currently operated by PSEG, Locational Market Prices in PJM East would be lower in at least some hours (PECO St. 1, p. 8).

87. Dr. Hieronymus performed the vertical market power analysis required by FERC when natural gas assets are included in a merger, and Dr. Morris also analyzed the natural gas market effects of the proposed Merger (PECO Sts. 3, 3-R and 11-R).

A. The relevant geographic market includes transportation capacity deliverable in New York and New England as well as in PJM East, because capacity deliverable in New York and New England can be diverted to PJM East in the event that natural gas prices rise in PJM East. Although there are sporadic periods in which prices separate between PJM East and New York and New England, these periods are brief, unpredictable, and would not permit any sustained price increase in PJM East (PECO St. 3-R pp. 47-49; PECO St. 11-R pp. 16-21).

B. To the extent that a PJM East is deemed the relevant market, PSEG's capacity that is deliverable in the New York market should not be included in the calculation of the Joint Applicants' PJM East capacity, just as all other capacity controlled by third parties that is deliverable in New York would not be included in a PJM East calculation (PECO St. No. 3-R, p. 47; Tr. 509-10).

88. Neither Exelon nor PSEG controls significant wellhead supplies, owns any long-distance interstate pipelines or has a dominant share of interstate pipeline capacity. PECO and PSE&G each own a gas distribution business, but their franchise areas are separate and distinct, located in different states, regulated by state commissions and open to retail access for all classes of customers (PECO St. 3, pp. 9-10).

89. PGW and its retail sales customers would not be harmed by any increase in natural gas prices in PJM East because they hold adequate contract rights to transport natural gas into PJM East from the producing regions (Tr. 472-75).

90. The Merger will not create market power in the natural gas market or vertical market power between the natural gas and electric markets.

91. The Joint Applicants have committed not to combine the natural gas procurement functions of PECO and PSEG without first obtaining the Commission's approval. This commitment should adequately address any potential natural gas market power issues (Tr. 512).

92. PGW's first proposed remedy – divestiture – is too broad. It is the Joint Applicants' contract rights, not their natural gas distribution assets, that cause the market power problems that he asserts. Divestiture of the natural gas distribution assets is not necessary to solve this problem, which is completely unrelated to the use of these assets (PECO St. No. 11-R, p. 51; Tr. 510).

93. PGW's second proposed remedy – the transfer of contract rights to a third party – also is too broad. It makes no sense to transfer contract rights that apply for the whole year to solve a problem that, at most, occurs only during the small number of days in which peak demand conditions cause prices to separate (Tr. 511).

94. On July 1, 2005, the FERC entered an Order (FERC Merger Order) granting the application of Exelon and PSEG for approval of the Merger. *ExelonCorporation*, 112 FERC ¶ 61,011; 2005 FERC LEXIS 1812. In that Order, the FERC found that, with the implementation

of the proposed mitigation plan, the Merger would not create horizontal market power in the electricity or vertical market power between the natural gas and electric markets.

95. Directed Questions Nos. 1-4 inquire into whether the synergies to be unlocked by the Merger could be harnessed to enhance economic development, and they specifically raise the prospect of a set aside of some portion of the nuclear generation to be "virtually" divested pursuant to the FERC-approved mitigation plan previously discussed.

96. In his supplemental testimony (PECO St. 1-DQ), Mr. O'Brien described in detail PECO's existing economic development initiatives.

97. PECO maintains a full-time staff dedicated to promoting the Greater Philadelphia region as a desirable business location for new and expanding businesses and provides rate incentives to existing and prospective customers that commit to creating jobs and/or investing capital (PECO St. 1-DQ, p. 4).

98. PECO offers discounted rates for economic development through the Employment and Economic Recovery Rider (E2R2) and the Keystone Opportunity Zone Rider (KOZR) programs (PECO St. 1-DQ, p. 5).

99. The E2R2 program is targeted to increasing manufacturing in PECO's service territory. The electric rate discounts are available to new manufacturing load and existing manufacturing activities where the customer can demonstrate increased levels of employment and/or investments. In the case of existing manufacturing activities, the E2R2 provides for increases in electric rate discounts as the customer expands the level of employment and capital investment (PECO St. 1-DQ, p. 5).

100. Effective in 2002, the KOZR provides electric rate discounts to customers who establish business in a Keystone Opportunity Zone or an Expanded Keystone Opportunity Zone, as those zones are defined by statute (Act 92 of 1998) (PECO St. 1-DQ, p. 5).

101. PECO also offers discounted rate opportunities to create incentives for companies to stay in the region or to locate in its service territory. These include: (1) Economic Efficiency Rider (EER) and Tariff Rule 4.6 Contracts, which provide negotiated electric rate discounts to customers using over 1,000 kW who have a viable competitive alternative, and (2) the Incremental Process Rider (IPR), which offers electric rate discounts to customers who install qualifying equipment that increases electric process load by at least 50 kW (PECO St. 1-DQ, p. 6).

102. Approximately 325 customers, representing over 1500 MW of new or incremental load, currently receive service under PECO's economic development rate programs (PECO St. 1-DQ, p. 6).

103. PECO's economic development programs will remain in place after the Merger (PECO St. 1-DQ, p. 6).

104. PECO presented evidence concerning economic development programs in New York, New Jersey and Ohio that were alluded to in Directed Questions 1-4 (PECO St. 1-DQ, p. 7-10).

105. In New York, there are two programs administered by the New York Power Authority ("NYPA") and the New York Economic Development Power Allocation Board ("EDPAB"), which are intended to target businesses facing expansion opportunities or

threatening to leave the State due to high electricity costs - - the "Economic Development Power" and the "Power for Jobs" programs (PECO St. 1-DQ, p. 7).

106. The New York programs were initiated to provide electricity from sources priced below-market. However, in their current form, the programs provide a discount from the regulated delivery rates charged by the transmission-owning utilities. The utilities are given a state tax credit to recoup the revenues lost from the discount (PECO St. 1-DQ, p. 7).

107. These programs have been changed over the years and continue to be revised by the New York legislature (PECO St. 1-DQ, p. 7).

108. Under the current New York programs, awards are made by the EDPAB which entitle successful applicants to purchase power from NYPA (a state agency) and to have the power delivered by the recipients' host electric utilities at reduced delivery rates (PECO St. 1-DQ, p. 8).

109. The power supplied under the New York programs formerly came from a combination of NYPA's Fitzpatrick nuclear plant and purchases made by NYPA from external market sources. The Fitzpatrick plant was divested by NYPA in 1999, and a purchase power contract with the new owner that supported these programs terminated at the end of 2004. All of the energy supporting these programs now comes from market sources acquired in bulk by NYPA (PECO St. 1-DQ, p. 8).

110. New York's investor-owned utilities deliver the electricity to the award recipients pursuant to delivery tariff schedules that exclude the utilities' stranded cost charges. This

reduction in delivery charges is the primary, and possibly the exclusive, benefit to program participants (PECO St. 1-DQ, p. 8).

111. The utilities are held economically harmless against the loss of delivery revenues by means of a tax credit. The tax credit is equal to the loss in net revenues caused by a customer switching from the normal delivery service (with stranded cost charges) to the special NYPA-related delivery service (without stranded cost charges) (PECO St. 1-DQ, p. 8).

112. The New Jersey Board of Public Utilities (NJBPU) and the New Jersey Economic Development Authority (EDA) administer New Jersey's "Clean Energy Program," which makes available grants and low interest rate financing for energy efficiency and renewable energy projects in New Jersey. This program is funded, in whole or substantial part, by a Societal Benefits Charge (SBC) assessed on all utility customers (PECO St. 1-DQ, p. 9).

113. The Office of Energy Efficiency (OEE), which is housed in Ohio's Department of Development, administers an "Energy Loan Fund," which makes available low interest rate financing to individuals and businesses for investments in products, technologies or services that will conserve energy and/or increase the use of renewable resources (PECO St. 1-DQ, p. 9).

114. The Energy Loan Fund was established as part of Ohio's 1999 electric restructuring legislation (Ohio Revised Code, Sections 4928.61-4928.63) and is financed through a surcharge on the bills of Ohio's five investor-owned electric utilities. According to information on the OEE's web-site, the surcharge approximates 9 cents per month for the typical residential customer and is expected to remain in place until 2011, by which time the Fund is projected to reach $100 million (PECO St. 1-DQ, p. 9).

115. Unlike the situation in New York, the programs in New Jersey and Ohio do not specifically target economic development, but instead seem designed primarily to promote energy efficiency and the increased use of renewable forms of energy (PECO St. 1-DQ, p. 10).

116. The programs in New York, New Jersey and Ohio were implemented on a statewide basis pursuant to legislative (New York and Ohio) or commission (New Jersey) mandate and apply equally to all jurisdictional utilities (PECO St. 1-DQ, p. 10).

117. The New York, New Jersey and Ohio programs are funded by consumers, either through surcharges to their utility bills or through tax credits granted the utilities themselves (PECO St. 1-DQ, p. 10).

118. There is no evidence that any existing program, in Pennsylvania or elsewhere, requires utility shareholders to subsidize state-sponsored economic development efforts (PECO St. 1-DQ, p. 10).

119. A set aside program of "virtually" divested power of the nature described in the Directed Questions could jeopardize the mitigation plan adopted by the FERC; could have the inadvertent effect of increasing the price of energy sold at the virtual divestiture auction; and could expose the Commonwealth or a designated competitive electric generation supplier to substantial market risk (PECO St. 3-DQ)

120. The set aside raises serious constitutional "takings" issues if it were implemented by requiring "divested" generation to be made available at less than fair market value (PECO St. 12-DQ).

121. The set aside is inconsistent with the policy and principles underlying electric restructuring in Pennsylvania (PECO St. 12-DQ).

122. To avoid the real and potential legal and regulatory obstacles posed by a set aside of generation as described in Directed Questions 1-4, the Settlement (¶ 52) provides for PECO to contribute $8.0 million ($2.0 million in each of the years 2007, 2008, 2009 and 2010) to PEDA to be used for energy related economic development projects and initiatives of benefit to the PECO service territory.

123. PEDA has agreed to provide to the Commission and the Joint Petitioners copies of the report it sends annually to the Governor and the General Assembly so that the use of these funds can be monitored. As the DEP observed (Statement in Support, p. 3), these dollars, coupled with other funding made available by the Settlement, "... will promote the use of efficient, clean and diverse energy technologies in Pennsylvania that will contribute to the welfare of Pennsylvania's citizens and to the continued economic prosperity of the Commonwealth."

124. Directed Question No. 5 asks the parties to consider the viability of combining the natural gas operations of PECO, PSE&G and PGW into a "profitable, shareholder owned, public utility, assuming a revenue stream from off system sales from an LNG facility, and separate resolution of the problem of a billion dollar debt."

125. Directed Question No. 5 cannot be answered without extensive further investigation including an understanding of the transaction terms upon which Exelon and PGW could agree and the regulatory treatment that would be accorded issues that might grow out of such a transaction (PECO St. 1-DQ, p. 3).

126. The Joint Petitioners agree that Direct Question No. 5 requires extensive further investigation. Therefore, they have recommended in the Settlement (¶ 55) that if the Commission desires to pursue this matter, it should do so in the context of a separate fact-finding investigation following the consummation of the Merger.

127. Such a proceeding could serve to identify issues and gather the information needed to determine whether the contemplated combination of gas operations would be in the public interest (PECO St. 1-DQ, p. 16).

128. This proceeding should not be delayed to obtain, nor the Merger conditioned upon, the resolution of PGW's operational, financial and cash flow problems.

129. Directed Question No. 5 inquires as to the viability of consolidating the gas operations of PECO, PSE&G and PGW into a "profitable, shareholder owned, public utility" which could either be a newly-formed and independent corporate entity (spin-off) or an entity owned and operated by Exelon (acquisition).

130. PECO presented the testimony of Mr. Todd J. Jirovec of Booz Allen Hamilton (PECO St. 13-DQ), who performed an initial assessment of two possible deal structures. Mr. Jirovec's analysis was not contested.

131. Based on Mr. Jirovec's analysis, a spin-off of the PECO and PSE&G gas properties would create significant diseconomies and cause operating costs to increase relative to the current organizational and cost structures (PECO St. 13-DQ, p. 7).

132. Mr. Jirovec estimated that the revenue requirement of the stand-alone business would increase by approximately $250 million per year and that PECO's and PSE&G's electric

divisions would experience lost economies totaling an additional $150 million per year (PECO St. 13-DQ, p. 8).

133. Any synergies that could be achieved by rolling PGW's gas operations into the combined entity would fall far short of offsetting these cost increases (PECO St. 13-DQ, p. 9).

134. Under the acquisition scenario, whereby Exelon would purchase the assets and business of PGW and combine them with its post-Merger gas operations, Mr. Jirovec identified areas where savings could be generated and possible constraints that would have to be carefully evaluated, including PGW's existing collective bargaining agreements, capital structure and tax differences, and PGW's collection problems (i.e. uncollectible accounts) (PECO St. 13-DQ, pp. 10-15).

135. The viability and potential profitability of the acquisition scenario would depend, in part, on the purchase price that the parties were able to negotiate and the ratemaking treatment it would be given.

136. Because of uncertainties and limitations on the data that were available to him, Mr. Jirovec was unable to offer an opinion as to whether Exelon's acquisition of PGW would be in the public interest (PECO St. 13-DQ).

137. PGW did not address the hypothetical posed by Directed Question No. 5 - - namely, the creation of a "profitable, shareholder owned public utility" to house the gas properties of PECO, PSE&G and PGW (PGW St. 2).

138. PGW's witness, Mr. Craig White, commented upon the possible consolidation of the PECO and PGW gas operations only in a not-for-profit Pennsylvania "state authority or similar entity" (PGW St. 2, p. 5).

139. Based upon a "preliminary analysis," Mr. White concluded that such a structure "could be viable" (*Id.*, p. 3).

140. Mr. White acknowledged that he had no expertise in matters related to the purchase or sale of business units or assets (Tr. 527); had never participated in a synergy study involving the merger of formerly separate utilities (Tr. 528); and was generally unfamiliar with his suggested "state authority" structure or what it entailed (Tr. 528, 530).

141. Mr. White testified that the "preliminary analysis" on which he based his conclusions had not been conducted by him or under his direct supervision (Tr. 533); that he was unaware that the Joint Applicants had performed their own synergy study (Tr. 540-41); and that he had not read the testimony of PECO witnesses William Arndt and Mr. Jirovec as it related to a possible divestiture of PECO's gas operations (Tr. 543).

142. Mr. White's cross-examination revealed that the "preliminary analysis" on which he relied contained unsupported and unrealistic assumptions including that PECO would be willing to sell its gas assets for between $1.1 and $1.2 billion, which is marginally above their net depreciated book value (Tr. 541; PECO Cross-Exam. Ex. 5).

143. Mr. White testified that a price for the purchase of PECO's gas assets higher than that assumed in his preliminary analysis could render the "state authority" model non-viable (Tr. 538; PECO Cross-Exam. Ex. 4, p. 7).

144. Evidence presented in this proceeding, including the testimony of Mr. White indicates that there is no basis to conclude that PGW's proposed LNG project is viable or that it would provide any benefits (Tr. 557, 565).

145. The "state authority" model described by Mr. White could make the debt burden of the new entity worse than that currently faced by PGW alone (Tr. 547-59).

146. PECO's existing gas rates are substantially less than PGW's and PECO has not needed to increase its base rates for nearly twenty years (Tr. 555-556).

147. PECO is more responsive to customer inquiries than PGW (Tr. 579-585).

148. The "municipalization" of PECO's gas operations would strip the Commonwealth of significant tax revenues (e.g., state income taxes, capital stock taxes), which would have to be replaced through other means (Tr. 588-590).

149. The creation of a "state authority" as Mr. White proposed would not be in the best interest of PECO's customers or in the public interest.

150. The initiation of a separate fact-finding investigation, as proposed in the Settlement, is a reasonable means to address the issues raised by Directed Question No. 5 should the Commission determine that this matter is worth pursuing.

151. The rates and the imposition of rate caps through December 31, 2010 as provided for in the Settlement reflect a reasonable compromise and accommodation among the parties of competing positions and provide a reasonable period of rate certainty to customers, PECO and the other Joint Petitioners.

152. The rates established pursuant to the Settlement, based on the evidence considered in this proceeding as delineated in Paragraph No. 17 of the Joint Petition, are just and reasonable rates for PECO and are based on PECO's cost of providing regulated electric service.

153. PECO remains subject to (a) the continuing authority of the Commission during the rate cap period under Chapter 13 of the Public Utility Code, 66 Pa. C.S. Chapter 13, to ensure that its rates are just and reasonable and (b) the continuing obligation to make earnings report filings pursuant to Chapter 71 of the Commission's regulations, 52 Pa. Code §§71.1 *et seq.*

THE JOINT APPLICANTS' PROPOSED CONCLUSIONS OF LAW

1. PSE&G is not a public utility as defined in 66 Pa. C.S. §102 in that it does not offer or render service to or for the public in this Commonwealth. *Application Of New York State Electric & Gas Corporation; Request For Abandonment Of Electric Service*, Docket Nos. A-93538, A-110001, F.200 (January 17, 1991).

2. The Joint Applicants have established by a preponderance of substantial evidence that the Merger, as described in the Merger Agreement and the Joint Application and subject to the terms of the Settlement will affirmatively promote the service, accommodation, convenience, or safety of the public in a substantial way; and, therefore, satisfies the legal standard, if applicable, set forth in 66 Pa.C.S. §1103(a), as interpreted by the Pennsylvania Supreme Court in *York v. Pa. P.U.C.*, 449 Pa. 136, 295 A.2d 825 (1972), for the issuance of a certificate of public convenience evidencing the PUC's approval under 66 Pa.C.S. §1102(a)(3) of the Merger.

3. The Joint Applicants have established by a preponderance of substantial evidence that the Merger, as described in the Merger Agreement and the Joint Application and subject to the terms of the Settlement, will not result in any anti-competitive or discriminatory conduct, including the unlawful exercise of market power, which will prevent retail electricity customers in this Commonwealth from obtaining the benefits of a properly functioning and workable competitive retail electricity market in contravention of the legal standard set forth in 66 Pa.C.S. §2811(e).

4. The Joint Applicants have established by a preponderance of substantial evidence that the Merger, as described in the Merger Agreement and the Joint Application and subject to the terms of the Settlement, will not: (1) result in any anti-competitive or discriminatory conduct,

including the unlawful exercise of market power, which will prevent retail gas customers in this Commonwealth from obtaining the benefits of a properly functioning and effectively competitive retail natural gas market in contravention of the legal standard set forth in 66 Pa.C.S. §2210(a)(1); or (2) produce any unreasonable, adverse effect on the employees of PECO's Gas Division or on any authorized collective bargaining agent representing those employees, as the same are defined in 66 Pa. C.S. §2210(a)(2).

5. No further approval from the Commission is required to consummate the Merger described in the Merger Agreement and the Joint Application.

THE JOINT APPLICANTS'
PROPOSED ORDERING PARAGRAPHS

1. The *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* is hereby granted and approved.

2. The Joint Petition for Settlement is hereby granted and approved.

3. PECO Energy Company is hereby granted a Certificate of Public Convenience evidencing approval of the merger of Public Service Enterprise Group Incorporated with and into Exelon Corporation under 66 Pa. C.S. §1103(a) if, and to the extent that, such approval is required.

4. The Protests filed in this proceeding and not satisfied or withdrawn pursuant to the terms of the Settlement are denied and dismissed.

5. The proceedings at Docket No. A-110550F0160 are concluded and the docket shall be marked closed.

6. PECO Energy Company shall file with the Commission written notice of the Merger within 30 days of the consummation of that transaction.

APPENDIX B

112 FERC ¶ 61,011
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Pat Wood, III, Chairman;
Nora Mead Brownell, Joseph T. Kelliher,
and Suedeen G. Kelly.

Exelon Corporation
Public Service Enterprise Corporation, Inc.

Docket No. EC05-43-000

ORDER AUTHORIZING MERGER UNDER SECTION 203 OF THE FEDERAL POWER ACT

(Issued July 1, 2005)

1. In this order, the Commission 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). This order benefits customers because it ensures that the transaction, which includes mitigation of market effects through very substantial divestiture of generation, is consistent with the public interest, as required by section 203 of the Federal Power Act[1] (FPA).

Background

A. The Parties

2. Exelon is a registered holding company, under the Public Utility Holding Company Act of 1935 (PUHCA)[2] that distributes electricity to approximately 5.1 million customers in Illinois and Pennsylvania through its subsidiaries, mainly Commonwealth Edison (ComEd) and PECO Energy (PECO). Through ComEd and PECO, it is the Provider of Last Resort (POLR) for customers who do not or cannot exercise retail choice for their electricity needs in Illinois and Pennsylvania, respectively. Exelon is also involved in gas distribution through PECO. The PECO gas facilities are local distribution facilities that are not interstate facilities and, therefore, are not subject to the

[1] 16 U.S.C. § 824(b) (2000).

[2] 15 U.S.C § 79 (2000).

Commission's jurisdiction under the Natural Gas Act.[3] Exelon Generation Company, LLC (Exelon Generation) conducts Exelon's generation business. Exelon Generation owns or controls generation assets throughout the country with a net capacity of approximately 33,000 MWs, including ownership interests in 11 nuclear generating stations.

3. PSEG Holdings is an exempt public utility holding company, under PUHCA, with four major subsidiaries, including Public Service Electric and Gas Company (PSE&G), which is a public utility company engaged in the transmission and distribution of electric energy and gas service to approximately 3.6 million customers, primarily in New Jersey. PSEG Holdings' subsidiaries also include PSEG Power LLC, the parent company of most of PSEG's United States power production business, PSEG Services Corporation, and PSEG Energy Holdings LLC, the parent company of PSEG's other businesses.

4. Both Exelon and PSEG Holdings have transferred control of their transmission systems to the PJM Interconnection, LLC (PJM), a Commission approved Regional Transmission Organization (RTO). Both entities sell power under market-based rate authority.[4]

B. The Proposed Transaction

5. On February 4, 2005,[5] Exelon and PSEG Holdings filed, under section 203 of the FPA and Part 33 of the Commission's Regulations,[6] an application for Commission approval of a transaction that includes: (1) Exelon's acquisition of PSEG Holdings and the resulting indirect merger of Exelon's and PSEG Holdings' jurisdictional facilities; and (2) the internal restructuring and consolidation of Exelon's and PSEG Holdings' subsidiaries to establish an efficient corporate structure for EE&G.

6. PSEG Holdings would no longer have a separate corporate existence and would merge into Exelon, forming EE&G. PSEG Holdings' shareholders would each receive 1.225 shares of Exelon common stock for each PSEG Holdings share held and cash in

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[3] Application at 7.

[4] *Exelon Generation Company, LLC,* 93 FERC ¶ 61,140 (2000); *PSEG Energy Resources & Trade, LLC,* Unpublished Letter Order in Docket Nos. ER99-3151-002 and ER97-837-003 (June 16, 2003).

[5] Applicants submitted an errata to their application on February 9, 2005.

[6] 18 C.F.R. § 33 (2004).

lieu of any fraction of an Exelon share that a PSEG shareholder would have otherwise been entitled to receive. EE&G will remain the ultimate corporate parent of PECO and ComEd and other Exelon subsidiaries and will become the corporate parent of PSE&G and all other PSEG subsidiaries. EE&G will assume all of PSEG Holdings' outstanding indebtedness.

7. EE&G will be a registered public utility holding company under PUHCA. ComEd, PECO and PSE&G will continue to operate franchised public utility companies.

8. In addition to merging jurisdictional assets, Applicants intend to revise their corporate structure. They plan to make PSE&G a direct subsidiary of Exelon Energy Delivery Company LLC and keep the subsidiaries of PSE&G intact. PSEG Energy Holdings LLC will become a direct subsidiary of EE&G and the subsidiaries of PSEG Holdings LLC will remain intact. The PSEG Services Corporation will sell all of its assets to Exelon Business Services Company, making Exelon Business Services Company the sole "service company" of EE&G. PSEG Power and its direct subsidiaries, PSEG Nuclear, PSEG Fossil and PSEG Energy Resources and Trade, would all become part of Exelon Generation, and their business functions would become part of their respective Exelon Generation business units. The subsidiaries owned by PSEG Power, PSEG Nuclear, PSEG Fossil and PSEG Energy Resources and Trade, will either be merged into Exelon Generation or kept as direct subsidiaries of Exelon Generation. The reorganization will not result in merchant affiliates that have market-based rate authority being moved back into the regulated companies of EE&G.

9. Applicants state that the proposed merger will benefit the public interest by providing an increased scale and scope of both energy delivery and generation, improved service and reliability, and a more balanced generation portfolio to serve over seven million electric customers and two million gas customers. Applicants' further state that the proposed merger will lead to improved stability, higher capacity utilization rates and lower costs from combining the nuclear operations under Exelon's experienced management.

C. Standard of Review under Section 203

10. Section 203(a) provides that the Commission must approve a merger if it finds that the consolidation "will be consistent with the public interest."[7] The Commission's analysis under the Merger Policy Statement of whether a consolidation is consistent with the public interest generally involves consideration of three factors: (1) the effect on

[7] *Id.*

competition; (2) the effect on rates; and (3) the effect on regulation.[8] As discussed below, we will approve the proposed merger as consistent with the public interest and find that it will not adversely affect competition, rates, or regulation.

1. Effect on Competition

a. Applicants' Analysis of Horizontal Competitive Issues

11. Exelon retained Dr. William Hieronymus and PSEG Holdings retained Mr. Rodney Frame to analyze the effect of the merger on competition. Both witnesses identify three relevant products: non-firm energy, capacity, and ancillary services, across the geographic markets affected by the merger. Both witnesses conclude that, as mitigated, the merger will not harm competition.

i. Energy Markets

12. Dr. Hieronymus identifies four relevant geographic markets using the approach described by Appendix A of the Merger Policy Statement: Expanded PJM, PJM Pre-2004, PJM East, and Northern PSEG.[9] In his analysis of non-firm energy markets, Dr. Hieronymus uses economic capacity and Available Economic Capacity, as defined in the Merger Policy Statement, as proxies to represent a supplier's ability to participate in the

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[8] *Inquiry Concerning the Commission's Merger Policy Under the Federal Power Act: Policy Statement*, Order No. 592, 61 Fed. Reg. 68,595 (1996), FERC Stats. & Regs., Regulations Preambles July 1996-December 2000 ¶ 31,044 (1996), *reconsideration denied*, Order No. 592-A, 62 Fed. Reg. 33,341 (1997), 79 FERC ¶ 61,321 (1997) (Merger Policy Statement); *see also Revised Filing Requirements Under Part 33 of the Commission's Regulations*, Order No. 642, 65 Fed. Reg. 70,984 (2000), FERC Stats. & Regs., Regulations Preambles July 1996-December 2000 ¶ 31,111 (2000), *order on reh'g*, Order No. 642-A, 66 Fed. Reg. 16,121 (2001), 94 FERC ¶ 61,289 (2001) (Merger Filings Requirements Rule).

[9] Expanded PJM is all of PJM including American Electric Power Service Corporation (AEP), Dayton Power and Light, and ComEd; PJM Pre-2004 is the portion of PJM consisting of the original PJM members in MAAC plus Allegheny Energy Supply Company, LLC (Allegheny); PJM-East is that part of PJM east of the Eastern Interface within PJM; and Northern PSEG is the portion of the PSE&G service territory in northeastern New Jersey. However, Dr. Hieronymus does not place Northern PSEG on par with the other three relevant markets.

market.[10] He uses the Delivered Price Test to evaluate the effect on competition in the relevant markets over 10 separate time periods: Super Peak, Peak and Off-Peak periods for Summer, Winter and Shoulder seasons, along with an extreme Summer Super Peak. Dr. Hieronymus uses a range of prices from $20 per megawatt hour (MWh) in the Shoulder Off-Peak to $250 per MWh in the extreme Summer Super Peak. He considers actual prices in the PJM markets during 2004, fuel prices in 2004, and forecast fuel prices for 2006, the test year for his analysis.[11]

13. In his analysis, Dr. Hieronymus presumes simultaneous import limits for imports into each geographic market based on a study conducted by PSE&G's transmission engineering group. The simultaneous import limits in his analysis are 7,300 MW for PJM-East; 4,600 MW for PJM Pre-2004; and 7,500 MW for Expanded PJM. Dr. Hieronymus allocates scarce transmission availability on a *pro rata* basis.

14. Dr. Hieronymus states that Exelon has several long-term contracts that are relevant to the analysis. Exelon has long-term contracts to purchase the output of two coal-fired generating plants and approximately 3,600 MW of supply from peaking facilities, all in the ComEd service territory. Dr. Hieronymus assigns control of that capacity to Exelon. Exelon sells 400 MW of the output of the Clinton nuclear unit under a long-term contract, and Dr. Hieronymus assigns control of that capacity to the buyer. He states that PSE&G has sold a substantial amount of energy and capacity in the New Jersey Basic Generation Service auction. He assigns control of that capacity to PSE&G. He does, however, consider those commitments as part of PSE&G's native load deduction in his analysis of Available Economic Capacity.

15. Without mitigation, Dr. Hieronymus reports failures of the Competitive Analysis Screen[12] for economic capacity in all season/load conditions in PJM East, PJM Pre-2004, and Expanded PJM. For PJM-East, the screen failures are most severe, with post-merger market concentrations ranging from 2,057 to 2,492 on the Herfindahl-Hirschman Index (HHI) (indicating a highly concentrated market) and merger-related changes in HHI ranging from 848 to 1,067 HHI, all well above the 50 HHI screening threshold for highly

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[10] Each supplier's "economic capacity" is the amount of capacity that could compete in the relevant market given market prices, running costs, and transmission availability. "Available Economic Capacity" is based on the same factors but subtracts the suppliers' native load obligation from its capacity and adjusts transmission availability accordingly.

[11] Hieronymus Testimony, Exhibit J-1, at 37.

[12] Merger Policy Statement, Appendix A at 30,128 (Competitive Analysis Screen).

concentrated markets. As stated in the Merger Policy Statement, for moderately concentrated markets ($1000 \leq HHI < 1800$), the screening threshold for the change in HHI is 100. For the PJM Pre-2004 and Expanded PJM markets, the post-merger HHIs indicate moderately concentrated markets, with merger-related increases in HHI ranging from 172 to 668 HHI, all above the 100 HHI screening threshold for moderately concentrated markets.

16. For the other markets that could be affected by the merger, Northern PSEG, Electric Reliability Counsel of Texas (ERCOT) and ISO New England, Inc. (ISO-NE), Dr. Hieronymus does not perform a complete competitive screen analysis, but explains why he thinks such an analysis is not necessary and why the merger will not harm competition in those markets.

17. For Northern PSEG, Dr. Hieronymus argues that because Exelon does not own any generation in that market, the merger will not harm competition. He states that when there are not binding transmission constraints for imports into Northern PSEG, the geographic boundaries of the market are at least as broad as PJM-East, and he states that Applicants' proposed mitigation will offset any increase in market concentration in that market.[13] He argues that when there are import constraints for Northern PSEG, it should be considered a separate market from PJM East. However, in that case, the merger will not increase the amount of capacity controlled by the merged firm or its incentive to withhold generation to raise prices, because Exelon does not own any capacity in Northern New Jersey, so there is no overlap between the Exelon and PSE&G's generation capacity in that market. Despite his argument, Dr. Hieronymus does analyze Northern PSEG and shows screen failures due to some of Exelon's capacity being included in the *pro rata* allocation of transmission availability. His analysis shows post-merger concentrations ranging from 2,750 to 7,288 HHI, with merger-related increases in concentration ranging from 99 to 204 HHI. He finds that divesting 100 MW of generating capacity in Northern PSEG would return market concentration levels to approximately the pre-merger levels, with the concentration increasing by less than 50 HHI for some load levels and falling in others. He states that if the Commission decides it is necessary to mitigate the screen failures, Applicants would divest sufficient generation in the Northern PSEG market as part of their overall divestiture plan.

18. Dr. Hieronymus argues that there is little overlap between Exelon and PSE&G's generation assets in the ERCOT market. He states that Exelon owns or controls 3,651 MW of generation capacity, mostly in the North zone of ERCOT, while PSE&G owns 2,026 MW of affiliated generation capacity in the West and South zones. He argues that because Applicants' capacity is in different zones within ERCOT, the only market that

[13] Northern PSEG is a subset of PJM-East.

could be affected by the merger is ERCOT as a whole. He states that Exelon and PSE&G's capacity in ERCOT is less than five percent and 2.5 percent respectively, so the merger-related change in HHI would only be approximately 20 HHI, well under Commission's screening threshold.[14]

19. For the ISO-NE market, Dr. Hieronymus also argues that, because Exelon's and PSE&G's generation is in different constrained regions, the smallest relevant market in which both Applicants' generation would compete would be ISO-NE as a whole. He concludes that because Exelon and PSE&G control only two and three percent of the generation capacity in ISO-NE, combining such small market shares would not harm competition.[15]

20. PSE&G's witness, Mr. Frame, also analyzes non-firm energy markets, using economic capacity and Available Economic Capacity to represent a supplier's ability to participate in the market. Mr. Frame analyzes three geographic markets using the approach described by Appendix A of the Merger Policy Statement: Expanded PJM, PJM Pre-2004, PJM East. He uses the Delivered Price Test to analyze the effect of the merger on market concentration. Like Dr. Hieronymus, Mr. Frame uses ten season/load conditions. He uses a range of prices from $30 to $150 per MWh based on prevailing market-clearing prices in PJM over the last two years for the relevant season/load conditions. He allocates scarce transmission availability on a *pro rata* basis and imposes simultaneous imports limitations in his analysis. Mr. Frame states that he follows the Commission's procedures by assigning control of generation under contract to the party that has operational control of the facility.

21. Mr. Frame's results are consistent with those of Dr. Hieronymus. He reports screen failures in PJM-East and Pre-2004 PJM for all season/load conditions, and in Expanded PJM for most season/load conditions. For PJM-East, he reports post-merger

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[14] Dr. Hieronymus refers to the "2ab" change in HHI, which is derived from the difference between adding the squares of the pre-merger market shares of the two firms ($a^2 + b^2$), and squaring the combined firm's post-merger market share ($(a+b)^2 = (a^2 + b^2 + 2ab)$). The term is commonly used in analyses of changes in market structure.

[15] Dr. Hieronymus cites the Commission's finding in *USGen New England, Inc.*, 109 FERC ¶ 61,341 (2004), where the Commission approved the purchase of approximately 7 percent of the capacity in ISO-NE by a company that already controlled approximately 6 percent of the capacity in ISO-NE. A "2ab" analysis of combining Exelon's and PSEG's capacity in ISO-NE would lead to an increase of approximately 12 HHI, well below the screening thresholds of 50 HHI for highly concentrated markets and 100 HHI for moderately concentrated markets.

concentrations ranging from 1,688 to 2,816 HHI, with merger-related changes in HHI ranging from 695 to 1,252 HHI, all well above the Commission's screening thresholds. For Pre-2004 PJM, he reports post-merger concentrations ranging from 1,133 to 1,509 HHI, with merger-related changes in HHI ranging from 336 to 443 HHI, all well above the Commission's screening thresholds. For Expanded PJM, he reports post-merger concentrations ranging from 919 to 1,197 HHI, with merger related changes in HHI ranging from 178 to 236 HHI, with six of the ten season/load conditions above the Commission's screening thresholds.

22. Dr. Hieronymus also performs a Competitive Analysis Screen for Available Economic Capacity in Expanded PJM, PJM Pre-2004, PJM East, and Northern PSEG. However, he argues that Available Economic Capacity is not an accurate measure in PJM because utilities have been largely released from their native load obligations in states with retail choice programs; or serve as providers of last resort through power purchase agreements, or, in the case of New Jersey, through the Basic Generation Service auction. He reports screen failures in eight of the 10 season/load conditions in PJM East,[16] all season/load conditions in PJM Pre-2004, and none of the season/load levels for Expanded PJM.

23. Mr. Frame also performs a Competitive Analysis Screen for Available Economic Capacity in Expanded PJM, PJM Pre-2004, and PJM East. He states that Available Economic Capacity is difficult to measure in PJM because native load obligations have changed in states with retail choice programs, standard offer services and Basic Generation Service auctions. He states that the purpose of his Available Economic Capacity analysis is to show that the mitigation offered to address the screen failures in the Economic Capacity analysis will mitigate any Available Economic Capacity screen violation. He states that he uses conservative assumptions for his Available Economic Capacity analysis and reports screen failures for most season/load conditions for those markets, all of which are eliminated by the mitigation.

24. Like Dr. Hieronymus, Mr. Frame argues that it is not necessary to analyze the effect of the merger on competition in the Northern New Jersey market because Exelon does not own any generation in that market. He does, however, analyze Northern New Jersey by starting with his analysis of the PJM East market, removing suppliers located in

[16] Under the scenario where only the PECO and PSE&G loads are taken into account, there are no screen failures. However, when all PJM Pre-2004 loads are considered, there are screen failures in all seasons. According to Dr. Hieronymus, this assumption is not critical to the outcome of his analysis because the mitigation for the screen failures in economic capacity more than offsets the increases in concentration in Available Economic Capacity under either assumption.

Northern New Jersey, and then allocating the import capability into Northern New Jersey among the PJM East suppliers.[17] He states that based on his analysis, divesting approximately 100 MW of generation capacity, including at least 80 MW of coal-fired capacity within Northern New Jersey, would eliminate any screen violations in the Northern New Jersey Market.

ii. Mitigation for identified screen failures

25. Applicants propose mitigation to address the harm to competition indicated by the screen failures. First, they propose divesting 2,900 MW of generation capacity in PJM-East in order to eliminate the peak and super-peak screen failures described above. The 2,900 MW would consist of 1,000 MW of peaking generation and 1,900 MW of mid-merit generation, of which at least 550 MW would be coal-fired capacity. They state that no more than half of the 2,900 MW would be sold to a single buyer and that no capacity would be sold to a market participant with a greater than five percent market share in PJM-East or Expanded PJM (original Buyer Restrictions).[18] Applicants note that they have not yet identified the specific generation units that they intend to divest. They do, however, list those generating units that will be considered for divestiture.[19] Applicants also state they will make a compliance filing showing the effect on market concentration given the actual divestitures.

26. Applicants originally committed to complete the divestiture within 18 months after the date of merger consummation, but later committed to complete the divestiture within 12 months.[20] They recognize that the Commission requires that interim mitigation for any merger-related harm to competition be in place at the time of merger consummation. Accordingly, they propose that within 30 days following the end of the month in which the merger closes, they will sell the rights to 2,900 MW of energy and capacity from

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[17] Frame Testimony at 39-40.

[18] Applicants' original commitment was designed to ensure that the divestiture will reduce market concentration enough to eliminate the harm to competition indicated by the screen failures. If, for example, the capacity were sold to an existing market participant with a large market share, or if all of the capacity were sold to a single buyer, the divestiture would not restore market concentration to a level close to the pre-merger concentration. Applicants subsequently revised their mitigation proposal, eliminating most of the Buyer Restrictions.

[19] Application, Exhibit J-12.

[20] Answer at 47.

designated coal, mid-merit and peaking facilities in PJM–East.[21] As with the permanent mitigation, they state that no more than half of the 2,900 MW would be sold to a single buyer and that no capacity would be sold to a market participant with a greater than five percent market share in PJM-East of Expanded PJM. The interim contracts will have a minimum term of one month and will be in effect for no longer than 18 months after merger consummation. Applicants explain that the purchasers of the interim capacity and energy will acquire all of the Unforced Capacity associated with the units, and full dispatch unit and offering rights, including the right to call for market-based ancillary services, thus enabling the purchaser to offer the units into the PJM capacity, energy and ancillary services markets.[22]

27. Applicants propose a "virtual divestiture" to address the Appendix A screen failures for the off-peak periods. They will sell long-term energy rights from nuclear baseload units.[23] They state that the virtual divestiture will remove any merger-related increase in Applicants' ability or incentive to withhold baseload energy in order to exercise market power. Applicants propose virtually divesting 2,250 MW of energy from nuclear units located in PJM-East in order to address the screen failures in that market.[24] They note that Dr. Hieronymus' analysis shows that an additional divestiture of 200 MW of capacity in the larger Pre-2004 PJM market is also required and, accordingly, they will virtually divest another 200 MW of baseload nuclear energy in the larger, Pre-2004 PJM market.

28. Applicants state that the virtual divestiture will take one of two forms: (1) a firm sales contract expiring no earlier than 15 years after the date of the merger consummation (Long-Term Contract Option); or (2) an annual auction of 3-year entitlements to baseload energy, in 25 MW blocks. Applicants state that the auction process will be administered

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[21] Application at 34.

[22] Cassidy testimony at 6.

[23] The energy sales are not meant to address the identified screen failures in the capacity markets; rather, they target the off-peak energy screen failures described above. Applicants have provided a separate mitigation plan for capacity markets, which is described later in this order.

[24] Exelon's witness, Dr. Hieronymus, identified the need to divest 2,400 MW of baseload capacity in order to restore competition in PJM-East. Applicants argue that "virtually" divesting 2,250 MW on a 100 percent load factor basis is the "energy equivalent" of selling 2,400 MW of capacity operating at Exelon's historical capacity factor of 93 percent. Application at 24.

by an independent auction manager in order to ensure a transparent and objective auction process.[25] The sum of the baseload energy entitlements sold under the two options will be 2,450 MW (Baseload Mitigation Amount), unless, as described below, the Baseload Mitigation Amount needed to mitigate harm is reduced by other structural mitigation measures. In addition, no single purchaser will be allowed to purchase more than 50 percent of the Baseload Mitigation Amount.

29. Applicants state that under the Long-Term Contract Option, they will sell entitlements to PJM East baseload nuclear energy for terms of at least 15 years in return for cash or similar rights to energy taken for delivery outside of PJM (Energy Swap). Applicants originally committed to the divestiture restrictions regarding the potential purchasers under the Long-Term Contract Option, and, additionally, committed that they will not sell more that 25 percent of the Baseload Mitigation Amount to market participants owning three to five percent of the installed generation capacity in Expanded PJM or PJM East.[26]

30. Applicants state that, under the auction option, the auctions will be held to coincide with the New Jersey Basic Generation Service auctions. The product to be auctioned will be a three-year obligation to take 25 MW of "7 x 24" energy. In the first year, the auction will be phased in by selling one third of the capacity for a one-year term, one third of the capacity for a two-year term, and one third of the capacity for a three-year term. In subsequent years, one third of the capacity will be sold for a three-year term.[27]

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[25] Cassidy Testimony at14.

[26] Applicants argue that this additional condition is to ensure that the virtual divesture will sufficiently mitigate the harm to competition indicated by the off-peak screen failures.

[27] As constructed, the Auction Amount will be under contract at all times. For example, assuming the Auction Amount were 1,500 MW in the first year (in that case 2,250 MW minus 750 MW under the Long-Term Contract Option), 500 MW would be under one-year contracts, 500 MWs would be under the first year of two-year contracts, and 500 MWs would be under the first year of three-year contracts. In the second year, 500 MWs would be under the second year of two-year contracts, 500 MW would be under the second year of three-year contracts, and the 500 MWs that expired under the initial one-year contracts would be in the first year of new, three-year contracts. So each year, one third of the existing contracts expire and are replaced by new three-year contracts.

31. Dr. Hieronymus analyzes the effect of the merger, given Applicants' proposed mitigation, and finds that the merger would not harm competition. For PJM-East, the merger-related changes in concentration range from falling by 101 HHI in the Winter Peak period to rising by 63 HHI in the Winter Super Peak period. The post-merger and mitigation markets are moderately concentrated for all season/load conditions, with the change in market concentration falling within the Commission's tolerance for all periods. For PJM Pre-2004 and PJM Expanded, with mitigation, the markets are moderately concentrated in 14 of the 20 total season/load conditions and unconcentrated in the other 6 season/load conditions. With exception of one season/load condition in each market, all of the changes in concentration are within the Commission's tolerances. Dr. Hieronymus concludes that Applicants' proposed mitigation eliminates any harm to competition indicated by the screen failures in his analysis of economic capacity. In addition, the proposed mitigation would reduce market concentration below the pre-merger level in the three PJM markets in all season/load conditions for Available Economic Capacity. Therefore, he also concludes that the proposed mitigation eliminates any harm to competition indicated by the screen failures in his analysis of Available Economic Capacity.

32. Mr. Frame also finds that the proposed mitigation would eliminate the harm to competition in energy markets indicated by the screen failures in economic and Available Economic Capacity. Mr. Frame finds that the proposed mitigation would reduce market concentration below the pre-merger level in the three PJM markets in virtually all season/load condition for Available Economic Capacity. For economic capacity, he finds that the post-merger and mitigation markets will be moderately concentrated for 15 of the 30 season/load condition in the three PJM market scenarios and unconcentrated for the other 15 season/load conditions, with all changes in HHI falling within the Commission's tolerance levels.

Notice of Filing and Pleadings

33. Notice of Applicants' filing was published in the *Federal Register*,[28] with interventions and protests due on or before April 11, 2005. Numerous parties filed motions to intervene.[29] The Pennsylvania Public Utility Commission, the New Jersey

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[28] 70 Fed. Reg. 8,355 (2005).

[29] NRG Power Marketing, Inc., Arthur Kill Power, LLC, Astoria Gas Turbine Power, LLC, Vienna Power, LLC, and Indian River Power LLC (collectively NRG Companies); Dynegy Power Corp. (Dynegy); Consolidated Edison Company of New York (ConEd NY); Reliant Energy, Inc. (Reliant); Amerada Hess Corporation (Hess); New Athens Generating Company (New Athens); Strategic Energy, LLC (Strategic); LS

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Board of Public Utilities and the Illinois Commerce Commission filed notices of intervention. Additionally, several parties filed motions to intervene and protests and some parties file motions to intervene and comments[30]. Allegheny Electric Cooperative,

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Power Associates, LP (LS Power); Constellation Energy Commodities Group, Inc. (CCG), together with Constellation Generation Group, LLC (CGG), and Constellation NewEnergy, Inc. (CNE) (collectively, Constellation); American Electric Power Service Corporation (AEP); Wisconsin Electric Power Company (Wisconsin Electric); East Coast Power LLC (ECP); New Jersey Large Energy Users Coalition (NJLUPC); Mid-Atlantic Power Supply Association (MAPSA); UGI Development Company (UGID); and TXU Portfolio Management Company (d/b/a TXU Wholesale Markets) (TXU).

[30] Protests and motions to intervene were received by Ameren Services Company, who later filed a motion to withdraw their protests but not their motion to intervene; the Maryland Office of the People's Counsel (Office of the People's Counsel); New Jersey Division of the Ratepayer Advocate (Division of the Ratepayer Advocate); National Railroad Passenger Corporation (Amtrak); PJM Industrial Consumers Coalition (Coalition) and Philadelphia Area Industrial Energy Users Group (Energy Users Group); Hoosier Energy Rural Electric Cooperative, Inc. (Hoosier); Direct Energy Services (Direct Energy); Dominion Energy, Inc. (Dominion); City of Dowagiac, Michigan (Dowagiac); Environmental Law and Policy Center; Pennsylvania Office of the Consumer Advocate (POCA); American Public Power Association (APPA) and the National Rural Electric Cooperative Association (NRECA); Midwest Generation, LLC (Midwest Generation); Citizen Power, with the Energy Justice Network, the Illinois Public Interest Research Group, New Jersey Citizen Action, the New Jersey Public Interest Research Group, the Pennsylvania Public Interest Research Group, Public Citizen's Energy Program, and Three Mile Island Alert (collectively, Citizen Power *et al.*); FirstEnergy Service Company, with Pennsylvania Electric Company, Metropolitan Edison Company; Jersey Central Power & Light Company, and FirstEnergy Solutions Corporation (collectively, FirstEnergy); Pepco Holdings Inc., with Potomac Electric Power Company, Delmarva Power & Light Company, Atlantic City Electric Company, Conectiv Energy Supply, Inc., and Pepco Energy Services, Inc. (collectively, PHI Companies), who later filed a Notice of Conditional Support; PPL Electric Utilities Corporation, with PPL Energy Plus, LLC, PPL Brunner Island, LLC, PPL Holtwood, LLC, PPL Martins Creek, LLC, PPL Montour, LLC, PPL Susquehanna, LLC, and Lower Mount Bethel Energy, LLC (collectively, PPL Companies); the Office of the Attorney General for the State of Illinois; NiSource Inc. (NiSource); Philadelphia Gas Works and

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Inc. (Allegheny Electric), Indiana Utility Regulatory Commission, and H-P Energy Resources LLC each filed motions to intervene out-of-time.

34. Three individuals[31] filed comments in this proceeding expressing concerns about the proposed merger and the effect it would have on individual consumers and the future energy markets. We find that the issues raised by the individual commentors are outside the scope of this proceeding.

A. Protests

35. Protestors state claims of factual errors in Applicants' analyses: (1) Hoosier contends that Dr. Hieronymus understated the amount of generation controlled by Applicants when developing the Competitive Analysis Screen because he failed to include a 200 MW power purchase agreement between PECO and Hoosier in 2006; (2) the PHI Companies state that Conectiv Energy Services, Inc. only controls 2,595 MW of generating capacity in PJM East rather than the 4,800 MW used in Applicants' analyses; (3) the analyses should have included the PPL Companies recently-completed 600 MW Lower Mount Bethel combined cycle facility; and (4) the analyses failed to account for Dominion's native load obligation in the calculation of Available Economic Capacity. Some protestors, including the PHI Companies, argue that given the material issues of fact raised by inaccuracies in Applicants' analysis, a hearing is necessary.

36. A number of protestors argue that Applicants have not analyzed all of the geographic markets that will be affected by the merger. The POCA argues that Dr. Hieronymus and Mr. Frame understated the extent of market concentration resulting from the proposed merger and that it is unclear whether Applicants analyzed all relevant load pockets and geographic markets, especially the Northern New Jersey load pocket.

37. Protestors argue that Dr. Hieronymus failed to analyze the merger's effect on markets in PJM other than PJM- East, PJM Pre-2004, and PJM-Expanded.

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the City of Philadelphia (collectively, City of Philadelphia); and H-P Energy Resources, LLC (H-P Energy). Comments were filed by the American Antitrust Institute (AAI); Williams Power Company (Williams); and the New Jersey Board of Public Utilities (NJBPU).

[31] William E. Cleary and Kevin B. Carr filed comments in this docket. We also received an unsigned filing that ends with the term "the insider."

38. Environmental Law and Policy Center is concerned about the effects that the proposed merger would have on market power in the Midwest ISO markets and its effect on the interconnection between the Midwest ISO and the PJM markets.

39. FirstEnergy, through its expert, Ms. Julia Frayer, argues that Applicants' Appendix A analysis underestimates the Applicants' combined post-merger market power, understates the ` levels in the relevant PJM markets and leads to Applicants' proposal of inadequate mitigation. Ms. Frayer specifically questions Dr. Hieronymus' fuel price and market price assumptions. She performs an alternative analysis showing higher concentration levels and merger-related changes in concentration, and, thus, higher amounts of capacity needing to be divested. Other protestors, including the New Jersey Advocate, question assumptions in Dr. Hieronymus' analysis and argue that he should have performed tests of sensitivity of his results to changes in the underlying assumptions. They conclude that a hearing is necessary to determine the accuracy of his assumptions and any effects on his results.

40. FirstEnergy argues that Applicants overestimate the entry of new generation and underestimate the retirement of old generation, thus overstating the degree of competition in PJM and understating the merger's effect on competition. Ms. Frayer argues that when Dr. Hieronymus's erroneous assumptions regarding entry and exit (along with other assumptions she questions) are corrected, post-merger concentration levels are as high as 2,818 HHI, calling for up to 900 MW more capacity to be divested in order to mitigate the harm to competition.

41. Hoosier also raises questions regarding the model that Applicants used to perform the Competitive Analysis Screen. It states that Applicants should be required to submit studies regarding the effect the increased consolidation of suppliers as a result of the proposed merger would have on market power concentration in PJM and other affected markets. Hoosier specifically questions Dr. Hieronymus' use of a pro-rata allocation of scarce transmission availability rather than an economic allocation, which it asserts is more accurate and which would result in greater merger-related changes in market concentration and thus a need for a larger amount of generation divestiture. Hoosier argues that if the Commission does not reject the application outright, then the Commission should establish an evidentiary hearing to address the issues of fact raised by the proposed merger. The PPL Companies also protest the lack of support for Applicants' use of the 'squeeze down'[32] method to allocate imports into the relevant PJM

[32] Under the "squeeze down" allocation method, shares of available transmission are allocated at each interface, diluting as they get closer to the destination market. When there is competing economic supply to get through a constrained transmission interface into a control area, the transmission capability is allocated to the suppliers in proportion

(continued...)

markets and the failure to address the effect of Applicants' Financial Transmission Rights on transmission capacity in the affected markets.

42. The PHI Companies question the value of Applicants' Available Economic Capacity analysis because state-level restructuring is at different stages in the various PJM states. Thus, the deduction for native load obligations used in Available Economic Capacity analysis does not accurately reflect competitive conditions in the various PJM geographic markets analyzed by Dr. Hieronymus. The PHI Companies also argue that the native load deduction in Dr. Hieronymus's Available Economic Capacity analysis is incorrect because it imputes PECO's provider of last resort obligations to PECO's affiliated generating companies, which violates the Commission's policy requiring regulated, load-serving companies to stand at arm's length from their marketing affiliates. In addition, PPL's witness, Dr. Kalt, argues that although Available Economic Capacity analysis in PJM East is "not straightforward," there is sufficient data on buyer and seller transactions in New Jersey to develop a more refined analysis that would ensure that Applicants' proposed divestitures will pass the Competitive Analysis Screen for Available Economic Capacity. He concludes that by failing to satisfy the Commission's requirements and not properly analyzing Available Economic Capacity, Applicants may have substantially underestimated post-merger concentration levels in both PJM East and PJM Pre-2004.[33]

43. Some intervenors argue that the merger will increase Applicants' ability to exercise market power through strategic bidding and that Applicants have not sufficiently analyzed the merger's effect on strategic bidding in the relevant markets. Furthermore, the New Jersey Division of the Ratepayer Advocate (Division of the Ratepayer Advocate) states that the Competitive Screen Analysis submitted by Applicants raises several questions. It argues that data published by PJM shows that the PJM East markets are substantially more concentrated than Applicants' analysis suggests and that the Applicants' methodologies might not detect certain market power problems, such as strategic bidding concerns. The Division of the Ratepayer Advocate also argues that the mitigation measures proposed by Applicants do not adequately address the market power problems created by the proposed merger. In addition, POCA argues that Applicants have not analyzed the potential for strategic bidding or other actions that could increase prices in the PJM market.

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to the amount of economic capacity each supplier has outside of the interface. Application, Exhibit J-4 at 10-11.

[33] Kalt Testimony at 30-31.

44. Direct Energy argues that Applicants' market power analysis significantly understates Applicants' potential market power after the merger. Direct Energy's expert witness, Dr. Andrew Kleit, argues that the merger significantly enhances the merged firms' ability to unilaterally exercise market power by withholding output of key generation resources along the market supply curve. Dr. Kleit compares Applicants' post-merger costs of withholding output (foregone revenue) to the benefits (higher prices), and finds that the benefits of withholding the output of peaking facilities are significantly enhanced by the merger. Dr. Kleit concludes that the merger enhances the incentive of the merged firm to exercise market power through withholding of output from peaking facilities. He recommends that the Commission analyze the costs and benefits of withholding from each of the merged firm's peaking facilities.

45. Some parties argue that the Commission does not apply the Competitive Analysis Screen as a bright line test and that the Applicants, by proposing mitigation specifically designed to restore the concentration level to within the screens' tolerances, have misinterpreted the Commission's merger policy. For example, the PPL Companies argue that tools such as market share and HHI screens "provide only the starting point" for assessing the competitive implications of a merger.[34] They argue that the issue is whether the divesture will result in a market structure that is sufficiently competitive, not whether a particular HHI level is achieved.

46. A number of parties protest Applicants' proposed Buyer Restrictions. The PPL Companies' witness, Dr. Kalt, argues that market forces should determine who acquires the divested assets and at what price. He further argues that the restrictions may harm market efficiency by not allowing those buyers that could most efficiently use the generation resources to participate in the auction.[35] The AAI argues that giving Applicants control of the divesture process is "akin to the fox guarding the henhouse."[36] It notes that a Federal Trade Commission (FTC) Staff Study showed that when the FTC

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[34] PPL at 7, *citing* U.S. Department of Justice and Federal Trade Commission, Horizontal Merger Guidelines, 57 Fed. Reg. 41,552, Sec. 2.0 (1992), revised, 4 Trade Reg. Rep (CCH) ¶ 13,104 (April 8, 1997) (Merger Guidelines).

[35] Kalt Testimony at 15-17.

[36] AAI at 13.

determined the assets that were to be divested, merging companies urged the FTC to divest assets to weak buyers; proposed packages of assets that were too narrow to ensure fully viable competition; and took actions that diminished the viability of the business acquired by the buyer.[37]

47. Midwest Generation states that the Commission should consider whether Applicants' proposed Buyer Restrictions are reasonable; it says that they could undermine Applicants' ability to fully divest the assets necessary to mitigate the market power problem. Therefore, the Commission should consider requiring Applicants to eliminate the restrictions or, in the alternative, require Applicants to identify an alternative should their restrictive divestiture plan fail.

48. Protestors argue that Applicants' proposed virtual divestiture is not as effective as physical divestiture for a number of reasons. Hoosier requests that the Commission reject Applicants' virtual divestiture proposal and require absolute and permanent divestiture of ownership. The APPA and NRECA state that the proposal is inadequate to remedy the potential market power abuses that will result from the proposed merger. Additionally, POCA argues that virtual divestiture has never before been relied upon by the Commission as a mitigation tool and that it is not a permanent structural change.

49. Regarding the virtual divestiture proposal, FirstEnergy argues that Applicants must submit the terms and conditions of the long-term contracts; specify the auction protocols; include the long-term rights to capacity as well as energy so that there is sufficient capacity-related mitigation; and enter into long-term, firm contracts for nuclear energy and capacity, or impose bid caps for the non-nuclear assets that are more likely to set prices. It also states that the PJM Market Monitoring Unit (MMU) must monitor the implementation of the interim mitigation measures. FirstEnergy also questions the practical effects of virtual divestiture, such as how the Applicants' market power will be held in check after the long-term contracts expire, and what Applicants will do if there are not enough purchasers in the auction process or those buyers default. In addition, FirstEnergy states that Applicants will obtain a market price for their energy, and questions whether the energy sales are actually mitigation if Applicants are able to receive the same price (*i.e.*, post-merger, post-mitigation) for the energy that they would have received without mitigation.[38]

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[37] AAI at 14, citing Federal Trade Commission, Bureau of Competition, *Study of the Commission's Divestiture Process.* Washington, D.C. 1999 at 16.

[38] FirstEnergy at 46.

50. FirstEnergy argues that the Commission rejected partial divestiture in the *AEP/CSW* merger[39] for the reasons stated above. It states that, in that case, the Commission rejected applicants' proposal to divest a minority interest in a generating facility while retaining operational control over the output of the facility, and required applicants to divest their entire ownership interest in the generating facilities at issue.[40] Finally, FirstEnergy argues that the Commission rejected a proposal similar to Applicants' baseload auction in *Allegheny/DQE*[41], where the Commission expressed concern that the entire output of the facility in question would not be sold under the proposed RFP, and stated:

> Divestiture would permanently eliminate the opportunity for the merged company to exercise the market power (by withholding output to raise electricity prices) conferred on them by the merger.[42]

51. AAI also finds flaws in Applicants' proposed divestiture plan, arguing that it does not provide sufficient information to satisfy concerns such as the need to create viable, independent competitors in the markets. Specifically, AAI argues that Applicants' proposed virtual divestiture would allow Applicants to keep ownership and control of the capacity while they sell or swap the energy to third-party purchasers and that this would not adequately address the market power concerns raised by the proposed merger or create a viable competitor in the market. Another problem is that with Applicants controlling the virtual (and actual) divestiture process, the Commission could not modify or oversee the divestiture plans; and Applicants would have little incentive to divest and mitigate in a way that would create viable competitors and markets. AAI also argues that Applicants have not demonstrated the claimed efficiencies or other benefits that would allegedly result from the merger, particularly Applicants' nuclear assets. Finally, AAI notes that the antitrust agencies prefer structural mitigation, such as divestiture, to conduct-based remedies, which are often difficult to design, cumbersome and costly to administer, and easier to circumvent than structural remedies.[43]

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[39] American Electric Power Co., *et al.*, 90 FERC ¶ 61,242 (2000) (AEP/CSW).

[40] FirstEnergy at 43, citing *AEP/CSW* at 61,792.

[41] Allegheny Energy, Inc., *et al.*, 84 FERC ¶ 61,223 (1998) (Allegheny/DQE).

[42] FirstEnergy at 45, citing *Allegheny/DQE* at 62,070.

[43] AAI at 9, citing U.S. DOJ, Antitrust Division, *Antitrust Division Policy Guide to Merger Remedies* (2004).

52. The City of Philadelphia also protests Applicants' use of virtual divestiture. The Office of the People's Counsel claims that Applicants do not sufficiently explain how virtual divestiture will effectively mitigate market power. Therefore, they state that the Commission should establish hearing procedures to address the validity of the proposed mitigation and to explore how the mitigation, including the proposed virtual divestiture, will remedy the market power problems and screen failures resulting from the proposed merger.

53. Amtrak argues that the Applicants fail to set forth the legal basis for using the virtual divestiture as permanent mitigation and fail to demonstrate its effectiveness.' Furthermore, Amtrak argues that the proposed virtual divestiture is not a permanent mitigation measure, since control of all generation will return to the merged entity after a fixed time period. Amtrak also argues that the PJM Market Monitoring Unit (MMU) is unable to compensate and adequately administer the unduly complicated and administratively burdensome proposed virtual divestiture.

54. The PHI Companies state that virtual divestiture is unacceptable because it fails to transfer control over the units' operation, including the scheduling and duration of maintenance outages, and because the actual merged entity, and its market power, will outlast the virtual divestiture. The PHI Companies argue that the three year baseload auction energy sales might not continue over the proposed 15-year period, and urge the Commission to evaluate the actual mitigating effects of the virtual divestiture and impose certain conditions on the virtual divestiture. The PHI Companies' economic witness, Dr. Cichetti, argues that the three-year and 15-year contracts do not adequately mitigate Applicants' market power because the nuclear units would not be divested and would still be controlled by EE&G, which will be able to affect market prices in the Basic Generation Service auction. He concludes that the virtually divested MWs should be considered to be controlled by EE&G in Dr. Hieronymus' Appendix A analysis. Therefore, in order to fully evaluate the effect on the PJM markets and the validity of Applicants' mitigation plan, the PHI Companies request that the Commission establish an evidentiary hearing.

55. The NJBPU states that it is concerned about the creation of significant market power in the PJM markets involved in the state's Basic Generation Service auctions and the effect that that market power would have on the Basic Generation Service auction process. The NJBPU asked the PJM MMU to study the effects of the proposed merger on competition in all relevant PJM markets. It also raises several concerns regarding Applicants' proposed mitigation plan and the effect the mitigation would have competition in the relevant PJM markets. Therefore, the NJBPU requests that the Commission establish an evidentiary hearing to fully evaluate all aspects of Applicants' proposed merger.

56. The Illinois Attorney General states that the merger would exacerbate already existing market power problems in the PJM markets that influence the prices paid for electricity by Illinois customers. It states that the Illinois Commerce Commission is in the process of approving an auction similar to the Basic Generation Service auctions that take place in the New Jersey markets, and argues that the proposed merger could undermine the ability of the proposed auction to secure electricity at competitive prices for Illinois consumers. Therefore, the Illinois Attorney General requests that the Commission set this matter for hearing.

57. AAI argues that Applicants' failure to specify which units will be divested allows Applicants to divest the units that are least likely to compete with the assets kept by Applicants. Similarly, numerous parties, including Hoosier, AAI, the PHI Companies, FirstEnergy, the PPL Companies and the Division of the Ratepayer Advocate, argue that Applicants' mitigation plan fails to comply with the Commission's requirements by failing to specify which of Applicants' facilities would be divested.[44]

58. FirstEnergy's witness, Ms. Frayer, raises a number of concerns regarding Applicants' interim mitigation proposal. Specifically, she argues that: (1) Applicants have not provided sufficient detail about the interim mitigation;[45] (2) there must be a credible and transparent means of oversight over Applicants' enforcement of the interim auctions, as the Commission recognized in *OG&E*;[46] and (3) Applicants' proposal to bid the nuclear capacity into the PJM markets at a $0 price does not mitigate market power because the nuclear plants do not set the market-clearing price.

59. Protestors also point out that transmission expansion is a form of market power mitigation. FirstEnergy argues that the Commission should consider what studies the PJM MMU might perform to identify the specific transmission enhancements Applicants could be required to construct to relieve congestion in PJM East as a condition of merger approval. The PHI Companies argue that Applicants may have positions in the PJM queue for generation interconnection projects and that they should be required to

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[44] Protestors cite the Merger Policy Statement at 30, 136, where the Commission stated that merger applicants must specify the units to be divested.

[45] Ms. Frayer cites the Commission's finding in *AEP/CSW*, where the Commission required Applicants to file the "terms and conditions" associated with interim mitigation so the Commission could assess whether the proposed mitigation would be effective. Frayer Testimony at 51, citing *AEP/CSW* at 61,794.

[46] Frayer Testimony at 51, citing *Oklahoma Gas & Elec. Co.*, 108 FERC ¶ 61,004 at PP 38-39 (2004) (*OG&E*).

relinquish these positions in order to enable other parties to construct generation in the affected markets, thus limiting the merged company from re-establishing its pre-mitigation market power.[47]

60. The PHI Companies argue that the sheer size of the merged company (nearly 40,000 MW of generation in PJM) creates market power problems that the Commission's Competitive Analysis Screen does not address. POCA also argues that the size and scope of this proposed merger will present opportunities for the merged entity to wield market power, even after the proposed mitigation and divestiture. POCA points out that Applicants would still own 37,100 MW of generation in PJM, including 14,400 MW, or 36 percent of the capacity in PJM East, the most constrained market in PJM.

61. Protestors question how the proposed merger will affect Applicants' authorization to sell power at market-based rates. First Energy's witness, Ms. Frayer, performed an analysis which she characterized as being required for Applicants to be able to continue to sell power at market-based rates, and concluded that Applicants would fail the 20 percent market share screen.[48] While acknowledging that this case is under section 203 of the FPA, not section 205, FirstEnergy concludes that the Commission will have to address the issue of the merged firm's market-based rate authorization, and that the Commission should make a decision in the 203 proceeding that will "pass muster" in the related section 205 market-based rate proceedings.[49] FirstEnergy argues that when the 20 percent market share threshold is violated, which Ms. Frayer shows will occur even when Applicants' proposed mitigation plan is imposed, the Commission then requires a delivered price test – which is exactly what the Applicants performed in this section 203 proceeding. Dominion's witness, Mr. Frank Graves, also finds that, even with mitigation, Applicants will have a greater than 20 percent market share in Expanded PJM, and that Applicants would need to divest an additional 1,200 MW in order to pass the Commission's market share screen for market-based rate authorization.

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[47] PHI Companies at 45.

[48] In April 2004, the Commission established a 20 percent Wholesale Market Share indicative screen, as well as another screen, for analyzing generation dominance in market-based rate applications. *AEP Marketing, Inc., et al.*, 107 FERC ¶ 61,018 (2004).

[49] First Energy at 38.

62. Dominion argues that the market-share screen failure indicates that Applicants will have market power in PJM and urges the Commission to reject any argument that the PJM MMU can address market power issues in the PJM market. Amtrak, the Coalition and the Energy Users Group also argue that the Commission should not rely on the PJM MMU to identify and prevent exercises of market power.

63. FirstEnergy states that Applicants have not provided any details regarding their planned reorganization of the "unregulated" entities owned by Exelon and PSE&G, and argues that the Commission cannot find that the reorganization will be consistent with the public interest until Applicants provide details. FirstEnergy states that in *Ameren Energy*, the Commission recognized that some types of internal reorganizations can harm competition, and asserts that the Commission cannot act on Applicants' proposed internal restructuring based on the limited information provided in the application.[50]

64. NiSource states that it does not oppose the merger, but it requests that the Commission condition approval on the resolution of NiSource's increased parallel path flow, or "loop flow," problems, which will be exacerbated by the proposed merger. Therefore, NiSource requests that the Commission require Applicants to further study how the proposed merger will affect loop flow and take certain remedial actions, such as requiring Applicants to mitigate their loop flow if the Applicants' proposed merger is approved.

B. Applicants' Answer to the Protests

65. On May 10, 2005, Applicants filed an answer and amendment to their original filing. Notice of the answer and amendment to the filing was published in the *Federal Register*,[51] with comments due on or before May 27, 2005.

66. Applicants acknowledge that protestors have raised some good points regarding errors in Dr. Hieronymus's original analysis, but argue that, even with the appropriate revisions to the inputs in their analysis, Applicants have shown that the proposed divestiture fully mitigates the merger-related harm to competition. Applicants cite four specific examples of factual errors in the original analysis: (1) the analysis should have included a 200 MW power purchase agreement between PECO and Hoosier in 2006;

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[50] FirstEnergy at 54-56, *citing Ameren Energy Generating Co., et al.*, 103 FERC ¶ 61,128 (2003) (*Ameren Energy*).

[51] 70 Fed. Reg. 29, 299 (2005).

(2) the analysis should have included PPL's recently completed 600 MW Lower Mount Bethel combined cycle facility; (3) the analysis should have used 2,595 MW, rather than 4,800 MW, of generating capacity for Conectiv Energy Services, Inc. in PJM East; and (4) the analysis failed to account for Dominion's native load obligation in the calculation of Available Economic Capacity. Applicants state that Dr. Hieronymus has made those changes in his analysis and that the resulting changes are minor and do not affect the mitigation required to repair the merger's harm to competition.

67. Applicants respond to protestors' arguments regarding the relevant geographic markets that would be affected by the merger. Answering the PPL Companies and the PHI Companies' argument regarding the Northern New Jersey market, Applicants state that, because there was no overlap between Exelon's and PSE&G's generation in Northern New Jersey, Dr. Hieronymus analyzed the effect of the merger on that market and found that the mitigation for the PJM East market, along with an additional 100 MW divestiture of generation located in Northern New Jersey, would mitigate the harm to competition.

68. The PPL Companies argue that due to prevailing transmission constraints, the "PJM Classic" market, consisting of PJM Classic and the Allegheny Power system (Allegheny), should be analyzed as a separate market within the larger PJM Pre-2004 market. In response, Applicants assert that although PJM's western interface once created a transmission constraint separating Allegheny from PJM Classic that constraint no longer exists, because PJM now redispatches the system when the constraint threatens to limit the west-to-east flows within PJM.[52] Applicants cite the PJM Market Monitor's 2004 State of the Market Report, which explains how the system operator redispatches higher-cost generating units in order to maintain the prevailing west-to-east flows from Allegheny into PJM Classic.

69. Applicants also address Protestors' assertion that they should have analyzed PJM West and the "Rest of PJM Pre-2004" market (PJM Pre-2004 minus PJM West). They argue that the prevailing power flows are east-to-west, so the resulting transmission constraints can make PJM East a load pocket and, thus, a separate geographic market. However, Applicants argue that east-to-west flows are unconstrained, so there is no reason to consider PJM West as a separate market, because suppliers in PJM East can compete in the PJM West Market. Applicants contend that Protestors' rationale for defining the relevant geographic market based on sellers' opportunity costs is inconsistent with Commission precedent and Appendix A of the Merger Policy Statement. They state that Appendix A instructs applicants to consider those suppliers

[52] Answer at 11.

with low enough variable costs that they could compete (subject to transmission constraints) in a geographic market, not whether potential suppliers would consider the opportunity cost of selling into a particular geographic market.

70. Applicants address protestors' questions about the fuel cost and assumed wholesale market prices in their analysis. While acknowledging that the assumed market prices are important parameters in the model, they argue that consistency between fuel cost assumptions and the prevailing market prices is most critical, and that Dr. Hieronymus's and Mr. Frame's testimonies are each internally consistent in their fuel cost and market price assumptions. That is, fuel cost assumptions on the low end of the range of observed or projected costs should correspond to market price assumptions on the low end of the range of observed or projected prices; likewise for high prices. They state that the protestors, including FirstEnergy's witness, Ms. Frayer, have been able to show different results by changing one or the other of Dr. Hieronymus' assumptions about fuel costs or market prices, but that those results are meaningless without a corresponding change in the other assumption. Moreover, Applicants assert that Ms. Frayer's arguments about the accuracy of the fuel cost inputs are overstated because they do not change the merit order of the plants that would be dispatched under various market conditions; thus, they do not materially affect the results of Applicants' analysis.[53] Applicants point out that Dr. Hieronymus and Mr. Frame used different fuel cost and market price assumptions, but arrived at very similar results, thus showing that the results are not sensitive to changes in fuel cost and market price assumptions. Finally, Applicants argue that some of the fuel costs and market prices assumed by protestors' witnesses are wrong.[54]

71. Applicants address claims that they should have performed more tests on the sensitivity of their results to changes in the assumed market prices. First, they argue that by using a range of prices from $20/MWh to $80/MWH and arriving at similar results throughout the range, Dr. Hieronymus has shown that changes in the assumed market price will not materially change his results. Second, as noted above, they argue that Mr. Frame's analysis serves as a sensitivity test of Dr. Hieronymus' analysis and confirms that the results are not sensitive to changes in fuel cost and market price assumptions.

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[53] Applicants argue that under any plausible forecast, changes in fuel cost assumptions would not, for example, make coal-fired capacity cheaper than nuclear capacity, or natural gas-fired capacity cheaper than coal-fired capacity. Thus, the results for economic capacity would not be materially different under any reasonable fuel cost assumption.

[54] Answer at 17.

72. Regarding FirstEnergy's assertion that Dr. Hieronymus overestimated the amount of new generation coming on line and underestimated the amount of old generation being retired in PJM, Applicants state that FirstEnergy's claims are erroneous and are based on statements Dr. Hieronymus used in a different context, not in his analysis of energy markets. They state that in his analysis of energy markets, Dr. Hieronymus relied on PJM reports as to which plants would be coming on line and which would be retired in 2006, the test year, and that his comments about entry that FirstEnergy cites were more general and in the context of the competitiveness of long-term capacity markets. They also note that FirstEnergy's witness, Ms. Frayer, used the same assumptions regarding generation entry and exit in her analysis of the relevant energy markets as did Dr. Hieronymus.

73. Applicants also address protests regarding Dr. Hieronymus' allocation of available transmission in his analysis. Applicants challenge Hoosier's and the PPL Companies' claims that using a *pro rata*, rather than economic, allocation of available transmission skews the results of the analysis by understating the allocation of import capability for Applicants' low-cost generation and systematically reducing the HHI. They say that the Commission has accepted the use of *pro rata* transmission allocation in numerous DPT analyses. They further state that, despite claims of an "opportunistic" use of the *pro rata* allocation by Dr. Hieronymus, he has always used that method in his many DPT analyses before the Commission.

74. Regarding their analysis of Available Economic Capacity, Applicants reiterate their argument that in retail choice states such as those affected by the merger, Available Economic Capacity is difficult to measure and does not accurately portray competitive conditions. They state that protestors largely agree with that assertion and that protestors' attacks on Dr. Hieronymus' analysis of Available Economic Capacity miss the fundamental point. While other suppliers' native load data are not available, they do have data on their own native load obligation, so they are able to model their own Available Economic Capacity and conclude that the divestiture will bring that total below the pre-merger level.

75. Applicants address the numerous protests regarding the possibility of the merger creating or enhancing the merged firm's incentive and/or ability to engage in strategic bidding, thus increasing its unilateral market power. First, they argue that the Commission's Merger Policy Statement does not require an analysis of strategic bidding, nor is there case precedent requiring such an analysis. Rather, the Commission relies on the analysis described in Appendix A of the Merger Policy Statement, which is based on the Merger Guidelines, a well-established and court-affirmed analytical methodology. They further state that HHI screens are useful for analyzing the effect of a merger on the unilateral exercise of market power and cite the Merger Guidelines, which state that "[o]ther things being equal, market concentration affects the likelihood that one firm, or a

small group of firms, could successfully exercise market power."[55] Finally, they state that the analysis by Direct Energy's witness, Dr. Kleit, of the cost and benefits of withholding and strategic bidding, is filled with errors and questionable assumptions.

76. Applicants characterize the protests regarding their proposed mitigation as falling into two major categories: (1) the Applicants proposed an inadequate amount of divestiture; and (2) virtual divestiture does not adequately mitigate market power. They further state that the questions raised by protestors are not issues of material fact that would require a hearing to explore, but legal and policy issues that can be decided by the Commission without a hearing.

77. Applicants respond to the PHI Companies, the PPL Companies and FirstEnergy's argument that Applicants have misinterpreted the HHI screen as an absolute standard for Commission approval of a merger or acquisition. They assert that it is the PHI Companies, PPL Companies and FirstEnergy who have misinterpreted the Commission's reliance on the HHI screen. Citing the Merger Policy Statement and the Merger Filings Requirements Rule, Applicants state that the Commission uses the screen to identify those mergers or acquisitions that will not require a hearing or additional mitigation in order to be authorized by the Commission, absent compelling evidence otherwise raised by intervenors. They conclude that because their proposed mitigation returns market concentration to levels that would pass the Competitive Analysis Screen, and no intervenor has made a showing that the merger has anticompetitive effects despite passing the screens, they have met the Commission's standard for showing a lack of harm to competition.

78. Applicants argue that FirstEnergy's assertion that an additional 890 MW of divestiture is required to avoid screen failures in the "summer rest of peak" and "shoulder rest of peak" periods is based on a miscalculation of Applicants' proposed divestiture. They argue that Ms. Frayer undercounted the amount of the proposed divesture that would be relevant for the "summer rest of peak" and "shoulder rest of peak" periods by 1200 MW, because she was inconsistent between the types of units that would be considered economic capacity given her assumed price levels and the types of units that Applicants have committed to divest.[56]

79. While Applicants disagree with the argument raised by numerous protestors regarding Applicants' proposed Buyer Restrictions to purchase the divested plants and virtually divested energy, they offer to withdraw most of the proposed restrictions. They

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[55] Answer at 25, citing § 2.0 of the Merger Guidelines.

[56] Hieronymus Supplemental Testimony at 23-24.

are willing to withdraw the restrictions that: (1) no more than half of the fossil generation would be sold to a single buyer and; (2) none would be sold to a market participant with a greater than five percent market share in PJM-East or Expanded PJM. Additionally, they withdraw the restriction that they will not sell more than 25 percent of the Baseload Mitigation Amount to market participants owning three to five percent of the installed generation capacity in Expanded PJM or PJM East. They continue to propose, however, the 50 percent limit on the total purchase of the virtually divested nuclear capacity.[57]

80. In order to allow suppliers with larger pre-existing market shares in PJM to purchase the divested capacity, Applicants propose divesting an additional 1,100 MW of generating capacity (900 MW of fossil generating capacity and 200 MW of virtual nuclear capacity) in the PJM Pre-2004 market. Dr. Hieronymus analyzes the effect of the merger on competition with the increased divestiture and the assumption that equal shares of the entire divestiture amount were purchased by the four largest owners of capacity in PJM-East: PPL, Reliant, Conectiv and FirstEnergy. Under that scenario, for PJM-East, he finds that the post-merger-and-mitigation concentration levels range from 1,218 to 1,465 HHI, with changes in concentration ranging from negative 88 to 95 HHI, all within the Commission's screening threshold for moderately concentrated markets. For PJM Pre-2004, he finds that the post-merger-and-mitigation concentration levels range from 996 to 1,292 HHI, with changes in concentration ranging from 48 to 105 HHI, with one period (shoulder peak, a moderately concentrated market with a change in concentration of 100 HHI) failing the Commission's screening threshold for moderately concentrated and unconcentrated markets.[58]

81. Applicants acknowledge that the additional mitigation does not necessarily cure all possible screen failures for all possible combinations of sales to companies with large market shares. They state that they will, therefore, make a compliance filing showing the effect on market concentration given the actual divestitures and the same data and assumptions used in Applicants' revised Appendix A analysis, in order to show that no material screen failures will have resulted.

82. Applicants characterize the protests regarding their proposed virtual divestiture as falling into two major categories: (1) virtual divestiture is not as effective as physical divestiture in mitigating market power; and (2) compliance with the virtual divestiture commitment will be difficult to monitor, giving Applicants the ability to avoid the commitments they have made to the Commission.

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[57] Answer at 32.

[58] Hieronymus Supplemental Testimony at 50.

83. Applicants argue that the virtual divestiture is as effective as physical divestiture. They argue that the fact that the Commission has never approved sales of capacity, such as the virtual divesture proposal, as long-term mitigation, does not preclude the virtual divesture plan from being effective long-term mitigation. They state that, in the Merger Policy Statement, the Commission contemplated a possible alternative to physical divestiture that is similar to their proposed virtual divestiture:

> [O]ne alternative might be to divest the ownership rights to energy and capacity to a number of owners. The unit could then be operated as a competitive joint venture and parts of its output could be bid or sold independently.[59]

Applicants argue that their virtual divestiture plan, while not a joint venture, does divest the ownership rights to energy to a number of owners that can independently sell that energy or bid it into the PJM market.

84. Applicants argue that the Commission did not, in the Merger Policy Statement, establish physical divestiture as the only plausible mitigation for harm to competition; rather it recognized that "there are numerous mitigation measures that can be effective" and stated that it would consider the adequacy of various mitigation measures on a case-by-case basis.[60] Applicants assert that they have provided the analysis necessary for the Commission to determine the adequacy of virtual divestiture, and cite the testimony of Mr. Cassidy and Mr. Sabitino, explaining that the rights to the energy are firm rights and that the Applicants would have to pay liquidated damages if they failed to deliver. They further argue that, because the liquidated damages are based on the cost of covering any shortfall, they would have no incentive to withhold the energy subject to the virtual divestiture in order to profit from increased energy prices, because they would have to pay the cost of any such increase.

85. Applicants state that, under the virtual divestiture plan, the obligation to deliver energy is not tied to any specific unit and that they will guarantee the delivery of a specific amount of "24/7" energy under both the Auction Plan and the Long-Term

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[59] Answer at 35, *citing* Merger Policy Statement at 30,137.

[60] *Id.* at 30,900.

Contract Plan, regardless of which units are operating.[61] They assert that this guarantee eliminates the ability to profit by withholding output from the units that are under the virtual divestiture plan. Finally, Applicants note that the Commission has recognized in a number of cases that the operating characteristics of nuclear units reduce the danger of withholding output in order to raise prices.[62]

86. In response to FirstEnergy's assertion that the Commission rejected the sale of long-term power as mitigation in *Allegheny*, Applicants argue that FirstEnergy omitted the reasoning behind the Commission's decision and that the circumstances are different here. They state that, in *Allegheny*, the Commission was concerned that "the merged company reserve[s] the right to reject any and all bids," and that the merged company would thus retain control over the generation facility. Here, they argue, Applicants have committed to sell all of the energy that is offered, regardless of the price of the bids, and an independent auction monitor will oversee Applicants' compliance with that commitment.

87. Applicants dispute FirstEnergy's assertion that they will receive the same price for the virtually divested energy as they would have in the absence of mitigation. They state that, under the virtual divestiture plan, they will receive the price determined in the auction for the three-year life of each contract, whereas if they retained control of the output of the nuclear units, they would be able to benefit from any market price increases during the same three-year period. They conclude that, because of the three-year contracts, they will have no economic incentive to increase the market price in order to increase profit from the virtually divested capacity.

88. Applicants challenge Dr. Cichetti's assertion that they will retain control of both the three-year and the 15-year products offered in the virtual divestiture plan because the purchasers of those products will likely resell the power in the Basic Generation Service auction. They state that, in both cases, the Applicants are obligated to deliver 24/7 energy to the buyers, and the buyers, not the sellers, will determine whether to participate in the Basic Generation Service auction or use it elsewhere. Applicants conclude that they cannot control the capacity or the price of the energy in the Basic Generation Service auction.

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[61] Answer at 36.

[62] Answer at 37, *citing U.S. Gen New England*, 109 FERC ¶ 61,361 at P23 (2004); *Ohio Edison Co.*, 94 FERC ¶ 61,291 at 62,044 (2001); and *Commonwealth Edison Co.*, 91 FERC ¶ 61,036 at 61,134 n. 42 (2000).

89. Regarding protestors' claims that the proposed energy swaps could harm competition in other geographic markets by increasing the concentration of control of capacity and energy in other geographic markets, Applicants argue that any such swap would have to be approved under section 203 and that the Commission could address any competitive concerns. Moreover, Applicants argue that they control very little electric generation capacity in other geographic markets, so the possibility of harm to competition elsewhere is remote.

90. Applicants recognize protestors' arguments that the antitrust agencies generally prefer structural mitigation to behavioral mitigation and that behavioral mitigation requires ongoing monitoring for compliance. In response, Applicants commit to establish a public compliance web site that will show how they are complying with the virtual divestiture and all other mitigation requirements.[63] Applicants reiterate their commitment that the annual auctions for three-year energy contracts will be administered by an independent auction manager.

91. Applicants respond to the numerous protests regarding their proposal for implementing the mitigation. In response to the PHI Companies' concern that the three year baseload auction energy sales might not continue over the proposed 15-year period, Applicants state that the PHI Companies are mistaken, and restate their commitment from the Application:

> Applicants explicitly reaffirm that the entire Baseload Mitigation Amount of nuclear virtual divestiture (2,600 MW) will remain in place after 15 years, subject to a reduction in the mitigation amount if the Applicant's PJM East nuclear capacity is decommissioned, derated, or sold or there is construction of new transmission transfer capability into PJM East.[64]

92. A number of protestors question the 18-month time period for the fossil divestiture and argue that it should be shorter. For example, AAI states that antitrust agencies advocate shorter time periods for completing divestitures. In response, Applicants commit to "executing sales agreements and making filings before the Commission for the approval of the sales no later than one year after the closing date of the Transaction."[65]

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[63] Answer at 43.

[64] Answer at 46.

[65] Answer at 47.

93. Regarding protestors' arguments that the Merger Policy Statement requires Applicants to identify the specific units that will be divested, Applicants argue that while they did not identify the exact units, they did identify the location and the types of generation to be divested and the pool of generation facilities eligible for divesture. They further argue that by not specifying the exact units, they give potential buyers more flexibility and let market forces decide which units should be divested. Finally, they argue that in *AEP/CSW*, rather than accepting applicants' commitment to divest portions of two generating facilities totaling 550 MWs, the Commission expressly directed applicants to divest "any unit or units totaling the same number of megawatts and having the same cost, operation, and location characteristics as the specific plants."[66] They conclude that the Commission has made it clear that it is not necessary to specify the plants that will be divested to mitigate Appendix A screen failures.

94. Applicants respond to protestors' arguments regarding the proposal to reduce the amount of the baseload mitigation MW-for-MW for any increase in transmission transfer capability into PJM-East or for any reduction in Applicants' nuclear generating capacity due to de-rating, decommissioning, or sales of nuclear capacity in PJM-East. Applicants assert that the market power concern regarding nuclear units is that, because they are low-cost units that are always in merit, their owners benefit from any withholding of other units that would raise the market-clearing price.[67] They argue that a decrease in the amount of nuclear capacity held by Applicants, whether through divestiture, de-rating, or unit retirement, would have the same effect in terms of mitigating market power. Thus, any reduction in the nuclear capacity held by Applicants should be considered effective market power mitigation, because any such reduction reduces the ability to profit from withholding output from other units. Regarding decreases to the baseload mitigation amount for increases in transmission transfer capability into PJM East, Applicants argue that increasing transfer capability into PJM-East would enable competitive suppliers to defeat attempts by generators in PJM East to drive up prices by withholding output, and, thus, should also be considered effective market power mitigation.

95. Applicants respond to the numerous challenges to the effectiveness of their proposed interim mitigation. Regarding FirstEnergy's assertion that the PJM MMU should monitor Applicants' compliance with their interim mitigation plan, Applicants reiterate their commitment to establish a public compliance web site that will show how they are complying with the virtual divestiture and all other mitigation requirements,

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[66] Answer at 49 *citing AEP/CSW* at 61,792.

[67] Applicants reiterate their argument that the Commission has recognized, in a number of cases, that the operating characteristics of nuclear units reduce the danger of withholding output from nuclear plants in order to raise prices.

including the interim mitigation plan. Moreover, they state that the PJM MMU has access to all the bid data in the PJM markets and will be able to track the amount of capacity bid into the PJM market under the interim mitigation plan. Regarding FirstEnergy's claim that the Application provides insufficient detail about the interim mitigation, Applicants refer to the Cassidy testimony, which describes the amount of the dispatch rights; the rights afforded the purchasers of the capacity; the terms of the master agreement for the sales; the price of the energy and capacity; the timing and duration of the interim sales; and any associated rollover provisions.[68]

96. FirstEnergy asserts that Applicants' proposal to bid the output of their nuclear plants into the PJM energy market at a $0 price is inadequate because nuclear plants do not set the market-clearing price, and, therefore, Applicants should propose bid caps for their generating units that are likely to set the price. Applicants respond that they are doing precisely what FirstEnergy recommends. They have committed to bid the mid-merit and peaking units (the units most likely to set the clearing price) into the PJM market subject to a variable cost bid cap. Applicants challenge various claims that they should only be allowed to charge cost-based rates. They say that such claims are unfounded and, as a practical matter, no protestors have explained how offers of cost-based sales could be made in the single-clearing-price PJM Market.

97. A number of protestors, including FirstEnergy and PHI Companies, request that Applicants provide transmission upgrades as part of their mitigation package. Applicants state that, while they have opted for generation divestiture rather than transmission expansion as their form of market power mitigation, they are engaged in the PJM Regional Transmission Planning Process, and commit to additional transmission expansion. Specifically, in addition to their existing transmission commitments, they commit to complete two transmission projects whether or not the merger is approved by the Commission, and, if the Commission approves the merger without an evidentiary hearing, they commit to fund $25 million of transmission projects on PJM's list of Economic Projects over the next five years.[69]

98. Applicants characterize a number of issues raised by protestors as being policy issues that have no merit and do not require a hearing to resolve. First, they respond to protestors' claims that, if the merger is approved, it will halt future merger activity in PJM by increasing the level of market concentration. They argue that the Commission

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[68] Application, Cassidy testimony at 5-8.

[69] Answer at 60.

has determined that it will review mergers on their own merits, rather than based on the effect they could have on possible future mergers.[70]

99. In addition, Applicants argue that claims that the merger would create a "mega-utility" with a dominant market position and that the Commission's Appendix A analysis does not sufficiently address such a possibility are misguided. They state that no intervenor has identified any specific issues that cannot be addressed using the tools available to the Commission.

100. Applicants note that a number of protestors have argued that the merged firm will not pass the Commission's screen for generation market power under its market-based rates review. In response, Applicants state that they disagree with protestors' conclusions, but, more importantly, they argue that the Commission can address the issue of the merged firms' market-based rates when Applicants make their updated market-based rates filing.

101. Applicants argue that NiSource's protests regarding loop flows should be rejected because they are not related to the merger. They state that NiSource's complaint is about loop flows that might arise due to ComEd joining PJM, and that the Commission already has a proceeding regarding loop flows between PJM and the Midwest ISO.[71] They further note that NiSource has filed a complaint in Docket No. EL05-103 in which it raised the same concerns.

102. Applicants respond to FirstEnergy's assertion that they have not demonstrated that their proposed internal corporate restructuring is consistent with the public interest. They state that FirstEnergy's cite to the Commission's finding in *Ameren Energy* is misplaced, because Applicants have committed that there will be no transfers of generation assets from merchant generating companies to traditional franchised utilities, which was the Commission's concern in *Ameren Energy*.

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[70] *Id.* at 63, *citing Ohio Edison Co.*, 85 FERC ¶ 61,203 at 61,846 (1998) (rejecting intervenors' requests to "look at possible future mergers when assessing the potential competitive effects of a merger.")

[71] Applicants cite the Joint Operating Agreement in Docket No. ER04-375, first accepted in *Midwest Independent Transmission System Operator, Inc.* 106 FERC ¶ 61,251 (2004). Answer at 76.

C. The PJM MMU Study

103. The PJM MMU analyzed the effect of the proposed transaction on competition in PJM's energy, capacity, regulation, and spinning reserve markets.[72] In its energy market analysis, the PJM MMU looks at the market for all of PJM, as well as defined locational markets.[73] The PJM MMU notes that one must take care in interpreting the results and offers that one must recognize that Dominion entered the PJM market on May 1, 2005, so the market conditions before that date no longer exist. Further, the post-Dominion integration data reflects only a narrow range of market conditions.

104. The PJM MMU states that it calculated market concentration levels on a pre- and post-merger basis for two time periods: (a) October 1, 2004 through April 30, 2005, and (b) May 1, 2005 through May 8, 2005. The PJM MMU states that on average, the hourly energy market was moderately concentrated, both pre- and post-merger, during both periods. The post-merger increase in average HHIs ranges from 290 to 301, and the average HHI in the post-merger market is between 1,537 and 1,643.[74] The PJM MMU concludes that the proposed merger results in an increase in HHI that exceeds that specified as raising concern in the Merger Guidelines. It states that the proposed merger would significantly increase concentration in the energy market as defined by these metrics and the standards of the Merger Guidelines and therefore raises concerns about potential adverse competitive effects, absent mitigation.[75] The PJM MMU states that the divestiture of 4,500 MWh of generation would reduce the post-merger HHI levels to pre-merger levels and that the divestiture of 2,600 MWh of generation would reduce the post-merger HHI levels so that the increase is less than 100 points.

105. The PJM MMU states that in PJM's locational marginal pricing based market, transmission constraints create smaller, locational markets with different structural characteristics than the aggregate market. Thus, the PJM MMU examines the locational

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[72] In response to a request from the NJBPU, the PJM MMU prepared a report and analysis of the proposed transaction's impact on the PJM wholesale markets (PJM MMU Study). The NJBPU filed the study with the Commission making the PJM MMU Study part of the record.

[73] The MMU examined the energy markets created when the Western, Central, and Eastern interfaces are constrained as well as the smaller market created when the Keeney Transformer is constrained.

[74] PJM MMU Study at 12 and 14.

[75] *Id.* at 14.

markets created when the Western, Central, and Eastern interfaces are binding constraints. It also examines the locational eastern market created when the Keeney 500/230 kilovolt (kV) transformer is constrained. The PJM MMU states that it performed this analysis in a way that is fully consistent with PJM's actual procedure for dispatching units to solve a constraint.[76] The PJM MMU notes that its analysis included only those units whose increased output would relieve the constraint. That is, the PJM MMU calculated the HHI based on the ownership of combustion turbine capacity that could relieve the transmission constraint. It states that its approach is consistent with the Commission's approach that looks at a variety of demand conditions.

106. The PJM MMU states that the Eastern interface pre-merger HHI is 2,593, but that this market is structurally competitive because it passes PJM's three-pivotal-supplier test for market concentration.[77] It states that the merger would result in an HHI increase of 972 points and the failure of the three-pivotal-supplier test. The PJM MMU states that this harm to competition could be mitigated by capping market offers when the Eastern interface market is not competitive; by the merged company agreeing to offer power from units only at marginal cost (as defined in the offer capping rules); or by adequate divestiture of generation by the merged company. The PJM MMU states there is sufficient capacity in the list of candidate facilities to return the post-merger HHI to pre-merger levels, but that it is not possible to state definitively how many MW of capacity must be divested without knowing which units would be divested and the purchasers of these units.[78]

107. The PJM MMU states that the Western interface's pre-merger HHI is 1,552, and that this market is structurally competitive because it passes the three-pivotal-supplier test for market concentration. It states that the merger would result in an HHI increase of 240 points, but that the market still passes the three-pivotal-supplier test. The PJM MMU concludes that the merger nonetheless raises concerns about potential adverse competitive effects absent mitigation, because it would significantly increase concentration in the Western interface market. The adverse competitive impact of the merger could be mitigated by capping market offers when the Western interface market is not competitive, an agreement of the merged company to offer units only at marginal

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[76] *Id.* at 17.

[77] The MMU states that this conclusion is consistent with the conclusion reached in the October 26, 2004 filing by the MMU in Docket Nos. ER04-539-001, 002, and EL04-121-000.

[78] PJM MMU Study at 18 and 19.

cost, or adequate divestiture of generation by the merged company. The PJM MMU states that there is sufficient capacity within the list of candidate facilities to return the post-merger HHI to pre-merger levels, but that it is not possible to state definitively how many MW of capacity must be divested without an exact specification of the units to be divested and the purchasers of these units.[79]

108. The PJM MMU states that the Central interface's pre-merger HHI is 1,870, but that this market is structurally competitive because it passes the three-pivotal-supplier test for market concentration. It states that the merger would result in an HHI increase of 479 points, but that the market still passes the three-pivotal-supplier test. The PJM MMU concludes that the merger nonetheless raises concerns about harm to competition because it would significantly increase concentration in the Central interface market. This could be mitigated by capping market offers when the Central interface market is not competitive, an agreement of the merged company to offer units only at marginal cost, or adequate divestiture of generation by the merged company. The PJM MMU reiterates there was sufficient capacity within the list of candidate facilities to return the post-merger HHI to pre-merger levels, but that it is not possible to state definitively how many MW of capacity must be divested without an exact specification of the units to be divested and the purchasers of these units.[80]

109. The PJM MMU states that the Keeney transformer market pre-merger HHI is 3,004 and that this market is not structurally competitive because it fails the three-pivotal-supplier test for market concentration. It states that the merger would result in an HHI increase of 161 points. The PJM MMU states that the adverse competitive impact of the merger could be mitigated by capping market offers when the Eastern-interface market is not competitive, an agreement of the merged company to offer units only at marginal cost (as defined in the offer capping rules), or adequate divestiture of generation by the merged company. The PJM MMU states there is sufficient capacity in the list of candidate facilities to return the post-merger HHI to pre-merger levels, but that it is not possible to state definitively how many MW of capacity must be divested without an exact specification of the units to be divested and the purchasers of these units.[81]

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[79] *Id.* at 20 and 21.

[80] *Id.*

[81] *Id.* at 18 and 19.

D. Responses by Protestors to Applicants' Answer and to the PJM MMU Study

110. NJBPU argues that EE&G's plant retirements should not result in a MW-for-MW reduction in the amount of market power mitigation, because unlike divestiture, plant retirements do not create new competitors. It also asserts that more information is required to determine whether the mitigation plan is effective. Many different permutations of actual and virtual divestiture are possible, and the Commission cannot evaluate the merits of all of them without an evidentiary hearing.

111. FirstEnergy argues that because transmission expansion is required by the PJM Regional Transmission Expansion Plan, it cannot be considered market power mitigation. In addition, H-P Energy argues that Applicants' commitment of $25 million towards transmission expansion projects may supplant transmission projects being built by merchant transmission companies. It further states that Applicants are unfairly bypassing the PJM RTEP process.

112. Protestors continue to question some of the assumptions in Dr. Hieronymus' analysis and argue that the Applicants have offered mitigation based on inaccurate results that are favorable to Applicants. Specifically, FirstEnergy and the PPL Companies argue that the market prices used for electricity are still inaccurate. FirstEnergy further argues that what Applicants characterize as FirstEnergy's witness' "mistakes" were actually mistakes in Dr. Hieronymus' database, and that upon correcting for Dr. Hieronymus's mistakes, the merger fails the HHI screens. The PPL Companies argue that using actual FTR holdings to allocate imports to generators results in PJM-East market concentration that is considerably higher than indicated by Dr. Hieronymus, and that Applicants' proposed divestiture is not sufficient to mitigate the harm to competition. FirstEnergy further argues that lifting the restrictions on who can buy the units will result in an inadequate amount of divestiture.

113. The PPL Companies argue that Applicants continue to ignore PJM Classic and Northern New Jersey as relevant geographic markets. In addition, the PPL Companies assert that EE&G may have the ability and incentive to shut down nuclear units to drive up energy prices. It says that Applicants did not address the effect of the proposed merger on PJM's three-pivotal supplier rule.

E. Applicants' Answer to Protestors' Responses and Comments on the PJM MMU Study

114. Applicants reply that the PJM MMU Study confirms the validity of their analysis. They read the PJM MMU Study as concluding that the proposed merger raises market power issues, but that the Applicants' proposed mitigation can resolve them. Applicants note that the PJM MMU did not perform an Appendix A analysis, and advise the

Commission not to rely on the PJM MMU Study as a substitute for one. Applicants note that their own Appendix A analysis shows that there are no screen violations after divestiture, so the Commission can find that the transaction will not harm competition without considering the PJM MMU Study. Applicants do, however, believe that the PJM MMU Study confirms Dr. Hieronymus' analysis in two important respects: (1) the PJM MMU Study reaches results similar to those reached by Dr. Hieronymus regarding the state of the markets studied before and after the proposed merger, and (2) the PJM MMU concludes that it is possible to implement the mitigation proposed by the Applicants to address the market power issues associated with the proposed merger, depending on the units divested and who buys them.[82]

115. With respect to point (2) above, Applicants argue that the need to identify the units to be divested and the purchasers of the capacity (before concluding that the transaction addresses market power concerns) can be met without further analysis or a hearing. It is not possible to identify the purchasers of the generation at present. Applicants commit to make a filing when they implement their divestiture in order to demonstrate, based on the specifics of the divested units and purchasers, that no material Appendix A screen violations will occur as a result of the divestiture.[83] Applicants state that the fact that the units it included as its divestiture candidates can return the markets to their pre-merger state should give the Commission confidence that their proposed divestiture of 1,200 MW of peaking generation can adequately mitigate screen failures in the PJM MMU's energy submarkets.[84]

116. Applicants criticize the PPL Companies' supplemental affidavit from Dr. Kalt. They state that the affidavit does not respond to their May 9 Answer, that there is no reason Dr. Kalt could not have performed his analysis and included it in his original comments, and that Dr. Kalt's analysis is easily dismissed because Financial Transmission Rights do not provide the holder with any physical right to import power.[85]

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[82] Comments and Answer of Exelon at 6.

[83] *Id.* at 7.

[84] *Id.* at 9.

[85] *Id.* at 12.

117. Likewise, Applicants state that FirstEnergy's supplemental affidavit from Ms. Frayer presents a new study of the effect of the merger on energy markets that does not respond to the Applicants' revised mitigation proposal. They state that Ms. Frayer analyzed a higher price for various market conditions, thus including more generation in her analysis than did Dr. Hieronymus. However, Ms. Frayer neglected to take into account, when assessing Applicants' mitigation proposal, additional divested generation that is economic at higher prices. Applicants conclude that this results in a systematic understatement of the effectiveness of the mitigation they offer.

118. Applicants respond to FirstEnergy's and the PPL Companies' claim that Applicants' commitment to fund additional transmission expansion projects is just a commitment to do what they are already required to do under PJM's Regional Transmission Planning Process. They point out that one of the projects to which they commit is on the list of projects required by the Regional Transmission Planning Process, but that they are committing to accelerate the project so that it will be in service a year earlier than required by the Regional Transmission Planning Process. Applicants note that the other projects they propose are or will be on PJM's Economic Project list and that transmission owners are under no obligation to go forward with projects on this list.[86] In response to concerns raised by H-P Energy that the Applicants may fund projects that H-P Energy already is pursuing, Applicants commit to not attempt to supplant any of the three projects identified by H-P Energy.[87]

Discussion

119. Pursuant to Rule 214 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.214 (2004), the timely, unopposed motions to intervene serve to make the entities that filed them parties to the proceeding. We will grant Allegheny Electric, H-P Energy and the Indiana Utility Regulatory Commission's motions to intervene out-of-time, since we find that doing so will not unduly disrupt the proceeding or place an undue burden on the parties. Rule 213(a)(2) of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.213(a)(2) (2004), prohibits an answer to a protest unless otherwise ordered by the decisional authority. We will accept the answers filed herein because they have provided information that assisted us in our decision-making process.

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[86] *Id.* at 18.

[87] Applicants' Answer 2 at p. 19.

120. Applicants have shown that the merger, with the mitigation proposed, will not harm competition in any relevant energy market. We find that Applicants' revised mitigation proposal, which increases the total mitigation from 5,500 to 6,600 MW and removes almost all of the restrictions on who can buy the assets, addresses the competitive concerns raised by intervenors.

A. Adequacy of Applicants' Analysis

121. Applicants have corrected the factual errors in their original analysis that commenters identified. This does not materially alter the results. We note that none of the protestors that identified the factual errors in Applicants' original analysis argue that Applicants did not correct those errors.

122. We are not convinced by Applicants' argument that Northern New Jersey is not a relevant geographic market. As noted by the PHI Companies and others, there are times when transmission constraints bind, leaving Northern New Jersey isolated from the rest of PJM-East. However, we agree with Applicants that, during those periods, the merger would not harm competition because Exelon does not have any generating facilities that would be combined with PSE&G's existing generation in that load pocket. We note that there are times when imports from the rest of PJM East, where Exelon does own significant generating resources, would result in a merger-related increase in concentration due to Exelon's share of the *pro rata* transmission allocation. In those cases, there are screen failures in the Northern PSEG market. We note Applicants have committed to mitigate all screen failures. We also note that Dr. Hieronymus' testimony indicates that a 100 MW divestiture of generation capacity located in Northern PSE&G, along with the proposed mitigation for the PJM East market, is necessary to fully mitigate the merger-related increase in market concentration in Northern PSE&G. While Applicants have not explicitly committed to divesting 100 MW of generation located within Northern PSE&G, we consider the two statements above to be a commitment to do so, and we rely on that commitment in finding that the merger will not adversely affect competition in the Northern PSE&G wholesale electricity market.[88].

123. We reject arguments that "PJM-Classic" should be considered a separate relevant geographic market within PJM Pre-2004. We note that the PJM MMU report does not consider PJM-Classic as a separate market, and no one has shown that there are frequent binding transmission constraints that isolate PJM-Classic from the rest of PJM Pre-2004.

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[88] Application at 19.

124. We also reject arguments that PJM-West should be considered a separate geographic market. The critical issue in defining geographic markets is identifying the sellers who can physically and economically compete in the market. Given that the binding transmission constraints within PJM are predominantly west-to-east, it is reasonable to model PJM-East as a separate market within PJM, but not necessary to model PJM-West as a separate market because suppliers from all of PJM are able to sell into PJM-West.

125. Applicants have adequately addressed the protests concerning the fuel cost and wholesale market price assumptions in their analysis of energy markets. Dr. Hieronymus' fuel cost and market price assumptions are consistent in that the assumed market price corresponds with the running costs of the units most likely to set the market-clearing price in the PJM energy markets for the given season-load conditions. We agree with Applicants that the fact that Dr. Hieronymus and Mr. Frame used different fuel cost and market price assumptions, but arrived at very similar results,' indicates that the results are not sensitive to changes in fuel cost and market price assumptions. Moreover, the consistency of Dr. Hieronymus' results across various assumed market prices shows that the results of the analysis are robust.[89] In addition, the PJM MMU Study largely confirms the accuracy of Applicants' results, finding similar pre-merger and post-merger concentration levels.

126. Applicants appropriately accounted for generation entry and exit in their analysis. They used publicly available data from PJM covering the 2006 test year and included retirements and new plant entries that are reasonably expected to occur in 2005 and 2006. In *OG&E*, we noted that we will consider foreseeable and reasonably certain changes in market conditions as part of the baseline scenario.[90] Applicants have met that standard in their analysis.

127. Applicants and intervenors modeled various scenarios regarding who buys the divested assets. As noted by numerous protestors, as well as the PJM MMU Study, the effectiveness of Applicants' proposed divestiture depends critically on the distribution of the buyers and their pre-existing presence as sellers in the PJM markets. Applicants initially addressed this issue by putting restrictions on the pool of eligible buyers and the

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[89] For example, using Economic Capacity in PJM-East, under assumed prices ranging from $55 to $80, the merger-related change in concentration ranges from 860 to 1,113 HHI and Applicants' proposed divestiture of 4,500 MW of Economic Capacity returns the concentration to within 100 HHI of the pre-merger level. *See* Supplemental Hieronymus testimony, Exhibit J-28 p 1.

[90] *OG&E* at P 32.

amount of the divested capacity that any one purchaser can acquire. However, many protestors argued that such restrictions could harm the competitive process and could even allow Applicants to gain a dominant position in PJM by having only smaller, weaker competitors.

128. The parties raise valid issues on both sides of this argument. We find that Applicants' elimination of the restrictions on eligible buyers addresses protestors' concerns about harming the competitive process by freezing out some of the possible or likely purchasers of the assets. However, we need to be sure that, at the conclusion of the divestiture, competition has been restored to its pre-merger level, for the merger to be consistent with the public interest. Therefore, in addition to our section 203 review of the individual divestiture transactions, at the end of the divestiture process Applicants must make a compliance filing in this docket and we will review the results to be sure that concentration in the affected markets is close to pre-merger levels. If the analysis shows that the merger's harm to competition has not been sufficiently mitigated, we will require additional mitigation at that time. We will direct Applicants to make a compliance filing within 30 days of the closing of the final divestiture, with an Appendix A analysis showing the post-merger-and-divestiture market concentration levels for economic capacity in all relevant markets.

129. We are not persuaded by arguments that Applicants should have used an economic (*i.e.* least cost) allocation rather than a *pro rata* allocation of scarce transmission transfer capability in their analysis. We have accepted the *pro rata* allocation methodology in numerous merger cases, and believe it reasonably models suppliers' ability to compete in a given destination market. Moreover, in Order No. 642, we stated:

> A variety of allocation methods are possible, and the Commission has acknowledged that certain methods provide more accurate and reasonable results than others (*i.e.*, *pro-rata* as opposed to least-cost). Applicants must describe and support the method used and show the resulting transfer capability allocation.[91]

Here, Applicants have described and supported their transmission allocation methodology.[92]

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[91] Order No. 642 at 31,894.

[92] *See* Application Exhibit J-4 at p. 9.

130. Protestors raise a number of issues regarding Applicants' Available Economic Capacity analysis. We agree with protestors and Applicants that in analyzing wholesale markets in retail choice states such as New Jersey and Pennsylvania, the native load deduction for the Available Economic Capacity calculation is difficult to assess. We have stated, in a number of contexts that as states move toward retail competition, native load obligations may change so that it is part of a broader set of contractual obligations, and we encourage applicants to test the sensitivity of the Available Economic Capacity results to changes in the native load assumptions.[93] Here, Applicants have analyzed Available Economic Capacity under two different assumptions of the native load obligation and reported similar results: moderately concentrated markets with screen failures under most season/load conditions. Most importantly, in all time periods, the divestiture proposed to address the screen failures identified in the Economic Capacity analysis more than offsets the increase in concentration shown in the Available Economic Capacity analysis. We conclude that Applicants have shown that the merger, as mitigated, will not harm competition when Available Economic Capacity is used to measure suppliers' ability to compete in those markets.

131. We are not convinced by arguments that Applicants should have analyzed the merger's effect on their ability and incentive to harm competition by engaging in strategic bidding (which is a form of unilateral market power). The Commission's analysis focuses on a merger's effect on competitive conditions in the market. That is, we look at the merger's effect on the concentration of the relevant markets, as measured by the HHI. Protestors argue that the HHI solely looks for the possibility of the coordinated exercise of market power and misses the possibility of the unilateral exercise of market power. They say that Applicants have not shown that the merger will not increase the likelihood of the merged firm exercising unilateral market power. We reject this argument for two reasons. First, the Merger Guidelines recognize that the HHI does, in fact, convey information about the likelihood of the unilateral exercise of market power.[94] Second, in order to address the screen failures in various season/load conditions, Applicants have proposed divesting units with a range of operational and cost characteristics, including the types of units that protestors argue could be used to engage in strategic bidding or withholding in order to exercise unilateral market power.

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[93] *See* Order No. 642 at 31,888.

[94] Section 2.0 of the Merger Guidelines.

Furthermore, such strategic bidding or withholding could qualify as market manipulation under the Market Behavioral Rule #2[95] and result in, among other things, revocation of market-based rate authority.

132. Protestors argue that Applicants have erroneously interpreted the Commission's HHI screen as an absolute standard for merger authorization and, thus have offered mitigation that is focused solely on passing the screen, rather than on mitigating the merger-related harm to competition. We agree with protestors that the mitigation needs to preserve competition, not necessarily to restore the HHIs to avoid screen violations. There are a number of ways to mitigate increases in market power (*e.g.* generation divestiture, transmission expansion, or behavioral measures such as must-offer requirements), and we have imposed various forms of market power mitigation depending on the circumstances. Applicants' proposal to divest sufficient capacity to reduce market concentration to within the screening tolerance for increases from the pre-merger concentration level is one reasonable way to mitigate the merger-related harm to competition.[96] As stated above, the HHI conveys information about the likelihood of both the coordinated and unilateral exercise of market power. By restoring the HHI to near pre-merger levels, Applicants will restore competition to the pre-merger level, and meet their burden to show that the merger, as mitigated, will not harm competition in wholesale energy markets.

B. Adequacy of Applicants' Proposed Mitigation

133. We are not convinced by FirstEnergy's arguments that Applicants' proposed divestiture does not sufficiently mitigate the merger-related increase in market power. In both studies, FirstEnergy's witness, Ms. Frayer, understated the amount of the proposed mitigation in various seasons because she assumed a lower price in the mitigation scenario than in the post-merger-without-mitigation scenario, thus not giving credit for some of the units being divested. In short, divested units that were "economic" were incorrectly considered "uneconomic" by Ms. Frayer.

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[95] Market Behavior Rules, 105 FERC ¶ 61,218 (2003) *Order on Reh'g*, 107 FERC ¶ 61,175 (2004) Rule # 2.E "bidding the output of or misrepresenting the operational capabilities of generation facilities in a manner which raises market prices by withholding available supply from the market."

[96] We note that Applicants' analysis of the post-merger-and-mitigation market concentration shows one season/load condition for the PJM-East energy market where the change HHI is large enough to fail the Competitive Analysis Screen. As we have said in other merger cases, we do not find that borderline, non-systematic screen failures necessarily indicate harm to competition.

134. Protestors raise numerous issues regarding the effectiveness of Applicants' proposed virtual divestiture of 2,600 MW of energy from nuclear capacity. In particular, many protestors argue that the Commission should only accept actual, physical divesture as effective mitigation. However, as stated above, there are a number of possible effective market power mitigation tools, and we have recognized that different options can be reasonable for a given set of circumstances. We have recognized that operational control of generation resources is a key element of market power analysis and mitigation.[97] Here, the virtual divesture effectively transfers control of the output of 2,600 MW of nuclear capacity from the merged firm to the purchasers. That is, the merged firm cannot withhold the energy from the market and the buyer of the firm rights, not the seller, determines where and to whom the energy is ultimately sold. Applicants have committed to sell all of the energy that is offered, regardless of the price of the bids, and that an independent auction monitor will oversee Applicants' compliance with that commitment. Moreover, the liquidated damages provisions in the contracts, reduce the merged firm's incentive to withhold output to drive up wholesale energy prices because it would be contractually obligated to pay the cost of any price increase. In effect, the virtual divestiture is a must-offer provision that removes the ability to withhold output, along with a contractual provision that reduces the incentive to withhold output in order to affect market outcomes. As we have said in numerous contexts, we are concerned about a merger's effect on the merged firm's ability and incentive to harm competition.[98] Furthermore, as a condition of the Commission's approval, Applicants must agree that, if the virtual divestiture does not in fact mitigate the problems identified, Applicants will propose to the Commission mitigation that will mitigate the problems identified.

135. Protestors also object to the virtual divesture on the grounds that it will be difficult to monitor. For example, AAI notes that the antitrust agencies prefer physical divestiture because it removes the need for ongoing monitoring. We recognize that concern, but find two critical factors supporting virtual divesture as a reasonable alternative to physical divestiture. First, as we have stated in a number of cases, the operational characteristics of, and regulatory scrutiny over, nuclear units virtually eliminate the possibility of withholding output to drive up prices.[99] Second, Applicants have committed to establish an independent monitor to oversee the auction itself and Applicants' compliance with the contracts, and Applicants will establish a public compliance website that will show how

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[97] *See, e.g.*, Order No. 642 at n. 39.

[98] *See, e.g.*, Order No. 642 at 94.

[99] *Commonwealth Edison Co.*, 91 FERC ¶ 61,036 (2000).

they are complying with the virtual divestiture and other mitigation requirements. We rely on those commitments in our finding that the virtual divestiture effectively mitigates the merger-related harm to competition. We will direct Applicants to make a compliance filing within 30 days of this order, detailing the process for the selection of the independent monitor.

136. We reject arguments that Applicants may have market power in the three-year and 15-year contract markets and that they may retain control of the contracts through the New Jersey Basic Generation Service auction. First, the Commission has determined that long-term capacity markets, absent specified entry barriers, are inherently competitive.[100] No protestor has raised compelling evidence that there are significant entry barriers in the PJM markets. Second, if Applicants attempted to withhold from the three-year contract market by selling only the 15-year contracts, as hypothesized by Ameren, the purchasers of the 15-year contracts would have an incentive to sell three-year contracts in response to any price increase. Regarding the PHI Companies' argument about the New Jersey Basic Generation Service auction, Applicants have designed the three-year baseload energy auctions to support sales into the Basic Generation Service auction, but the buyers of the three-year baseload energy products will control the energy and can therefore resell them into the Basic Generation Service auction, or in some other manner. The fact that the buyers of the three-year baseload energy products may be likely to resell the energy into the New Jersey Basic Generation Service auction does not imply that the Applicants will regain control of the energy.

137. We reject FirstEnergy's assertion that Applicants will receive the same price for the virtually divested energy as they would have in the absence of mitigation. First, as argued by Applicants, under the virtual divestiture plan, Applicants will receive the price determined in the auction for the three-year life of each contract, whereas if they retained control of the output of the nuclear units, they would be able to benefit from any market price increases during the same three-year period. Second, by giving up control of

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[100] Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities and Transmitting Utilities, Order No. 888, FERC Stats. & Regs., Regulations Preambles January 1991-June 1996 ¶ 31,036 (1996), order on *reh'g*, Order No. 888-A, FERC Stats. & Regs., Regulations Preambles July 1996-December 2000 ¶ 31,048 (1997), order on *reh'g*, Order No. 888-B, 81 FERC ¶ 61,248 (1997), order on *reh'g*, Order No. 888-C, 82 FERC ¶ 61,046 (1998), aff'd in relevant part sub nom. Transmission Access Policy Study Group v. FERC, 225 F.3d 667 (D.C. Cir. 2000), aff'd sub nom. New York v. FERC, 535 U.S. 1 (2002).

6,600 MW of through the divestiture and virtual divestiture, Applicants have adequately mitigated the merger-related increase in market power. Therefore, they would not be able to raise the price of energy by other means, as the previous contracts expire, in order to raise the price they receive for the three-year contracts.

138. Protestors have argued that, the proposed energy swaps could harm competition in other geographic markets. Any such energy swaps will require section 203 authorization, and we will review the effect on competition in those proceedings. We note that swaps with suppliers in markets adjacent to PJM, such as MISO or the New York ISO, might not warrant a MW-for-MW reduction in the mitigation amount because Applicants would get control of capacity that could sell into PJM, subject to transmission constraints. In such cases, the MW reduction in Applicants' mitigation amount would be reduced by the merged firm's *pro rata* share of the import capability into PJM.

139. Likewise, we reject arguments regarding this merger's possible effect on future mergers. Future mergers will require section 203 authorizations, and we will review the effect on competition in those proceedings. We note, without prejudice to any future proceedings, that Applicants' divestiture plan will restore the concentration level in the relevant markets to within 100 HHI of the pre-merger level, so there will be little effect on future mergers.

140. The PHI Companies say that the three year baseload auction energy sales might not continue over the proposed 15-year period. In response, Applicants commit that the entire Baseload Mitigation Amount of nuclear virtual divestiture (2600 MW) will remain in place after 15 years, subject to a reduction in the mitigation amount if the Applicant's PJM East nuclear capacity is decommissioned, derated, or sold or there is construction of new transmission transfer capability into PJM East. Therefore, Applicants have adequately addressed the PHI Companies' concerns regarding the duration of the baseload auction energy sales.

141. A number of protestors argue that the Merger Policy Statement requires Applicants to identify the specific units that will be divested. In response, Applicants argue that while they cannot now identify the exact units, they do identify the location and the types of generation to be divested and the pool of generators eligible to buy. In addition, the PJM MMU states that without knowing the exact units and the buyers of those units, it could not "make a meaningful assessment of the effectiveness of the proposed divestiture," and "a supplemental analysis must be performed once a definitive declaration of the divested assets has been developed."[101] While the Merger Policy

[101] PJM MMU study at 2

Statement does state that applicants must identify the specific units to be divested,[102] in this instance, we find Applicants' proposal sufficient because the divestiture can adequately mitigate the merger-related harm to competition; moreover, once the specific units have been identified, we will be able to ensure that they are appropriate units to make divestiture effective through the subsequent compliance filing discussed above. Finally, establishing a pool of generation eligible for divestiture, rather than specifying exact units, addresses protestors' "reverse cherry picking" argument that Exelon will divest its least valuable units, rather than creating viable competitors by divesting the efficient units. Establishing a pool of generation eligible for divestiture allows the potential buyers of the plants to bid on the ones that they most highly value.

142. We note that, because of the way the PJM MMU did its analysis (using unit-specific historical energy sales and calculating HHIs for units that can relieve internal PJM constraints), it did need to know the exact plants that are going to be divested in order to assess the effectiveness of the proposed divestiture. However, under 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. Moreover, Applicants have committed to provide an Appendix A analysis of the merger's effect on competition, based on the actual acquirers of the actual divested assets, once they are known. We rely on that commitment in making our finding that the divestiture adequately mitigates any merger-related harm to competition in the relevant energy markets. If the analysis shows that the merger's harm to competition has not been sufficiently mitigated, we will require additional mitigation at that time, pursuant to our authority under FPA.

143. We find that Applicants' proposed MW-for-MW reduction of the amount of the baseload energy mitigation is reasonable. As stated earlier in this order, there are a number of reasonable market power remedies, including divesture and transmission expansion and we have relied on those remedies based on the circumstances before us. We agree with Applicants that offsets to the baseload mitigation amount for increases in transmission transfer capability into PJM East are reasonable because increasing transfer capability into PJM-East would enable competitive suppliers to defeat attempts by generators in PJM East to drive up prices by withholding output. In fact, in *OG&E*, we found that a transmission expansion was a reasonable form of mitigation for the increase

[102] We note that the Merger Policy Statement is not binding as a statute or regulation.

in market power associated with OG&E's acquisition of a rival generator.[103] 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.

144. We find that the amount of interim mitigation, along with Applicants' variable cost bid caps for the mid-merit and peaking units, mitigates the merger-related harm to competition in the relevant energy markets. First, Applicants will offer the same amount of capacity in their interim mitigation (4,000 MW of fossil and 2,600 MW of nuclear) as in their proposed physical and virtual divestiture, which, as we explained above, adequately mitigates the merger-related harm to competition. Second, the commitment to bid the fossil units at variable cost eliminates the ability to harm competition by strategic bidding or economic withholding. In addition, we find that the Cassidy Testimony describing the amount of the dispatch rights; the rights afforded the purchasers of the capacity; the terms of the master agreement for the sales; the price of the energy and capacity; the timing and duration of the interim sales; and any associated rollover provisions, adequately describes the proposal. We rely on Applicants' commitment to establish a public compliance web site that will show how they are complying with the virtual divestiture and all other mitigation requirements, including the interim mitigation plan, and require that the interim mitigation be in place upon consummation of the merger.

145. We reject arguments that we should address in this proceeding whether Applicants will pass the Commission's market-based rates screen. Any issues regarding Applicants' generation market dominance will be addressed in the pending proceeding on Exelon's triennial review filing, and in future similar proceedings.

146. NiSource's concerns about loop flows are related to ComEd's participation in the PJM RTO and power flows between the Midwest ISO and PJM, not to the merger. Therefore we will address NiSource's issues regarding loop flows in the proceeding under Docket No. EL05-103.

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[103] *OG&E* at P 32.

147. We agree with FirstEnergy's argument that transmission expansion that is required by the PJM Regional Transmission Expansion Plan should not be considered market power mitigation. As we stated in *OG&E*, changes in market conditions that are "foreseeable and reasonably certain to occur" are not mitigation.[104] Transmission upgrades, depending on where they fall in the PJM Regional Transmission Planning Process queue, can be foreseeable and reasonably certain to occur, and thus might not be considered mitigation. However, although we will accept Applicants' transmission commitments, we are not relying on them in our finding that Applicants' proposed mitigation adequately addresses the merger-related harm to competition. Rather we are relying on Applicants proposed sale of 6,600 MW of capacity to mitigate the merger-related harm to competition. As stated above, we will allow offsets to the baseload mitigation amount specifically for transmission expansions that increase import capability into PJM-East. At this time, Applicants have not proposed any new projects that would expand import capability into PJM-East. In order to grant an offset of the baseload mitigation amount, we will require Applicants to make a showing that any transmission upgrades would increase transfer capability into PJM-East, and that they were not foreseeable and reasonably certain as of June 2005. H-P Energy argues that Applicants' commitment of $25 million towards transmission expansion projects may supplant transmission projects being built by merchant transmission companies. Applicants have addressed that concern, in part, by committing not to attempt to supplant any of the three projects identified by H-P Energy. In addition, we note that the PJM Regional Transmission Expansion Plan process identifies numerous transmission projects that could be undertaken by merchant transmission providers as well as other transmission providers and generators looking for interconnection. There are considerably more projects identified than undertaken in a given year. Therefore, we accept Applicants' commitment to fund $25 million of transmission expansion projects and their commitment to avoid supplanting any of the H-P Energy identified projects. To avoid supplanting any other bidder seeking to fund any other project on PJM's list of Economic Projects over the next five years, Applicants are required to bid only on those projects identified but not undertaken by any other entity. Additionally, we will require that Applicants follow all other procedures under the PJM Regional Transmission Expansion Plan for any transmission expansion projects.

148. Regarding FirstEnergy's argument that Applicants have not demonstrated that their proposed internal corporate restructuring is consistent with the public interest, we note that, absent concerns about transfers of generation assets from unregulated merchant generating companies to regulated franchised utilities we expressed in *Cinergy*[105] and

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[104] *Id.*

[105] *Cinergy Services Inc., et al.*, 102 FERC ¶ 62,128 at 63,345 (2003).

Ameren[106], the Commission has held that internal reorganizations will not result in harm to competition.[107] Here, Applicants have committed that there will be no transfers of generation assets from unregulated merchant generating companies to regulated franchised utilities. We rely on that commitment in finding that that internal corporate restructuring will not result in any harm to competition in any relevant market. In addition, as discussed *infra*, Applicants have committed to hold wholesale customers harmless from any merger-related costs so the internal reorganization will not adversely affect wholesale rates. Moreover, the internal restructuring will not adversely affect this Commission's or any state commission's ability to regulate the merged company. Therefore, we find that Applicants have shown that their proposed internal corporate restructuring is consistent with the public interest.

C. Capacity Markets

1. Applicants' Analysis

149. Dr. Hieronymus also analyzed the effect of the merger on capacity markets in PJM-East and Expanded PJM. For PJM-East, he assumed the same 7,300 MW import capability as in his analysis of economic capacity. He reports that Exelon's and PSE&G's pre-merger shares of capacity in PJM-East are 18 and 25 percent respectively and that the merger would increase market concentration from 1,282 to 2,196 HHI, well above the Commission's screening threshold for highly concentrated markets. For Expanded PJM, he assumed the same 7,500 MW import capability as in his analysis of economic capacity. He reports that Exelon's and PSE&G's pre-merger shares of capacity in Expanded PJM are 15 and 8 percent respectively and that the merger would increase market concentration from 799 to 1,044 HHI, above the Commission's screening threshold for moderately concentrated markets. He states that Applicants need to divest 5,300 MW of capacity in PJM-East to eliminate the screen failures and restore market competition to the pre-merger level.[108]

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[106] *Ameren Energy* at 61,142.

[107] *See* Order No. 642 at 31,902.

[108] Dr. Hieronymus finds that because PJM East is located within Expanded PJM, the capacity divestiture in PJM East would be effective mitigation for Expanded PJM and sufficiently reduce market concentration.

150. PSE&G's witness, Mr. Frame, analyzed the effect of the merger on competition in PJM-East and capacity markets. For PJM-East, he assumes the same 7,300 MW import capability as in his analysis of economic capacity. He reports that Exelon's and PSE&G's pre-merger shares of capacity in PJM-East are 16.8 and 24.0 percent, respectively, and that the merger would increase market concentration from 1,127 to 1,932 HHI, well above the Commission's screening threshold for highly concentrated markets. For capacity markets, he assumed the same 7,500 MW import capability. He reports that Exelon's and PSE&G's pre-merger shares of capacity in Expanded PJM are 15.0 and 8.0 percent respectively and that the merger would increase market concentration from 687 to 926 HHI, within the Commission's screening threshold for moderately concentrated markets.

151. As described above, Applicants commit to divest 2,900 MW of capacity in PJM-East in order to address the peak and screen failures identified in the analysis of economic capacity in PJM-East. Therefore, they state that they will need to mitigate an additional 2,400 MW of capacity, which they refer to as the "Capacity Mitigation Amount." Applicants propose bidding into the PJM monthly and annual Planning Year capacity auctions the lesser of the Capacity Mitigation Amount or the entire net Unforced Capacity Position in PJM less 100 MW.[109]

152. Applicants note that PJM is restructuring its capacity market, which may change relevant geographic capacity markets that could be affected by the merger. They commit to make a filing with the Commission 30 days after the closing of the merger in which they will make any necessary adjustments to their capacity market mitigation and will demonstrate the effect of that mitigation on PJM's restructured capacity markets.

153. Exelon's witness, Dr. Hieronymus, analyzes the effect of the merger, given Applicants' proposed capacity mitigation, and finds that the merger does not harm competition in the PJM capacity markets. For PJM-East, with mitigation, market concentration is 1,380, within 100 HHI of the pre-merger concentration, within the Commission's tolerance for moderately concentrated markets. For Expanded PJM, with mitigation, the capacity market is unconcentrated. Dr. Hieronymus concludes that Applicants' proposed mitigation eliminates any harm to competition indicated by the screen failures in his analysis of PJM capacity markets.

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[109] Applicants explain that they may not have the full 2,400 MW available to bid into the PJM-East capacity market because the capacity might otherwise be committed. They state that they need to retain a small amount of uncommitted capacity in order to hedge the risk of fluctuations in their POLR obligation. Application at 39.

154. PSE&G's witness, Mr. Frame, also finds that the proposed mitigation would eliminate the harm to competition in PJM capacity markets indicated by the screen failures. In his analysis of the PJM-East capacity market, he concludes that 4,614 MW of capacity would need to be divested in PJM-East and that no divestiture is necessary in Expanded PJM in order to restore market concentration to within the Commission's tolerance level. Therefore, he finds that the proposed 5,300 MW of capacity mitigation more than offsets the harm to competition resulting from the merger.

2. Protests

155. FirstEnergy argues that Applicants would own around 60 percent of the capacity and they could use that capacity to raise prices and otherwise exercise market power. Therefore, FirstEnergy states that that the Commission should direct Applicants to file an analysis of the effects of the forthcoming capacity markets, which are subject to redesign by PJM, and explain how Applicants' proposed mitigation will effectively deter the exercise of market power in those markets. In the alternative to a follow-up filing, FirstEnergy states that the Commission should set this matter for hearing.

156. First Energy's witness, Ms. Frayer, also reviewed and assessed Applicants' proposed capacity market mitigation, and concluded that Applicants' proposal is inadequate to mitigate their post-merger market power in PJM capacity markets. Ms. Frayer finds that Applicants would need to divest up to an additional 4,650 MW (above the 2,900 MW that Applicants have committed to divest) to mitigate market power in the PJM-Expanded capacity market, after the commencement of the single capacity market in June 2005. She also finds that Applicants would need to divest up to an additional 2,721 MW (above the 2,900 MW that Applicants have committed to divest) to mitigate market power in the PJM-East capacity market, after the establishment of local capacity markets.

3. Applicants' Answer

157. Regarding Applicants' proposed capacity market mitigation, protestors argued that despite their commitment to bid up to 2,400 MW of capacity into the PJM daily capacity auction at a zero price, Applicants could still have incentive to withhold any other capacity in order to drive up the market-clearing price. In response, Applicants have committed to bid all of their uncommitted capacity at zero, which, they assert, will remove any economic incentive they may have had to withhold capacity in order to increase the market clearing price.

4. The PJM MMU Study

158. The PJM MMU stated that it analyzed the aggregate capacity market as well as defined locational capacity markets. It analyzed the aggregate capacity market using actual market data and total capacity. It analyzed locational capacity markets using total and incremental capacity, where incremental capacity includes only those units whose increased output would relieve the relevant transmission constraint. The PJM MMU notes that the structure of the capacity market makes for an extremely inelastic demand curve for capacity, and one needs to account for this fact in an analysis of the competitive impacts of the proposed merger.

159. The PJM MMU found the pre-merger PJM capacity credit markets to exhibit moderate levels of concentration in the daily capacity credit market and high levels of concentration in the monthly and multimonthly capacity credit markets. It found the average HHI for the daily capacity credit market to be 1,233 with a minimum of 820 and a maximum of 2,500. HHIs for the longer term monthly and multimonthly capacity credit markets averaged 2,125 with a minimum of 841 and a maximum of 4,151. The PJM MMU found the post-merger HHI in the daily capacity credit market to average 1,389, an increase of 156 points from the pre-merger value. Post-merger HHIs for the monthly and multi-monthly capacity credit market averaged 2,149, for an increase of 24 points from the pre-merger average.

160. The PJM MMU also evaluated the market structure for total capacity in the aggregate PJM market, and the PJM East and PJM Mid-Atlantic regional capacity markets. The results showed that the merger caused HHI increases of 314 and 241 points for the Total PJM pre- and post-Dominion markets, respectively, 501 for the PJM Mid-Atlantic market, and 1,120 to 1,810 points for the PJM East market, depending on assumptions made for imports. The results also showed that post-merger market concentration is moderate in total PJM and PJM Mid-Atlantic, and high in PJM East, and that there is a single pivotal supplier in every case.

161. The PJM MMU states that, given the potential for a locational capacity market in eastern PJM, it performed an additional analysis for this market to more accurately reflect the incremental way in which a locational capacity market would clear. The results of the locational incremental analysis for eastern PJM show the pre-merger HHI to be in the moderate range with a single pivotal supplier. The proposed merger resulted in an HHI change of over 100 points.

162. The PJM MMU found that the proposed merger results in an HHI increase that exceeds the threshold specified in the Merger Guidelines for both the aggregate and local capacity markets. The merger therefore raises concerns about potential adverse competitive effects, absent mitigation. The PJM MMU states that the merging companies' proposal to offer capacity at a zero price represents a from of behavioral

mitigation that would resolve the issue if properly structured. It states that the companies' proposal must be structured so that it would provide the required mitigation for a variety of capacity market designs, given the current uncertainty about the ultimate design. If the capacity market were restructured so that all participants were required to offer all capacity into the market, it explains, the companies' proposal would have to cover all capacity offered to the market (where the market would include the monthly and multi-monthly auctions, as well as the daily market).

5. Protestors' Responses to Applicants' Answer and the PJM MMU Study

163. First Energy argues that Applicants proposal to bid all of their capacity at $0 will give them incentive to sell their capacity in the monthly ("term") market for capacity, thus rendering their capacity mitigation ineffective. Moreover, FirstEnergy argues that the PJM MMU has expressed serious concerns about market power in PJM capacity markets. Therefore, FirstEnergy requests that the Commission condition the merger on Applicants not acquiring any additional generation within PJM until two years after the implementation of the restricted capacity markets, and on Applicants submitting a compliance filing once PJM's capacity design is restructured, showing that they do not have market power in relevant capacity markets.

164. NJBPU argues that plant retirements can be a form of withholding to increase capacity market prices in a manner that would be profitable for the merged entity, but that would be riskier and less or unprofitable for PSE&G on a standalone basis. It states that the PJM MMU shares the concern that retirement may be a form of withholding. PJM itself is struggling with this issue and has not yet set policy much less had implementation experience. NJBPU discusses retirement policy including the need for a policy to "ensure that retirements are not used to exercise market power,"and PJM's need for a "clear retirement policy," with a "test for market power".[110]

6. Applicants' Answer to Protestors' Responses to Applicants'Answer and the PJM MMU Study

165. With respect to capacity markets, Applicants argue that the PJM MMU study effectively endorses Applicants capacity market mitigation. The PJM MMU study concludes that the proposal to offer capacity at a zero price represents a form of behavioral mitigation that would resolve the capacity market power issue if properly structured. Applicants note the PJM MMU's concern that this mitigation might not work

[110] NJBPU Response at 16, *Generator Retirement WG*, Joseph Bowring, PJM Market Monitoring Unit Manager. May 11, 2004.

for other capacity market structures adopted by PJM in the future. In response, Applicants note that they have committed to proposing a new capacity market mitigation plan for the Commission's approval 30 days after the closing of the Merger, when the details of the new PJM capacity markets should be known.

166. Applicants also dismiss Ms. Frayer's assertion that they will circumvent their zero-bid proposal in the daily capacity market by bidding into term capacity markets. Applicants state that to the extent that they attempt to increase the term market price by withholding capacity from that market, the other market participants will know that the Applicants are required to offer their uncommitted capacity into the daily capacity market at a price of zero. As a result, if the price in the term markets were to exceed competitive levels as a result of withholding by the Applicants, participants in those markets can simply refuse to purchase term capacity from Applicants and instead purchase the capacity that the Applicants must offer into the daily market at a price of zero. Thus Applicants state that the requirement to bid capacity into the daily market at a price of zero mitigates market power in both the daily and term capacity markets.

7. Commission Determination

167. Applicants have shown that the merger, with the mitigation proposed, will not harm competition in any relevant capacity market. In addition to the physical divestiture of 4,000 MW of generating capacity, Applicants have committed to bid all of their uncommitted capacity at zero. Therefore, they will have no ability to withhold capacity in order to increase the market clearing price. As noted by the PJM MMU, Applicants' proposal to offer capacity at a zero price represents a form of behavioral mitigation that would resolve the capacity market power issue if properly structured. We share the PJM MMU's concern that this mitigation might not work for other capacity market structures adopted by PJM in the future. Therefore, when the Commission approves a new capacity market for PJM, we will require Applicants to submit a new analysis of the merger's effect on the PJM capacity market and, if the analysis shows that the merger-related harm to competition is not fully mitigated, propose a new mitigation plan for the Commission's approval within 30 days of any such approvals.

D. Ancillary Services

1. Applicants' Analysis

168. Applicants state that the merger will not harm competition in any relevant ancillary services markets. They state that PJM does have markets for spinning reserves and regulation services, and therefore analyze competition in those markets. Dr. Hieronymus states that Exelon and PSE&G have 6 and 39 percent shares of the Mid-Atlantic spinning reserve capability, respectively.[111] He estimates that the market is moderately concentrated with a merger-related increase of 507 HHI. He finds that a divestiture of 147 MW of spinning reserve capacity would be necessary to bring the effect of the merger within the Commission's tolerance level. Dr. Hieronymus concludes that Applicants' proposed divestiture of 2,900 MW of fossil-fired generation capacity, some of which is capable of providing spinning reserves, will sufficiently mitigate the merger-related harm to competition in the spinning-reserve markets. PSE&G's witness, Mr. Frame, comes to the same conclusion, based on his review of the available PJM data.

169. Dr. Hieronymus also reviews the most recent available data for the PJM regulation market. He reports that the market is moderately concentrated, with Exelon and PSE&G holding 13 and 12 percent shares of the 2,011 MW of regulation-capable capacity in the Mid-Atlantic zone of PJM respectively. Therefore, the merged firm will have approximately 25 percent of the regulation-capable capacity (approximately 500 MW) in PJM Mid Atlantic Area Council (PJM MAAC), more than half of which is pumped-storage capacity, which he argues is generally an uneconomic source of regulation. He notes that the merged firm will not be a pivotal supplier of regulation services because there are more than 1,500 MW of competing supply able to serve a peak load of approximately 700 MW. He concludes that the merger will not harm competition in the PJM regulation market. PSE&G's witness, Mr. Frame, notes that the 2003 PJM Market Monitor Unit Report states that within PJM MAAC, there are 113 generating units capable of providing 2,011 MW of reserve capacity, and that in 2003, regulation requirements in PJM MAAC ranged from 220 MW to 750 MW. He concludes that because the regulation market demand can be met more than two times over by alternative suppliers at the peak, and by a far greater amount during the off-peak, the merger will not harm competition in the PJM regulation market.

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[111] He estimates the total market capability for spinning reserves in the Mid-Atlantic market as 3,033 MW, with Exelon and PSEG have 196 and 1,191 MW of spinning-reserve capable capacity, respectively. The numbers are from the 2001 PJM Market Monitoring Unit Report on Spinning Reserve Market.

170. Mr. Frame describes the ancillary services markets in PJM and states that there are two spinning reserve products offered in PJM: Tier 1 and Tier 2. He states that Tier 1 spinning reserves are provided by the unloaded capacity of steam generating units that have been bid into the PJM energy market, but have not been called on to produce energy. He concludes that because the provision of Tier 1 spinning reserves is essentially a by-product of participating in the energy markets, the merger's effect on competition in the Tier 1 spinning reserves market will not materially differ from the merger's effect on competition in energy markets. He concludes that because Applicant's proposed divestiture will mitigate any merger-related harm to competition, it will also mitigate any harm to competition in the Tier 1 Spinning PJM reserve market.

171. Mr. Frame states that Tier 2 spinning reserves are used when Tier 1 reserves are exhausted, and, historically, have been provided by hydroelectric units and combustion turbines with condensing capacity. He states that PSE&G and Exelon currently control 1,191 and 196 MWs of capacity capable of providing Tier 2 spinning reserves within the MAAC region of PJM, respectively.[112] He argues that the Applicants' proposed divestiture will likely offset any merger-related increase in the concentration of the Tier 2 spinning reserves market, because Applicants plan to divest more than 196 MWs of generation capacity capable of providing Tier 2 spinning reserves, so the merged firm will have a smaller share of the market than PSE&G's pre-merger share.

172. FirstEnergy questions Applicants' conclusion that the merger will not adversely affect competition in ancillary services markets. FirstEnergy's witness, Ms. Frayer, argues that Dr. Hieronymus has not supported his assertion that regulation and spinning reserves prices are intrinsically linked to energy market prices. She further argues that, because Applicants have not specified the exact units that will be divested, it is premature to conclude that the proposed mitigation plan for energy also satisfies ancillary services market concerns.

2. PJM MMU Study

173. The PJM MMU states that its merger analysis focuses on the Mid-Atlantic Regulation Market as the spinning reserves market most likely to be affected by the merger. It states that its results are based on 12 months of actual spinning reserves market data through March 31, 2005.

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[112] Mr. Frame notes that Tier 2 spinning reserves is procured on a cost basis in other PJM regions.

174. The PJM MMU calculated hourly HHI values based upon regulation offered, regulation offered and eligible, and regulation assigned as follows: Average HHI for pre-merger regulation offered – 1,692; Average HHI for regulation offered and eligible – 1,772; and Average HHI for regulation assigned – 2,497. The post-merger analysis is based on actual regulation market data for the twelve months that ended March 31, 2005, modified to combine the ownership of PSE&G and Exelon resources into a single company. The average post-merger HHI for regulation offered was 1,795, for a change of 103 points, for regulation offered and eligible it was 1,900, for a change of 128 points, and for regulation assigned it was 2,628, for a change of 131 points.

175. The PJM MMU states that the analysis of the regulation market shows that the proposed merger results in an increase in HHI that exceeds the increase specified in the Merger Guidelines. It states that the proposed merger would significantly increase concentration in the regulation market as defined by these metrics and the standards of the Merger Guidelines and therefore raises concerns about potential adverse competitive effects, absent mitigation. It bases its conclusion on the 128 point increase in average HHI for offered and eligible regulation. The PJM MMU states that mitigation of the merger effects could be provided by an application of existing PJM market rules to the PJM Mid-Atlantic Regulation Market; the merged company could agree to offer its regulation capability into the market at cost-based levels. It states that as an alternative, the merged company could agree to offer its regulation capability into the market at cost-based rates. The PJM MMU further notes that the anticompetitive effects of the merger could be mitigated by divestiture of regulation resources in the Mid-Atlantic Regulation Market, but that it is not possible to evaluate the Applicants' proposed divestiture plan without knowing which units would be divested.

176. The PJM MMU states that its merger analysis focuses on the Mid-Atlantic Regulation Market as the spinning reserves market most likely to be affected by the merger. Its results are based on 12 months of actual spinning market data through March 31, 2005. The PJM MMU analyzed the Tier 2 spinning reserve market (where Tier 2 resources include units that are backed down to provide spinning capability and condensing units synchronized to the system and available to increase output). It found the pre-merger average HHI to be 4,651 and the average post-merger HHI to be 4,671, a change of 20 points. The PJM MMU states that the proposed merger results in an increase in the HHI that is less than that specified in the Merger Guidelines, and that the merger does not raise competitive concerns in the spinning reserves market. The PJM MMU's analysis differs in two ways from the Commission's Delivered Price Test. Its analysis includes all regulation capability offered into the market without regard to cost. In addition, its analysis includes all regulation offered by each supplier, while the Delivered Price Test uses the gross supply by participants net of their load obligation.

3. Commission Determination

177. We recognize that ancillary service market data are not as readily available as that for energy and capacity markets. As such, we find Applicants' reliance on the PJM Market Monitor Reports to be a reasonable way of analyzing the effect of the merger on competition in those markets. Moreover, while pivotal supplier and market share analyses are not part of the Commission standard review in section 203 cases, we find them informative here, given the lack of sufficient data for complete analysis of the merger's effect on the ancillary service market concentration.

178. We find that the merger, as mitigated, will not harm competition in PJM ancillary services markets. Applicants have shown that there are numerous supply alternatives in the PJM ancillary services market. In addition, the divestiture of fossil units in PJM will include units capable of providing spinning reserves and regulation services. Applicants' analysis shows that their proposed divestiture will reduce their control of capacity able to supply ancillary services to less than the pre-merger level, under reasonable assumptions regarding the units that are ultimately divested. In addition, the PJM MMU found that the anticompetitive effects of the merger could be mitigated by divestiture of regulation resources in the Mid-Atlantic Regulation Market, where almost all of the fossil units Applicants have proposed divesting are located. Regarding FirstEnergy's concern that it is premature to conclude that the proposed mitigation plan for energy also satisfies ancillary services market concerns because Applicants have not specified the exact units that will be divested, as we stated regarding the mitigation for energy markets, Applicants have committed to provide an analysis of the merger's effect on competition, based on the actual acquirers of the actual divested assets, once they are known. We rely on that commitment in making our finding that the divestiture adequately mitigates any merger-related harm to competition in the relevant ancillary services markets. If the analysis shows that the merger's harm to competition has not been sufficiently mitigated, we will require additional mitigation at that time.

E. Vertical Market Power Issues

1. Applicants' Analysis

179. Applicants address the effect of combining their transmission and generation assets. They state that the only transmission owning entities involved, ComEd, PECO, and PSE&G, have all transferred operational control over their transmission facilities to the PJM RTO. Applicants state that the Commission has held on a number of occasions that such a transfer to a fully-functioning, Commission-approved RTO addresses the possibility of abuse of transmission market power.[113]

180. Applicants also address the concern that the transaction will allow them to obtain some control over the PJM decision-making process. They state that the transaction will have no effect on the makeup of PJM's independent Board of Directors. Applicants further state that with respect to the Members, Reliability, and Electricity Market Committee, PECO, the voting member for Exelon, and PSE&G, the voting member for PSE&G, are both in the Transmission Owners sector, which has a 20 percent voting interest in the committees. Applicants expect that the transaction will result in the Exelon and PSE&G votes combining into a single vote, increasing EE&G's voting interest from 10 percent (the current share for each of PECO and PSE&G) to 11 percent. They argue that this increase of 1 percent in a voting sector that has a total 20 percent voting interest is *de minimis*. They also note that even this change will be negated if Dominion Virginia Power joins the Transmission Owner Sector.

181. Applicants state that, with respect to the PJM East Transmission Owner's Agreement, voting rights are counted both based on individual members and on a weighted basis. A two-thirds vote in each category is required to approve all major changes, and at least three opposition votes are required to defeat any major change. They state that EE&G's increased share of individual member votes will be *de minimis*, going from one-in-nine to one-in-eight under the PJM East Transmission Owner's Agreement, and from one-in-14 to one-in-13 if the East, West, and South Transmission Owner's Agreements are consolidated into a single agreement, as is currently under consideration. Applicants note that EE&G's weighted share will go up more significantly, but provisions limiting the weighted vote of an individual transmission owner to a maximum of 25 percent and requiring a two thirds vote on each an individual and a weighted basis protect other transmission owners from EE&G's increased weighted share. EE&G will not be able to veto any proposed TOA changes because at least three individual votes are required for such block.

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[113] Application at 44 *citing Ameren Corp.*, 108 FERC at P 61.

182. Applicants also address the effect of combining their natural gas distribution and electric generation assets. PECO provides natural gas distribution service to only one electric generator, a 28 MW facility owned by Merck.[114] They note that there are two other independent generators in PECO's service area, but these generators take service directly from an interstate natural gas pipeline. Furthermore, they argue that newly built generation facilities could readily avoid PECO's small service area or connect directly to an interstate pipeline.[115] They state that PSE&G's natural gas distribution system serves eight current or former generating facilities in New Jersey under contract with the utility, as well as two merchant generators (the Tocso plant and the Williams Red Oak plant). They note that the latter facilities are served by PSE&G under long-term natural gas transportation contracts or discounted tariffs.[116] Applicants further state that both companies provide natural gas distribution services to affiliated generation facilities.

183. Applicants' witness, Dr. William Hieronymus, states that no vertical market power concerns arise as a result of the transaction's combination of natural gas distribution facilities and electric generation assets. This is because new generation can connect to one of EE&G's Local Distribution Companies (LDCs) or directly interconnect with a pipeline system, so the local distribution company cannot impede entry by other competitors. Dr. Hieronymus further states that the simple ownership of LDCs' operations does not allow Applicants to self-deal or use other means of using gas LDCs to favor affiliated activities. He notes that distribution tariffs are regulated by the state public utility commissions, which impose open access distribution requirements. Further, the ability to earn even ceiling rates in distribution tariffs is frequently constrained by bypass alternatives or the existence of long-term contracts.

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[114] Application at 46.

[115] *Id.* at 46-47.

[116] *Id.* at 47.

184. Dr. Hieronymus states that other vertical concerns are not present because both Pennsylvania and New Jersey have in place codes of conduct between gas and electric affiliates; both utilities are governed by the Commission's Order No. 2004;[117] and the amount of generation served is so small that knowledge of customers' operations is of no commercial value to electric generators. He conducted the analysis required under section 33.4 of the Commission's regulations, analyzing the downstream markets for PJM East, PJM Pre-2004, and Expanded PJM. He notes that the Commission has found that market power in both the upstream natural gas market and the downstream electric market is necessary for a vertical market power problem. After accounting for Applicants' mitigation commitments, he found that neither the PJM Pre-2004 nor the Expanded PJM downstream markets are highly concentrated post-merger. However, the PJM East market remains highly concentrated post-mitigation,[118] so he analyzed the PJM East upstream market, consistent with the Commission's regulations.[119] He found this market not to be highly concentrated and concludes that competitive conditions will not be conducive to a vertical foreclosure strategy.

185. PSE&G's witness, Mr. Frame, also concludes that the combination of Applicants' natural gas and electric generation resources would not harm competition. He states that neither Exelon nor PSE&G owns any interstate natural gas pipelines and that the natural gas facilities owned by their affiliated LDCs are available to electric generators on a state regulated open access basis.

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[117] *Standards of Conduct for Transmission Providers*, Order No. 2004, FERC Stats. & Regs., Regulations Preambles ¶ 31,155 (2003), *order on reh'g*, Order No. 2004-A, III FERC Stats. & Regs. ¶ 31,161 (2004), 107 FERC ¶ 61,032 (2004), *order on reh'g*, Order No. 2004-B, III FERC Stats. & Regs. ¶ 31,166 (2004), 108 FERC ¶ 61,118 (2004), *order on reh'g*, Order No. 2004-C, 109 FERC ¶ 61,325 (2004), *order on reh'g*, Order No. 2004-D, 110 FERC ¶ 61,320 (2005).

[118] Hieronymus testimony at 72.

[119] Revised Filing Requirements, FERC Statutes & Regulations ¶ 31,111 at 31,904.

2. Protests

186. The AAI asserts that membership in an RTO is not sufficient to ensure that sellers will not be able to exercise vertical market power through their ownership of transmission, citing a show cause order in which the Commission initiated an investigation of Exelon regarding alleged sharing of non-public information regarding maintenance outages.[120]

187. No party contests Applicants' description of the PJM governance structure. The PHI Companies assert, however, that EE&G might be positioned to exert undue influence on the PJM RTO as a result of its holding the largest transmission investment in PJM.

188. Protesters dispute Applicants' claim that they will not be able to exercise vertical market power in the natural gas market. Direct Energy asserts that Applicants' analysis is flawed for two reasons. First, Applicants use data that incorrectly represents interstate pipeline capacity deliverable to relevant markets, and says Applicants omitted capacity served in eastern Pennsylvania (in PJM East) in their calculation of Columbia Gas Transmission and Texas Eastern Transmission pipeline's deliverability from Pennsylvania to New Jersey and from New Jersey to Delaware, respectively. Direct Energy claims that as a result, Applicants have understated Columbia Gas and Texas Eastern's contribution to the PJM East gas market. Direct Energy also claims that Applicants have overestimated the size of the PJM gas market by incorrectly counting as deliveries in PJM gas that goes through PJM, but is ultimately delivered in New York and New England. Direct Energy's witness, Dr. Briden, states that as a result, Applicants' analysis understates the concentration in the upstream natural gas market, which he claims will be highly concentrated after the merger.[121]

189. The POCA expresses concern regarding EE&G's 35.6 percent share of natural gas transportation capacity in the PJM East market. It states that with one party controlling a substantial amount of a capacity in such a constrained market, the exercise of market power could result in significantly increased gas costs to other LDCs and marketers in that market.[122] The Commission should examine the amount of capacity that EE&G

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[120] AAI Protest at 17, citing Exelon Corporation, PECO Energy Company, Exelon Generation Company, L.L.C., and Exelon Power Team, Show Cause Order, 97 FERC ¶ 61,009, October 3, 2001.

[121] Briden Testimony at 7-8.

[122] POCA Protest at 22-23.

would hold on individual pipelines, as many LDCs in the Northeastern markets are captive to one or two pipelines. EE&G may be able to withhold capacity and raise natural gas prices.

190. The Division of the Ratepayer Advocates also expresses dissatisfaction with Applicants' analysis of the natural gas market. Division of the Ratepayer Advocate states that the Application does not address horizontal market power issues that may result from the merger of the PHI Companies' and PSE&G's gas capacity assets, the potential for aggregating additional power by providing asset management services for third parties, or the effect of such activities on various markets. Division of the Ratepayer Advocate says that with the Applicants holding 35.6 percent of available capacity in the PJM East market area, any additional control of gas capacity resources (for example, through asset management agreements) would place the Applicants in a position to exert market power through various actions.[123] Division of the Ratepayer Advocate's witness, LeLash, further states that Applicants fail to provide information concerning the control of storage capacity held by the entities holding the interstate transportation entitlements.[124] The City of Philadelphia echoes the concern that Applicants could abuse their market power in the transportation of natural gas to gain a competitive advantage in the relevant natural gas distribution markets.[125]

191. Three protesters (FirstEnergy, Direct Energy, and POCA) express concerns that concentration in the upstream and downstream markets may allow the exercise of market power. FirstEnergy states that post-mitigation, the upstream PJM East market is at least moderately concentrated and the PJM East downstream market is highly concentrated. Direct Energy adds that because both the upstream and downstream markets will be highly concentrated after the merger, the proposed merger raises vertical market power concerns for which Applicants offer no mitigation."[126] Direct Energy's witness, Dr. Briden, suggests mitigation in the form of a transfer of a share of Applicants' natural gas pipeline capacity to third party marketers not affiliated with Applicants. The POCA states that Applicants should not dismiss as irrelevant the failure to pass the downstream portion of the vertical market power test (in PJM East), because the ability to affect

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[123] Division of the Ratepayer Advocate Protest at 16.

[124] LeLash Testimony at 4.

[125] City of Philadelphia Protest at 7.

[126] Direct Energy Protest at 8.

electricity prices through the control of natural gas supply or delivery could result in increased prices to all consumers, particularly since gas-fired plants operate on the margin and often set the market-clearing price in PJM.

3. Applicants' Answer

192. Applicants reply to AAI's protest by stating that the Commission never found any violations in the proceedings that AAI cite. They conclude that AAI has presented no basis for concluding that the Commission should change its policy regarding RTO membership. They similarly dismiss, as mere speculation, the PHI Companies' assertion that Applicants will be able to exert influence on PJM.

193. Applicants address concerns regarding the effect of the merger on the upstream natural gas market by restating their assertion that the transaction will not create a new situation where the combined entity could increase electric prices by denying gas supplies to other participants. Applicants state that because of their substantial divestiture commitment, they will have less Available Economic Capacity in the downstream electric market than they do today and that the upstream market will not be highly concentrated post-merger. Applicants' witness, Dr. Hieronymus, answers protests that he calculated the HHI incorrectly by stating first that capacity that is bound for New York or New England is often sold into PJM East. Further, Dr. Hieronymus states that Direct Energy calculated upstream HHIs incorrectly by failing to remove Applicants' northern-bound capacity in their calculations. He also states that Dr. Briden incorrectly calculates "others" share in the HHI calculations as the sum of their market shares, quantity squared, as opposed to the sum of the squares of the individual market shares. Correcting for these errors, he states, the upstream HHI is 1,651, so there are no vertical market power concerns.[127]

194. Applicants address protesters' concerns regarding the storage market by stating that Applicants own no storage capacity and contract for relatively small amounts (less than 12 percent) of PJM's storage capacity. They state that because their share of storage capacity is smaller than their share of pipeline capacity, the storage market raises no vertical concerns.

[127] Hieronymus at 45.

4. Protestors' Response to Applicants' Answer

195. With regard to natural gas, the NJBPU states that it is concerned that the availability of spot market, short-term interruptible transportation in a market with peak period deliverability constraints is inadequate for new generation project developers and their lenders. It further argues that the Commission must decide whether the total pipeline capacity controlled by the Applicants will serve as a barrier to entry.[128]

196. Direct Energy repeats its claim that Applicants overstated the size of the PJM East natural gas market. With respect to the purported error in the "others" category of his HHI calculation, Direct Energy witness Briden states that Dr. Hieronymus made the same mistakes in Exhibit J-16 of his original testimony.

197. With regard to electric transmission, the NJBPU agues that Applicants' membership in PJM does not, by itself, ensure that their ownership and control of major electric transmission systems cannot be used to favor affiliated generation or hinder competing suppliers. The NJBPU remains concerned that influence in favor of corporate objectives may skew the projects that are built and stymie competing projects that could help other suppliers.

5. Commission Determination

198. Applicants have shown that the combination of their generation and transmission facilities will not harm competition. Applicants have, pre-merger, transferred operational control over their transmission facilities to PJM, and the Commission has held, on a number of occasions, that such transfer mitigates the ability to use control of transmission assets to harm competition in wholesale electricity markets. We agree with Applicants that AAI's protest does not provide a basis for concluding that the Commission should change its policy regarding RTO membership.[129]

199. Applicants have shown that that the proposed merger will not allow them to control PJM. While no party contests Applicants' description of PJM's governance structure, the PHI Companies speculate that Applicants might be able to exert "undue influence" on PJM as a result of holding the largest transmission investment in PJM. However, it does not explain how this would happen.

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[128] NJBPU Response at 19.

[129] See, *e.g.* AEP/CSW at 61,788.

200. Applicants have shown that the combination of their generation and natural gas distribution facilities will not harm competition. In Order No. 642, we stated that in order for a merger to create or enhance vertical market power, both the upstream and downstream markets must be highly concentrated.[130] Applicants' witness, Dr. Hieronymus, has shown that, given the mitigation, the downstream markets are not highly concentrated after the merger. Moreover, he has shown that the upstream market is not highly concentrated. Applicants have shown that protesters' claims to the contrary result, in part, from selective omission of relevant capacity, an assertion that protesters do not counter. Dr. Hieronymus' Exhibit J-16 clearly shows the "others" market share to be 16.7 percent, and their contribution to HHI to be 19. Had he used the calculation method Dr. Briden attributes to him, his contribution to HHI for "others" would have been 279 points, not 19.

201. We disagree with NJBPU's assertion that Applicants will be able to foreclose new generation entry. Neither company owns interstate pipeline facilities, so this is not a convergence merger comparable to those in which the Commission has identified vertical market power issues as a result of the combination of electric and gas utilities. While Applicants do own natural gas LDCs through PECO and PSE&G, they do not own interstate transportation facilities. Potential entrants seeking fuel supplies can opt for a direct connection to the interstate pipelines serving the relevant markets rather than Applicants' LDCs. Therefore, the merger does not give Applicants the ability to impede entry of gas-fired generating facilities.

202. Applicants have also shown that their presence in the natural gas storage market is small enough not to raise competitive concerns here. Applicants do not own storage facilities, and estimate their contracted share of the storage market to be less than 12 percent. Therefore, they would have little ability to influence downstream electricity prices.

203. With regard to the POCA's and the Division of the Ratepayer Advocates' concerns regarding horizontal effects in the natural gas market, we note that, under section 203 of the FPA, we consider the effects of an increase in concentration in the upstream market to the extent that it could harm competition in wholesale electricity markets. Here, as noted above, Applicants have shown that both the upstream and downstream markets are not highly concentrated, thus the horizontal upstream combination will not harm competition in the relevant downstream wholesale electricity markets.

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[130] Order No. 642 at 31,911 (emphasis added).

F. Effect on Rates

1. Applicants' Analysis

204. Applicants state the transaction will not adversely affect the rates for any wholesale power or transmission customers. First, Applicants commit to hold transmission customers harmless from any increase in Commission-jurisdictional transmission rates to the extent that such costs exceed demonstrated savings related to the transaction. Applicants further state that no wholesale power rates will be affected because, of the three franchised utilities involved in the merger (ComEd, PECO and PSE&G), only ComEd has any wholesale requirements customers, and Applicants commit to hold ComEd's customers harmless from any merger-related costs that exceed demonstrated merger-related benefits. Exelon and PSE&G's remaining customers are charged market-based rates that will not be affected by the seller's cost of service and, thus, will not be affected by the merger.

2. Protests

205. The POCA says that the PJM OATT would allow the Applicants to file surcharges mechanisms or formula rates that might allow transmission rates to increase without reflecting the benefits of the merger.[131]

206. Dowagiac states that without proper mitigation, consumers will face both power and transmission cost increases as a result of the proposed merger. Dowagiac argues that the proposed mitigation measures are long-term and complex and will allow numerous opportunities for Applicants to exercise market power. It is also skeptical of Applicants' pledge to protect current consumers from price increases as a result of the proposed merger. Dowagiac states that, regarding the ComEd and PECO merger, ComEd and PECO "pledged not to let financial injury fall on Dowagiac... [which is] now paying SECA charges of $1,107.83/MW- month to ComEd for PJM service."[132] Therefore, based on the current merger proposal and Exelon's history in past mergers, Dowagiac argues that the Commission should condition the approval of the proposed merger on the fulfillment of all conditions associated with the ComEd and PECO merger. Specifically, Dowagiac requests that Exelon be directed to protect Dowagiac against any possible financial injury resulting from either the current merger proposal or the ComEd/PECO merger.

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[131] POCA Protest at 33-34.

[132] Dowagiac Protest at 5.

3. Applicants' Answer

207. In response to protestors' assertions that the merger would harm wholesale competition in PJM, thus, adversely affecting wholesale electricity rates, Applicants state that they have already addressed those concerns with the proposal to mitigate any merger-related harm to wholesale competition. In addition, in order to address the POCA's concern that Applicants' hold harmless commitment is inadequate, Applicants clarify that their hold harmless agreement allows for no surcharge or formula rate that would allow them to recover merger-related costs unless those costs were offset by merger-related savings.[133]

208. In response to Dowagiac's protest regarding through-and-out transmission rates related to ComEd's participation in the PJM RTO, Applicants argue that Dowogiac's complaints are not related to the merger and should be addressed in Docket No. EL02-111 or another appropriate forum.[134]

4. Responses to Applicants' Answer

209. H-P Energy argues that Applicants should not be able to use the automatic cost recovery provisions of Schedule 12 of the PJM OATT without meeting all of the safeguards and procedures of Schedule 12. They state that the safeguards contained in Schedule 12 ensure that mandatory charges imposed on market participants are just and reasonable, and that Applicants have not justified bypassing any of those Commission-approved safeguards.[135]

5. Commission Determination

210. The Commission finds that Applicants have shown that the transaction will not adversely affect wholesale rates. We rely on Applicants' hold harmless commitment for transmission rates in making this finding. In addition, wholesale power rates will not be adversely affected by the merger because, only ComEd has any wholesale requirements customers and Applicants commit to hold ComEd's customers harmless regarding any

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[133] Applicants' Answer at 74.

[134] In Docket No. EL02-111, the Commission opened a section 206 proceeding to investigate the issue of rate pancaking between PJM and the Midwest ISO and to determine whether the transmission rates were just and reasonable.

[135] H-P Energy Protest at 18.

merger-related costs that exceed demonstrated merger-related benefits. We rely on Applicants' hold harmless commitment in finding that wholesale customers' rates will not be adversely affected by the merger. Applicants' other wholesale customers are charged market-based rates that will not be affected by the seller's cost of service and, thus, will not be affected by the merger.

211. We agree with H-P Energy that Applicants should not be able to use the automatic cost recovery provisions of Schedule 12 of the PJM OATT. Applicants shall make the appropriate filings under section 205 of the FPA, related to cost recovery of any transmission expansion projects. Finally, we find that Dowagiac's arguments regarding through-and-out transmission rates will be addressed in the complaint filed under Docket No. EL02-111.

G. Effect on Regulation

1. Applicants' Analysis

212. Applicants state that the transaction will not adversely affect federal regulation. They state that the transaction will not result in the formation a new holding company under PUHCA that would preempt the Commission's jurisdiction. They note that the transaction will bring PSE&G into the Exelon registered holding company system, and the Applicants commit to waive the pre-emptive effects of the Securities and Exchange Commission's jurisdiction on this Commission under *Ohio Power*.[136]

213. Applicants state the transaction will not adversely affect state regulation. They have filed for approval from the Pennsylvania Public Utility Commission (PaPUC) and the NJBPU, both of whom will therefore be able to protect their own jurisdiction. Applicants state that while the Illinois Commission does not have jurisdiction over the transaction, it does have jurisdiction to regulate ComEd, and they have filed notice of the transaction with the Illinois Commission. They further state that after the merger is complete, ComEd's ownership will not change; it will remain an operating company within a registered holding company system. They conclude that the transfer will not have any effect on regulation of ComEd under Illinois law and that ComEd will remain under the jurisdiction of the Illinois Commerce Commission.

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[136] *Ohio Power Co. v. FERC*, 954 F.2d 779 (D.C. Cir. 1992)(*Ohio Power*).

2. Protests

214. POCA argues that while Applicants submitted their application to the PaPUC, Applicants argued that the PaPUC lacks jurisdiction over this merger and only requested approval of the PaPUC in the alternative. Therefore, POCA requests that the Commission examine the potential adverse impact of the proposed merger on state regulation. Since this proposed merger would create one of the nation's largest public utility holding companies and presents significant market power issues with a novel and untested mitigation proposal, POCA requests that the Commission investigate all issues related to the proposed merger by establishing further discovery, a hearing and access to further filings to determine if the proposed merger satisfies the Commission's guidelines and is in the public interest.

215. Citizen Power, *et al.* raises concerns about the merger's effect on power markets in general, and, in particular, the NJBPU's regulatory authority, if the PUHCA is repealed.[137]

3. Applicants' Answer

216. In response to the POCA's concerns about the effect of the merger on state regulation in Pennsylvania, Applicants argue that the merger will not affect the structure of PECO, the one affected utility that is under the PaPUC's jurisdiction. They further note that the PaPUC has intervened in the proceeding before the Commission, but has not raised any concerns regarding the effect of the merger on its regulatory authority or requested that the Commission address that issue. In response to Citizens Power, *et al.*'s concerns about the effect of the merger on regulation if PUHCA is repealed, Applicants argue that the NJBPU can address any issues related to PUHCA repeal in the merger proceeding before it. In addition, they note that the NJBPU has not requested that Commission assist it on this issue.

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[137] Citizen Power notes that, because PSEG is headquartered in New Jersey, where it conducts the bulk of its utility business, it is not part of an interstate holding company, and PSEG's utility transactions are regulated by the New Jersey BPU. Citizen states that if PSEG is "swallowed up" by Exelon, a multi-state holding company, the NJBPU will lose its ability to protect New Jersey customers. Citizen Protest at 5.

4. Commission Determination

217. We find that the merger will not adversely affect Commission or state regulation. We rely on Applicant's commitment to follow the Commission's *Ohio Power* policy in finding that the merger will not adversely affect Commission regulation. Applicants have shown that the transaction will not harm any state's ability to regulate any of the merging parties. The merger is subject to review by the NJBPU, who can therefore protect its jurisdictional interests. We note that the PaPUC has intervened in the proceeding before the Commission, but has not requested that the Commission address any issues regarding the effect of the merger on its regulatory authority. Furthermore, the PaPUC, the Illinois Commerce Commission, and the NJBPU will retain regulatory authority over the merged company. We note that none of the affected state commissions have requested that the Commission address the effect of the merger on state regulation.

The Commission orders:

(A) Applicants' proposed merger and internal restructuring is hereby authorized, subject to Commission acceptance of the Applicant's compliance filings, as discussed in the body of this order.

(B) The foregoing authorization is without prejudice to the authority of the Commission or any other regulatory body with respect to rates, service, accounts, valuation, estimates or determinations of costs, or any other matter whatsoever now pending or which may come before the Commission.

(C) Nothing in this order shall be construed to imply acquiescence in any estimate or determination of cost or any valuation of property claimed or asserted.

(D) The Commission retains authority under sections 203(b) and 309 of the FPA to issue supplemental orders as appropriate.

(E) Applicants shall make any appropriate filings under section 205(a) of the FPA, as necessary, to implement the proposed Transaction.

(F) Applicants must submit their proposed final accounting within six months of the consummation of the merger. The accounting submission should provide all merger-related accounting entries made to the books and records of PSE&G, along with appropriate narrative explanations describing the basis for the entries.

(G) Applicants shall make a compliance filing to the Commission within 30 days of the completion of their divestiture, providing an Appendix A analysis of the merger's effect on competition in energy and capacity markets, given actual plants and

assets divested and the actual acquirers of the divested assets. If the analysis shows that the merger's harm to competition has not been sufficiently mitigated, Applicants must propose additional mitigation at that time.

(H) Applicants shall make a compliance filing to the Commission within 30 days of this order showing that they have established an independent monitor to oversee the baseload energy auction and Applicants' compliance with the terms of the energy contracts; and that they have established a public compliance website the showing how they are complying with the virtual divestiture and other mitigation requirements, including the interim mitigation.

(I) Applicants shall notify the Commission within 10 days of the date that the merger has been consummated.

By the Commission.

(S E A L)

Magalie R. Salas,
Secretary.

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

ORIGINAL

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

UNPUBLISHED AUTHORITIES
CITED IN
INITIAL BRIEF OF JOINT APPLICANTS,
PECO ENERGY COMPANY
AND
PUBLIC SERVICE ELECTRIC AND GAS COMPANY

Date: October 14, 2005

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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

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AND
PUBLIC SERVICE ELECTRIC AND GAS COMPANY

Date: October 14, 2005

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PENNSYLVANIA
PUBLIC UTILITY COMMISSION
Harrisburg, PA 17120

Public Meeting Held January 10, 1991

Commissioners Present:

William H. Smith, Chairman
Joseph Rhodes, Jr., Vice Chairman
Frank Fischl, Commissioner
Wendell F. Holland, Commissioner
David W. Rolka, Commissioner

Application of New York State Electric & Gas Corporation; Request for Approval of Abandonment of Electric Service	Docket Nos. A-93538 A-110001,F.200
Requests for Approval of the Purchase of the Stock of Columbia Gas of New York, Inc. and Transactions Involving its Subsidiaries	A-110001,F.500 A-110001,F.001 A-110001,F.002
Petition of New York State Electric & Gas Corporation for a Declaratory Order	P-900488

O R D E R

BY THE COMMISSION:

On December 12, 1990, New York State Electric & Gas Corporation (NYSEG) filed an application with the Commission at A-110001,F.200 requesting approval of the abandonment of electric service to the public in Pennsylvania, certificated at A-93538. In support of its application, NYSEG alleges that it originally applied for and was granted a certificate of public convenience to assure its ability to exercise the power of eminent domain in constructing an electric transmission line in Pennsylvania. Because of changes in the law, NYSEG alleges that its certificate is no longer necessary. NYSEG requests that Commission review of its abandonment application be made contingent upon granting of its petition for declaratory order relating to whether, as a federally regulated utility, it requires a certificate from the Commission under Section 1101 of the Public Utility Code, 66 Pa. C.S. §1101, prior to exercising the power of eminent domain in Pennsylvania

under the Business Corporation Law of 1988, (BCL), 15 Pa. C.S. §§1101, et seq.

Abandonment and Related Applications

NYSEG is a New York corporation primarily engaged in the generation and distribution of electricity and gas in the state of New York. NYSEG and Pennsylvania Electric Company (Penelec) are co-owners of an electric generating facility in Indiana County, Pennsylvania. Each utility is entitled to half of the capacity of the generating station and each is individually responsible for transmission of its electricity from the generating station to its respective retail customers. NYSEG transmits its power interstate from the generating station to its New York service territory by way of a 345 kV transmission line. NYSEG's interstate production and transmission of this electricity is regulated by the Federal Energy Regulatory Commission (FERC).

On May 1, 1967, at the time of construction of NYSEG's transmission line, the Commission entered an order granting the application of NYSEG at A-93538 for a certificate of public convenience authorizing the provision of electric service within 87.5 feet of the center line of the transmission line -- essentially only NYSEG's right-of-way. Moreover, the Commission order expressly prohibited NYSEG from serving any Pennsylvania customer without receiving specific Commission approval.

NYSEG has never requested or been granted authority to serve any Pennsylvania customer. The transmission line is utilized solely to transmit electricity out-of-state -- a FERC regulated activity. Nevertheless, NYSEG continues to make certain regulatory filings with the Commission required of Commonwealth utilities. In fact, NYSEG presently has three Section 1102 financial filings as identified in the caption to this order, pending before the Commission requesting approval of various business transactions related solely to its business in New York state. Since NYSEG does no intrastate business in Pennsylvania, it has no intrastate revenues and does not pay an annual assessment to the Commission; accordingly, the Commission's activities related to regulating NYSEG are inappropriately funded by legitimate Commonwealth electric utilities.

Clearly, NYSEG is not a public utility in Pennsylvania in that it does not provide electric service "for the public for compensation." 66 Pa. C.S. §102. Therefore, it is inappropriate for the Commission to continue to expend its resources regulating NYSEG and approval of NYSEG's abandonment application is appropriate. Approval of this application will have no effect on NYSEG's operation of its electric generating station or on its transmission line in Pennsylvania. Since NYSEG has never conducted any intrastate business in Pennsylvania, approval of the

application does not represent any substantive change in NYSEG's operations. Simultaneously, consistent with this decision, we will dismiss the three Section 1102 filings currently pending as docketed above.

Petition for Declaratory Order

Upon Commission approval of abandonment, NYSEG would no longer have a certificate of public convenience under 66 Pa. C.S. §1101 certifying it as a Commonwealth public utility. NYSEG's petition for declaratory order requests the Commission to declare that NYSEG is not required to hold a certificate under Section 1101 of the Public Utility Code as a condition to exercising the power of eminent domain pursuant to the BCL as a federally regulated utility.

Section 1511(a) of the BCL, 15 Pa. C.S. §1511(a), confers the power of eminent domain upon every "public utility corporation." A "public utility corporation" is defined as follows at 15 Pa. C.S. §1103: (Emphasis added).

> "Public utility corporation." Any domestic or foreign corporation for profit that:
>
> (1) is subject to regulation as a public utility by the Pennsylvania Public Utility Commission or an officer or agency of the United States; or
>
> (2) was subject to such regulation on December 31, 1980 or would have been so subject if it had been then existing.

Accordingly, utilities providing intrastate utility service subject to the jurisdiction of the Commission and utilities providing interstate service utilizing facilities in Pennsylvania subject to the jurisdiction of a federal agency are conferred the power of eminent domain.

Section 1104 of the Public Utility Code, 66 Pa. C.S. §1104 provides as follows:

> §1104. Certain appropriations by right of eminent domain prohibited
>
> Unless its power of eminent domain existed under prior law, no domestic public utility or foreign public utility authorized to do business in this Commonwealth shall exercise any power of eminent domain within this Commonwealth until it shall have received the

certificate of public convenience required by section 1101 (relating of organization of public utilities and beginning of service).

A "foreign public utility authorized to do business in this Commonwealth" would normally be considered a utility incorporated in another state which is authorized by its corporate papers to conduct business in Pennsylvania regardless of whether or not that business is jurisdictional to the Commission. See §102 of the Associations Act, 15 Pa. C.S. §102, and Section 4125 of the BCL, 15 Pa. C.S. §4125. However, a certificate of public convenience is issued pursuant to Section 1101 authorizing the commencement of Commonwealth public utility service within the jurisdictional limits established by Section 102 of the Public Utility Code, 66 Pa. C.S. §102. Accordingly, at first glance Section 1104 would arguably preclude the exercise of eminent domain by companies like NYSEG which do not provide jurisdictional public utility service but are authorized and do conduct business in the Commonwealth -- in this case interstate electric service subject to the jurisdiction of FERC.

To take this interpretation of Section 1104, however, would render more recently enacted Section 1103 of the BCL meaningless. Section 1103 expressly confers the power of eminent domain upon utilities, like NYSEG, regulated by federal agencies. Furthermore, Section 1511(c) of the BCL requires Commission approval prior to an intrastate or interstate electric utility's exercise of eminent domain utilized for constructing transmission lines and other aerial facilities. It is clear from the language of Section 1511(c) that this approval must be secured by all electric utilities regardless of whether the utility is certificated as a Commonwealth electric utility pursuant to the Public Utility Code. Accordingly, even after approval of abandonment of its certificate of public convenience at A-93538, NYSEG would be required by Section 1511(c) of the BCL to continue to receive Commission approval prior to exercising the power of eminent domain within this Commonwealth.

Reading together relevant provisions of the Public Utility Code and the BCL, it is clear that NYSEG's petition has merit. Overall, the most reasonable interpretation of the legislative intent is that upon prior Commission approval pursuant to Section 1511(c) of the BCL, NYSEG is conferred the power of eminent domain as a federally regulated electric utility, even though it does not provide jurisdictional utility service in the Commonwealth pursuant to Section 102 of the Public Utility Code and as a result can not be certificated pursuant to Section 1101; THEREFORE,

IT IS ORDERED:

1. That NYSEG's application at A-110001,F.200 for abandonment of jurisdictional electric service certificated at A-93538 is hereby approved.

2. That NYSEG's certificate of public convenience issued at A-93538 is hereby cancelled.

3. That NYSEG's applications pending at A-110001,F.001, F.002 and F.500 are hereby dismissed for lack of subject matter jurisdiction.

4. That NYSEG's petition for declaratory order is hereby granted consistent with the discussion herein.

BY THE COMMISSION,

Jerry Rich
Secretary

(SEAL)

ORDER ADOPTED: January 10, 1991

ORDER ENTERED: JAN 17 1991

PENNSYLVANIA
PUBLIC UTILITY COMMISSION
Harrisburg, PA. 17105-3265

Public Meeting held January 27, 2000

Commissioners Present:

John M. Quain, Chairman
Robert K. Bloom, Vice Chairman
Nora Mead Brownell
Aaron Wilson, Jr.
Terrance J. Fitzpatrick

Application of United Water Pennsylvania, Inc. (United) for approval of the acquisition by Lyonnaise American Holding, Inc. (Lyonnaise) of the remaining outstanding shares of United's parent, United Water Resources, Inc., so as to change Lyonnaise from being a minority owner of United's parent to becoming the latter's sole shareholder.	Docket Nos: A-310013 F0014 A-230077 F0003

ORDER

BY THE COMMISSION:

On November 15, 1999, United Water Pennsylvania, Inc. (United) filed the above-captioned application pursuant to Chapter 11 of the Pennsylvania Public Utility Code, 66 Pa C.S. §§ 1101-1103. By its application, United seeks approval of Suez Lyonnaise des Eaux Group's (Suez Lyonnaise's) becoming, through its U.S. subsidiary, the indirect sole shareowner of United's parent, United Water

Resources, Inc. (UWR)[1]. Notice was published as required, and the protest period ended December 20, 1999 with no protests having been received.

United provides water and wastewater service to the areas of Harrisburg, Dallas and Mechanicsburg, PA, serving approximately 47,000 customers. UWR is the nation's second largest water and wastewater services company, having operations in 19 states and serving a total population of more than 7.5 million through both regulated utilities and non-regulated contract municipal operations. UWR controls United through its financing subsidiary, United Waterworks, Inc. Suez Lyonnaise, a French corporation involved in, *inter alia,* water and wastewater activities on an international scale, first gained an interest in the predecessor Pennsylvania utilities in 1994 when their then parent, General Waterworks Corporation, was merged into UWR, and Suez Lyonnaise thereby gained an approximate 26% ownership of UWR. Through its American subsidiary, Lyonnaise now owns 30.1% of the common stock of UWR and 98.1% of UWR's convertible preference shares. The remaining shares of common stock in UWR are publicly held.

Suez Lyonnaise provides water and/or wastewater services in over 100 countries worldwide, having been formed as the result of the 1997 merger of Compagnie de Suez and Lyonnaise des Eaux. It is also the world's largest private supplier of electricity and has large electric generation operations, as well. In 1998, it had revenues of over 31 billion euros ($31 billion). Approximately 30% of its capital, or 8.7 billion euros ($8.7 billion), is employed in the water or wastewater business.

[1] On January 20, 2000, shareholders of UWR granted their approval of the acquisition by Lyonnaise of its acquisition of the remaining shares of UWR.

UWR and Lyonnaise have entered into a merger agreement under which UWR will be merged with a temporary subsidiary of Lyonnaise, with UWR surviving as a wholly-owned subsidiary of Lyonnaise. United Water Pennsylvania will continue as a separate corporate entity and will continue to supply service in Pennsylvania pursuant to its currently effective tariffs and under its current name, with, avers United, no reduction in its workforce. The acquisition therefore will be transparent to customers in the Commonwealth.

The transfer of control of a majority of UWR's stock appears to offer the possibility of greater amounts of capital being available as acquisition opportunities present themselves in Pennsylvania. Also, the research and development resources of Suez Lyonnaise should allow United to make improvements in the quality of water service now provided by smaller and often undercapitalized utilities. These advantages ensure that the proposed change in control satisfies the standard set by *City of York,* 449 Pa. 136, 295 A.2d 825 (1972), that the acquisition provide an affirmative public benefit.

Consequently, we have determined that acquisition of total indirect control of United is necessary or proper for the service, accommodation, convenience, or safety of the public, and that the application should be approved; **THEREFORE,**

IT IS ORDERED:

1. That the application of United Water Pennsylvania, Inc. for approval of the gaining of complete control of the utility by a subsidiary of Suez Lyonnaise des Eaux Group is hereby approved, and that a certificate of public convenience be issued evidencing such approval.

2. That within 30 days of the consummation of the transaction approved in Ordering Paragraph No 1, above, United Water Pennsylvania, Inc. file with this Commission notice of such consummation.

3. That if the parties to the merger agreement come to determine that the proposed acquisition will not occur, the utility promptly file with this Commission notice of such determination.

BY THE COMMISSION

James J. McNulty
Secretary

(SEAL)

ORDER ADOPTED: January 27, 2000

ORDER ENTERED: February 1, 2000

1ST OPINION of Level 1 printed in FULL format.

Joint Application of Commonwealth Telephone Company, Commonwealth Long Distance Company and Paging Plus, Inc., for approval of the transfer of a majority voting interest in the stock of the utilities' direct or indirect parent, C-TEC Corporation, to RCN Corporation.

A-310800.F0006

PENNSYLVANIA PUBLIC UTILITY COMMISSION

1993 Pa. PUC LEXIS 159

October 22, 1993

CORE TERMS: stock, affiliated, grandparent, subsidiary, controlling interest, jurisdictional, wholly-owned, transfer of stock, distance, affiliate, generic, voting, public utility, Law Bureau, statutory reference, public convenience, telecommunication, certificate, investigate, convinced, customers, carrier, protest

*1

Commissioners Present: David W. Rolka, Chairman; Joseph Rhodes, Jr., Vice-Chairman; John M. Quain, Dissenting; Lisa Crutchfield; John Hanger

OPINION: OPINION AND ORDER

BY THE COMMISSION:

On October 1, 1993, Commonwealth Telephone Company ("CTCo"), Commonwealth Long Distance Company ("CLD") and Paging Plus, Inc. ("PPI") filed the above-captioned application pursuant to Chapter 11 of the Pennsylvania Public Utility Code, 66 Pa. C.S. §§ 1101, et seq.. Notice was published as required and the protest period ended October 19, 1993 with no protests having been received.

BACKGROUND

CTCo is a direct, wholly-owned subsidiary of C-TEC Corporation ("C-TEC"), a publicly-owned corporation. CLD is a direct, wholly-owned subsidiary of C-TEC Properties, Inc. ("C-TEC Properties"), which in turn is 100 percent owned by C-TEC. PPI is a direct, wholly-owned subsidiary of Cellular Plus, Inc., ("Cellular Plus") which also is 100 percent owned by C-TEC. Having been granted its initial certificate of public convenience at A-310800, CTCo is a jurisdictional utility, as are CLD (A-310071) and PPI (A-0033007). C-TEC, C-TEC Properties and Cellular Plus are not Pennsylvania utilities.

CTCo is a *2 local exchange carrier which provides service to approximately 190,000 business and residential customers in portions of 20 counties in eastern Pennsylvania. CLD is a provider of long distance service in 23 eastern Pennsylvania counties and plans to expand its service to cover all of Pennsylvania. PPI offers one-and two-way paging services to approximately

3500 customers in numerous Pennsylvania municipalities.

Certain of C-TEC's shareholders, acting as the (unincorporated) C-TEC Control Group, have entered into an agreement with RCN Corporation ("RCN") providing for the transfer to RCN of 5.7 million shares of Common Stock and Class B Common Stock of C-TEC currently owned by members of the C-TEC Control Group. The shares to be transferred constitute in the aggregate approximately 34 percent of the equity interest in C-TEC and approximately 57 percent of the voting interest in C-TEC. The planned transfer of shares representing a majority voting interest will result in a transfer of control of C-TEC, and through C-TEC's direct or indirect ownership of its three Pennsylvania utility subsidiaries, a transfer of control of CTCo, CLD and PPI. It is this latter control transfer for *3 which the applicants seek Commission approval.

JURISDICTION

Before further reviewing the Joint Application, it is necessary to address the legal question of whether the transaction before us is jurisdictional. The Joint Application states that the Applicants are of the position that the transaction is not jurisdictional based on prior Commission precedent in Application of **Airsignal International** of Pittsburgh, Pennsylvania, Inc. (Airsignal I), A-101365 (January 14, 1980) and Application of MCI Airsignal of Pennsylvania, Inc. (Airsignal II), A-330035 (July 15, 1986) and are filing this application as a courtesy to the Commission in response to an informal request.

Airsignal I (involving a transfer of a controlling interest in the stock of a utility's second tier parent or grandparent) and Airsignal II (involving the transfer of a controlling interest in the stock of a utility's parent) both held that only the transfer of utility stock may constitute the transfer of used or useful property necessary to invoke jurisdiction pursuant to Section 1102(a)(3) of the Public Utility Code, 66 Pa. C.S. § 1102(a)(3). The rationale of both Airsignal cases *4 is that the express reference in 66 Pa. C.S. Section 1102(a)(3) to affiliated interests of public utilities as defined in 66 Pa. C.S. § 2101 was intended only to establish jurisdiction over an affiliated interest's transfer of utility stock. The Airsignal cases view stock transactions at the parent or grandparent level as too remote to constitute the transfer of used or useful property.

While we agree that application of the Airsignal cases would result in a lack of jurisdiction over the instant transaction involving the transfer of stock of the C-TEC as ultimate parent of three utilities, we would emphasize that the Airsignal cases, as any other prior Commission decision, are subject to reconsideration at any time. 66 Pa. C.S. § 703(g). Accordingly, we will exercise our discretion and review interpretation of Section 1102(a)(3) at this time.

Section 1102(a)(3) provides as follows in relevant part:

(3) For any public utility or an affiliated interest of a public utility as defined in section 2101 (relating to definition of affiliated interest), except a common carrier by railroad subject to the Interstate Commerce Act, to acquire from, or to transfer to, any person *5 or corporation, including a municipal corporation, by any method or device whatsoever, including the sale

or transfer of stock and including a consolidation, merger, sale or lease, the title to, or the possession or use of, any tangible or intangible property used or useful in the public service . . . .

Our attention is specifically drawn to the express reference to transactions involving affiliated interests of utilities. While it is unclear in the statute what level of stock transaction constitutes the transfer of used or useful property, we are not convinced by the rationale of the Airsignal cases. If the intent of the statutory reference to affiliated interest transactions was intended only to establish jurisdiction over an affiliate's transfer of utility stock, the reference would be unnecessary and meaningless since even without the reference, all transfers of a controlling interest in utility stock are jurisdictional regardless of whether the transferor or transferee is an affiliate. Clearly, the better interpretation is that the statutory reference to an affiliated interest's transaction applies jurisdiction to the transfer of stock of either a utility or of its *6 parent or grandparent affiliates, regardless of the remoteness of the transaction, if the effect of such transaction is the transfer of control of the utility.

Furthermore, from a practical view, the transfer of equity control of a utility parent or grandparent can directly affect the management of the utility. Stockholders exercising a controlling interest in a parent or grandparent can affect the Board of Directors, utility personnel and utility management philosophy and can ultimately have a direct effect on the cost and quality of service to the public. Accordingly, we are convinced that the General Assembly intended that the Commission have jurisdiction over these types of stock transactions and through this order will reverse the Airsignal cases as they apply to the case at hand.

Although we will assert jurisdiction over this transaction, it is necessary to clarify this interpretation of Section 1102(a)(3) on a generic basis. Accordingly, we will direct the Law Bureau to investigate procedures to implement our decision today on a generic basis, through either regulatory or legislative procedures, and report back to us with its conclusions.

EFFECTS OF THE PROPOSED *7 TRANSFER

RCN is a recently-formed corporation whose principal activity has focused on the instant transaction. It is a direct wholly-owned subsidiary of Kiewit Diversified Group, Inc. ("KDG"), all of whose stock is owned by Peter Kiewit Sons', Inc. ("PKS"). PKS is an employee-owned corporation with consolidated revenues of over $2 billion and is engaged in a variety of different industries, including telecommunications.

Through KDG, PKS controls MFS Communications Company, Inc., which provides telecommunication services to other long distance carriers and large end users, and operates fiberoptic networks in 14 cities in 11 states. Metropolitan Fiber Systems of Philadelphia, Inc., and Metropolitan Fiber Systems of Pittsburgh, Inc. were granted certificates of public convenience on March 5, 1991 at A-310004 and A-310005, respectively.

For its C-TEC stock, the C-TEC Control Group is to receive approximately $196 million in cash, a sum which appears to be readily available to the purchasers. At June 30, 1993, KDG has $956 million of cash and temporary investments, and

long- and short-term debt totalling only $66 million. The Kiewit companies thus seem to possess sufficient financial *8 strength to fund the immediate acquisition.

There appears to be no diminution of service to Pennsylvania ratepayers stemming from the proposed transfer of control nor will the transaction itself lead to any increase in the rates charged for utility services.

The Commission has examined the instant application and has determined that the proposed transfer of control appears necessary or proper for the service, accommodation, convenience or safety of the public, and that the application should be approved; THEREFORE,

IT IS ORDERED:

1. That the joint application of Commonwealth Telephone Company, Commonwealth Long Distance Company and Paging Plus, Inc., concerning the transfer of a majority voting interest in C-TEC Corporation is hereby approved, and that a Certificate of Public Convenience evidencing such approval be issued.

2. That the Law Bureau is hereby directed to investigate procedures to implement this Order on a generic basis through either regulatory or legislative procedures and report back its conclusions within 30 days of the entry date of this Order.

3RD OPINION of Level 1 printed in FULL format.

Joint Application of Paging Network of Pittsburgh, Inc. and Paging Network of Philadelphia, Inc. for approval of the transfer of approximately 32.6% of the common stock of the utilities' parent, Paging Network, Inc.

A. 330013, F.0005 (Corrected)

PENNSYLVANIA PUBLIC UTILITY COMMISSION

1993 Pa. PUC LEXIS 161

October 29, 1993

CORE TERMS: partners, transfer of stock, common stock, de facto, subsidiary, regulated, stock, transfers of stock, public convenience, ownership interest, rates charged, jurisdictional, wholly-owned, certificate, operational

*1

Commissioners Present: David W. Rolka, Chairman; Joseph Rhodes, Jr., Vice-Chairman; John M. Quain; Lisa Crutchfield; John Hanger

OPINION: OPINION AND ORDER

BY THE COMMISSION:

On July 19, 1993, Paging Network of Pittsburgh, Inc. (PageNet-PGH) and Paging Network of Philadelphia, Inc. (PageNet-PHL) filed the above-captioned application seeking commission approval, pursuant to Chapter 11 of the Public Utility Code, 66 Pa. C.S. §§ 1101 et seq., of the transfer of approximately 32.6% of the common stock of the utilities' parent, Paging Network, Inc. (PageNet, Inc.)

Summary

In their filing, the applicants have stated that the 32.6% interest in PageNet, Inc. constitutes de facto control of PageNet, Inc., and of PageNet-PGH and PageNet-PHL. We agree with the applicants and will grant approval of the transfer of control of the two Pennsylvania utilities.

Background

PageNet-PHL was granted its original certificate of public convenience at A-330644.F001 and is currently authorized to provide intrastate land mobile radio service to portions of 23 counties in eastern and central Pennsylvania. PageNet-PGH was granted its original certificate of public convenience at A-330013.F001 *2 and is currently authorized to provide similar service to portions of 17 counties in western Pennsylvania. Both utilities are direct, wholly-owned subsidiaries of PageNet, Inc., which is not a Pennsylvania jurisdictional utility.

PageNet, Inc. is a publicly-held organization whose common stock is regularly traded over-the-counter in transactions reported by NASDAQ. As of the date of filing, 10,941,438 shares of PageNet, Inc.'s common stock were owned by The Golder Thoma Fund (the Fund) a limited partnership having approximately 20 partners. The Fund's holding constitutes approximately 32.6% of the outstanding common stock of PageNet, Inc. Except for the Fund and the Chairman of PageNet, Inc. who owns approximately 6.6%, no other person appears to own as much as 5% of PageNet, Inc.'s stock.

The Fund plans to distribute its shares, from time to time and over a undetermined period of time, to its individual partners. Each of the partners owns stock in PageNet, Inc. as a result of a prior distribution from the Fund. Such direct holding by the partners aggregate not more than 3.5 million shares or approximately 10.4% of the outstanding shares.

The applicants further state that *3 the proposed distribution by the Fund will result in no change in the officers or directors of PageNet, Inc., and, by implication, no such changes at the two Pennsylvania utilities, PageNet-PGH and PageNet-PHL. Moreover, the applicants have stated that because there will be no change in management or in the operations of the jurisdictional utilities, there will be no adverse effect upon the service provided or the rates charged to customers of the utilities.

Discussion

In their application, applicants have asserted that the Fund, as a consequence of its 32.6% ownership interest, possesses and has exercised de facto control over PageNet, Inc. and, by extension, over the two wholly-owned Pennsylvania utilities. The applicants seek approval of the distribution of PageNet, Inc. stock since they view such distribution as a transfer of control of the utility subsidiaries from the Fund to shareholders of PageNet, Inc., generally. We agree with the applicants that the transfer of de facto control of PageNet, Inc. will result in the transfer of used or useful utility property, placing the transaction within the purview of 66 Pa. C.S. § 1102(a)(3).

Furthermore, as *4 we recently found in Application of **Commonwealth Telephone** Company, et al. (**A-310800 F.0006**, order entered October 22, 1993), the fact that a transfer of control of a utility is effected by the transfer of stock in the utility's parent does not remove the transaction from our jurisdiction. Overall, it is our view that any transfer of de facto control, whether at the utility or grandparent level, ultimately constitutes the transfer of used or useful property.

We have also reviewed certain substantive matters in connection with the proposed transfers of stock, and it appears that there will be no operational changes that would require us to withhold our approval of the transfer of control of PageNet-PGH and PageNet-PHL. The transfers of stock will result in the individual partners of the Fund becoming direct rather than indirect owners of the parent, PageNet, Inc., and the parent's ownership interest in the Pennsylvania utilities will be unaffected. The applicants have further averred that no changes in management of either the parent or of the Pennsylvania utilities are expected as a result of the transfer, nor will there be any operational changes. Therefore, the *5 transfer will not in itself lead to any diminution of service to Pennsylvania subscribers nor to any change

in rates charged for those services.

Having examined the instant joint application, the Commission has determined that the proposed transfer of control appears necessary or proper for the service, accommodation, convenience or safety of the public, and that the application should be approved; THEREFORE,

IT IS ORDERED:

1. That the joint application of Paging Network of Pittsburgh, Inc. and Paging Network of Philadelphia, Inc. for approval of the transfer of approximately 32.6% of the common stock of the utilities' parent, Paging Network, Inc., is hereby approved.

2. That Paging Network of Pittsburgh, Inc. and Paging Network of Philadelphia, Inc. file with this Commission following the end of each calendar quarter a joint report showing the number of shares of Paging Network, Inc. stock that were transferred from The Golder Thoma Fund during the quarter, together with a calculation of the Fund's remaining interest in Paging Network, Inc. at the end of the quarter. This filing requirement will terminate following notice to the Commission that the total transfer has been completed. *6

STATEMENT OF COMMISSIONER JOHN M. QUAIN

This Commission must provide direction to all members of the regulated community regarding which financial transactions fall within our jurisdiction. This is particularly true with regard to the telecommunications industry which is experiencing dramatic change in its business operations. Nevertheless, the exercise of our jurisdiction must be based upon the statutory authority set forth in the Public Utility Code. Exercising jurisdiction over the transaction before us, in my view, clearly oversteps that authority.

The facts before us concern the transfer of a 32.6% interest in PageNet, Inc. to a variety of investors. PageNet is the parent corporation of PageNet-PGH and PageNet-PHL, which are Pennsylvania regulated utilities. The parent corporation is not a Pennsylvania utility. Thus, the issue before us is: whether the transfer of a minority interest in the parent corporation of a regulated utility requires a Certificate of Public Convenience from this Commission?

It is suggested that at 66 Pa. C.S. § 1102(a)(3) provides this Commission with ample authority to exercise jurisdiction over such matters. I strongly disagree.

The *7 focus of § 1102(a)(3) is the transfer or title, use or possession of property used or useful in the public service. That is to say, property held by the public utility. The transaction at issue clearly will not result in any transfer of title, use or possession of any asset of the regulated subsidiaries. By contrast, it is the transfer of stock at the parent level.

Fundamental principles of corporate law require that we view separate corporations as separate entities. Hence, the transfer of stock of a parent is not equivalent to the transfer of stock of a subsidiary. Consequently, I view the proposed transaction as not subject to our jurisdiction.

PENNSYLVANIA
PUBLIC UTILITY COMMISSION
Harrisburg, PA. 17105-3265

Public Meeting held January 24, 2001

Commissioners Present:

John M. Quain, Chairman
Robert K. Bloom, Vice Chairman
Nora Mead Brownell
Aaron Wilson, Jr.
Terrance J. Fitzpatrick

Joint Application of Pennsylvania American Water Company (PA America) and Citizens Utilities Water Company of Pennsylvania (Citizens) for the approval of the commencement by PA American of water service in the certificated territory of Citizens; the transfer by sale of substantially all the water utility property of Citizens to PA American; the abandonment by Citizens of water service to the public; and certain additional regulatory approvals.

Docket Numbers:
A-212285 F0074
A-211070 F2000

ORDER

BY THE COMMISSION:

On April 11, 2000, Pennsylvania American Water Company (PA American) and Citizens Utilities Water Company of Pennsylvania (Citizens) filed a Joint Application seeking a Certificate of Public Convenience pursuant to Sections 1102(a)(1)(i) and (3) of the Public Utility Code, 66 Pa. C.S. §1102(a)(1)(i) and (3) seeking Commission approval of the commencement by PA American of water service in the certificated territory of Citizens; the transfer by sale of substantially all the water utility property of Citizens to PA American; the abandonment by Citizens of water service to the public; and certain additional

regulatory approvals. PA American and Citizens are current on their assessments and have no outstanding fines.

Philadelphia Suburban Water Company and the Office of Consumer Advocate filed Petitions for Intervention in the foregoing proceeding. However, the Petitions were later withdrawn and ALJ Cohen's November 27, 2000 Interim Order referred the proceedings back to the Bureau of Fixed Utility Services for appropriate action.

PA American, a wholly-owned subsidiary of American Water Works Company, Inc. (AWW) currently furnishes public water service to nearly 498,630 residential customers in portions of 31 counties across the Commonwealth. Citizens, a wholly-owned subsidiary of Citizens Utility Company (CUC) furnishes public water service to nearly 33,550 customers in Eastern and Southcentral Pennsylvania.

During the third quarter of 1999, CUC adopted a plan to divest all its water, wastewater, gas and electric assets and operations to focus on its telecommunications business. Accordingly, on October 15, 1999, CUC announced an agreement to sell all its water and wastewater assets to AWW and AWW's designated subsidiaries.

To implement the proposed sale of Pennsylvania operations, Citizens and CUC entered into an Asset Purchase Agreement (Agreement). Pursuant to the Agreement, all of Citizens water utility property and rights will be purchased and acquired by PA American. Additionally, PA American and AWW agreed to assume three series of Industrial Development Revenue Bonds (IDRBs). As of the date of the Agreement, the aggregate unpaid amount of IDRBs was $52,900,000.

The total purchase price, $152,280,000 as of the date of the Agreement, consists of the assumption of the outstanding IDRBs and a $98,380,000 cash payment for the balance. As of December 31, 1999, the balance sheet value of Citizen's assets was $111,679,223. The purchase price will be adjusted to reflect changes occurring between the date of the Agreement and date of closing in the recorded value of Citizen's assets and the outstanding balance of IDRBs.

PA American will finance the cash purchase price to be paid for Citizen's assets through the issuance of debt. PA American states it will request by separate filings all necessary Commission approvals under Chapters 19 and 21 of the Public Utility Code.

Pursuant to the Agreement, Citizens will transfer to PA American, or to an affiliated financing corporation, unamortized debt expenses related to the IDRBs and will transfer to PA American other deferred capital costs and other deferred charges attributable to Citizens' assets as delineated in Exhibit "P" of the instant application. PA American is requesting for approval to record, after closing, the deferred expenses and costs set forth in Exhibit "P" of the instant application, as regulatory assets. We agree with this treatment for accounting purposes, but not for ratemaking purposes.

Prior to closing on the proposed sale of Citizens assets, Citizens may have one or more applications, other than the instant Application, pending before this Commission. Accordingly, PA American is requesting approval to succeed to the interests of Citizens in and under such applications, to declare PA American to be the real party in interest thereunder and to authorize and direct the amendment of such applications to reflect PA American as the applicant therein effective upon the date of closing of the transactions under the Agreement. We require that if Citizens

has any pending application as of the date of closing, PA American file an amendment letter to reflect the change in applicant.

The proposed transaction will have no immediate adverse effect on the rates of customers of Citizens. PA American will file a tariff supplement adopting the rates contained in Citizen's tariff in effect on the date of closing.

Approval of the transfer is requested due to the following reasons:

(A) Focus on water service – CUC is divesting all non-telecommunications assets. PA American's primary focus is water service.

(B) Reduced exposure to unrelated businesses – PA American's acquisition will reduce financial and market risks associated with CUC's electric, gas and wastewater operations.

(C) Size and financing capability – Citizen's customers will be served by a large and financially sound company with the capability to finance any necessary capital additions. As of December 31, 1999, PA American's total permanent capitalization was $1.1 billion.

(D) Economies of scale and scope – given its size and association with AWW, PA American enjoys significant economies of scale and scope.

(E) Enhanced customer service – Citizen's customers will benefit from enhanced customer services such as more payment options and longer customer service and call center hours.

(F) Excellent geographic fit – the geographic proximity facilitates integration of Citizen's properties into existing operations and creates opportunities for functional and operational consolidation.

These advantages ensure that the proposed transfer of control provides an affirmative public benefit and satisfies the standard set by City of York v. Pa. P.U.C., 449 Pa. 136, 295 A.2d 825 (1972).

Upon full consideration of all matters of record, we find that approval of this Joint Application is necessary and proper for the service, accommodation and convenience of the public; **THEREFORE,**

IT IS ORDERED:

1. That the commencement by Pennsylvania American Water Company of water service in the certificated territory of Citizens Utilities Water Company of Pennsylvania is hereby approved.

2. That the transfer by sale of substantially all the water utility property of Citizens Utilities Water Company of Pennsylvania to Pennsylvania American Water Company is hereby approved.

3. That the abandonment by Citizens Utilities Water Company of Pennsylvania of water service to the public is hereby approved.

4. That the transfer by Citizens Utilities Water Company of Pennsylvania to Pennsylvania American Water Company, or to an affiliated financing corporation, of unamortized debt expenses related to the IDRBs, and other deferred capital costs and other deferred charges attributable to Citizens Utilities

Water Company of Pennsylvania's assets as delineated in Appendix "P" of the instant application, be recorded after closing as regulatory assets for accounting purposes, but not for ratemaking purposes.

5. That if as of the date of closing of the proposed transaction, Citizens Utilities Water Company of Pennsylvania has any pending applications, Pennsylvania American Water Company file with the Secretary's Bureau an amendment letter pertaining to each Citizens Utilities Water Company of Pennsylvania pending application to reflect the change in applicant as referred to in paragraph 27 of the instant application within five days after closing.

6. That within 30 days of the consummation of the transaction approved in Ordering Paragraph No 2, above, Pennsylvania American Water Company file with this Commission: (a) notice of such consummation, (b) a tariff adoption supplement effective on 1-day's notice incorporating the tariff of Citizens Utilities Water Company of Pennsylvania, and (c) a summary of the final financial terms of the sale and any related accounting entries.

7. That upon receipt of the tariff adoption supplement as required under Ordering Paragraph No. 6, above, a certificate of public convenience be issued evidencing the approvals granted in Ordering Paragraphs 1, 2 and 3, above.

8. That upon receipt of the tariff adoption supplement as required under Ordering Paragraph No. 6, above, the Secretary's Bureau shall remove the tariff of Citizens Utilities Water Company of Pennsylvania from the active utility list and mark closed all records with respect to Citizens Utilities Water Company of Pennsylvania, and the Assessment Section of the Bureau of Administrative Services shall delete Citizens Utilities Water Company of Pennsylvania from the active utility list.

9. That if the parties determine that the proposed merger will not take place, Citizens Utilities Water Company of Pennsylvania so notify this Commission promptly.

BY THE COMMISSION

James J. McNulty
Secretary

(SEAL)

ORDER ADOPTED: January 24, 2001
ORDER ENTERED: January 24, 2001

PENNSYLVANIA
PUBLIC UTILITY COMMISSION
Harrisburg, PA 17120

Public Meeting held October 6, 2005

Commissioners Present:

Wendell F. Holland, Chairman, Statement attached
James H. Cawley, Vice Chairman
Bill Shane
Kim Pizzingrilli
Terrance J. Fitzpatrick

Joint Application of SBC Communications, Inc., and AT&T Corp. Together with its Certificated Pennsylvania Subsidiaries for Approval of Merger	A-311163F0006 A-310213F0008 A-310258F0005

OPINION AND ORDER
(Non-Proprietary Version)

TABLE OF CONTENTS

I. HISTORY OF THE PROCEEDING[1]

On February 28, 2005, SBC Communications, Inc. (SBC), AT&T Corporation (AT&T) and the AT&T subsidiaries certificated to provide telecommunications services in the Commonwealth of Pennsylvania – AT&T Communications of Pennsylvania LLC, TCG Pittsburgh Inc. and TCG-Delaware Valley, Inc. f/k/a Eastern Telelogic Corporation (TCG-DV) (collectively, AT&T-PA Subsidiaries) (SBC, AT&T and the AT&T-PA Subsidiaries are collectively referred to as Joint Applicants) filed their Joint Application for a certificate of public convenience evidencing approval of the merger of SBC and AT&T. SBC and AT&T executed an Agreement and Plan of Merger (Merger Agreement) on January 30, 2005.

On March 19, 2005, notice of the Joint Application for merger was published in Volume 35 of the *Pennsylvania Bulletin* (35 *Pa.B.* 1859). On April 4, 2005, the Office of Consumer Advocate (OCA) and Full Service Network (FSN) protested the proposed merger.[2] Also on April 4, 2005, the Office of Small Business Advocate (OSBA) filed a Notice of Intervention and the Communications Workers of America (CWA) filed a Petition to Intervene. On April 13, 2005, the Commission's Office of Trial Staff (OTS) filed a Notice of Appearance to the Joint Application proceeding.

On April 8, 2005, the Office of Administrative Law Judge (OALJ) issued an order scheduling an initial prehearing conference for May 12, 2005. On April 11, 2005, presiding Administrative Law Judge (ALJ) Angela T. Jones issued a Prehearing Conference Order to consider procedural matters. The CWA, OCA,

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[1] Substantial attribution to the September 14, 2005, Initial Decision (I.D.) of ALJ Jones and the extensive Findings of Fact therein is acknowledged.

[2] FSN subsequently withdrew its Protest in this proceeding on May 12, 2005. (*See* Finding of Fact No. 9, I.D. at 4).

OSBA, OTS, and the Joint Applicants filed prehearing memoranda, participated in the prehearing conference, and provided input in establishing the procedural schedule. During the prehearing conference the ALJ granted the petition of CWA to intervene in the proceeding and the ALJ also encouraged the Joint Applicants to provide testimony regarding the Joint Application for merger and its effect on the maintenance and operation of the Pennsylvania Telecommunications Relay Service (TRS).

On April 26, 2005, the Joint Applicants filed a Motion for Issuance of a Protective Order requesting that proprietary information or information confidential in nature be prohibited from public disclosure. This Motion also requested that the parties to the proceedings appropriately identify and handle the proprietary or confidential information in accordance with Commission procedures. On April 28, 2005, the ALJ granted the Motion and issued a Protective Order for this proceeding.

At the pre-hearing conference, Joint Applicants submitted direct testimony of five witnesses:

(1) James S. Kahan, Senior Executive Vice President for Corporate Development, SBC;

(2) Christopher Rice, Executive Vice President – Network Planning and Engineering, SBC;

(3) Professor Dennis W. Carlton, University of Chicago, Graduate School of Business;

(4) Dr. Hal S. Sider, Senior Vice President, Lexecon; and

(5) Michael J. Morrissey, Vice President, Law and Government Affairs, AT&T.

On May 19, 2005, in response to the ALJ's comments at the prehearing conference, the Joint Applicants submitted supplemental direct testimony from Christopher Rice and Michael Morrissey specifically to address AT&T's current role as the TRS provider in Pennsylvania and the Joint Applicants' intention to continue to provide TRS after the merger.

Pursuant to the procedural schedule, on June 23, 2005, the OCA and the OSBA submitted direct testimony from their expert witness, Dr. Ben Johnson of Ben Johnson Associates, Inc., and Mr. Allen G. Buckalew, with J.W. Wilson & Associates, Inc., respectively. No other party submitted testimony.

On July 15, 2005, according to the procedural schedule, the Joint Applicants submitted rebuttal testimony from Christopher Rice, Dennis W. Carlton, Hal S. Sider, and Michael J. Morrissey. Dr. Ben Johnson and Mr. Allen Buckalew each submitted surrebuttal testimony on August 1, 2005, for OCA and OSBA, respectively. On August 9, 2005, on behalf of the Joint Applicants, James S. Kahan, Dennis W. Carlton, Hal S. Sider, and Michael J. Morrissey submitted rejoinder testimony.

At the hearing on August 9, 2005, the Parties stipulated to the pre-filed testimony and waived cross-examination of the witnesses. Additionally, ALJ Jones established filing dates for post-hearing briefs and reply briefs and closed the record. *See* I.D. at 3.

Main Briefs were filed by the Joint Applicants, the OCA and the OSBA on August 18, 2005. The OTS filed a letter advising that it would not be filing a Main Brief. Reply Briefs were filed by the same parties on August 25, 2005. The Initial Decision of ALJ Jones was issued on September 14, 2005.

Exceptions to the Initial Decision were received from the Joint Applicants, the OCA and OSBA on September 26, 2005. Replies to Exceptions were received from the Joint Applicants, OCA, and OSBA on October 3, 2005.

II. DISCUSSION

A. Background

1. The Merging Corporate Entities

SBC is a Delaware corporation and holding company with headquarters in San Antonio, Texas. (Jnt. App., ¶ 5). SBC is a former Bell Regional Operating Company (RBOC). (OSBA Stmt. 1, at 6). SBC currently services greater than thirty-one percent (31%) of the nation's local telephone customers but has very few local telephone customers in Pennsylvania. (OCA Stmt. 1 at 4 (Johnson Direct)). SBC's subsidiaries provide voice, data, and Internet services for residential, business, and government customers, mostly in a 13-state region. SBC serves 52.4 million access lines and has 5.1 million DSL (Digital Subscriber Line) lines in service. SBC holds a 60 percent economic and 50 percent voting interest in Cingular Wireless, which serves 49.1 million wireless customers. (Jnt. App. ¶ 5).

SBC wholly owns three subsidiaries that are certificated to provide competitive interexchange and local exchange telecommunications services in the Commonwealth of Pennsylvania. These entities are: (a) SBC Long Distance, Inc., f/k/a Southwest Bell Communications Services, Inc. (SBCLD); (b) SBC Telecom, Inc. (SBC Telecom); and (c) SNET America, Inc. d/b/a SBC Long Distance East, (SBC East).

SBCLD is authorized to offer, render, furnish, or supply competitive resold interexchange telecommunications services and to provide service as a competitive local exchange carrier (CLEC) and a competitive access provider

(CAP) and interexchange carrier. *See* Docket Nos. Docket No. A-310531;A-310531F0002, A-310531F0003 & A-3105312000, (Jnt. App., n. 2, at 3).

SBC Telecom is authorized to offer, render, furnish, or supply telecommunications services as an Interexchange Toll Reseller, a CLEC, a CAP, and an Interexchange Toll Facilities-Based Carrier. SBC Telecom provides competitive telecommunications services in the incumbent service territories of Verizon Pennsylvania Inc., Verizon North, Inc., and Sprint/United Telephone Company. On December 22, 2004, the Commission approved a joint application of SBC Telecom and SBCLD for the consolidation of the Pennsylvania operating authority of both entities into SBC Long Distance, LLC. *See* Docket Nos. A-310531F0003 and A-310894F2000.[3] The merger of SBC and AT&T will not affect the authorized consolidation in any fashion. (Jnt. App., n. 2, at 3).

SBC East is a wholly owned subsidiary of Southern New England Telecommunications Corporation which is, in turn, a wholly owned subsidiary of SBC. SBC East is authorized to offer, render, furnish, or supply interexchange telecommunications services as a reseller in Pennsylvania (Jnt. App., n. 2, at 3). *See* Docket No. A-310303.

Based on the foregoing, SBC's current presence in Pennsylvania consists of two SBC affiliated entities: SBC Telecom, its competitive local exchange carrier (CLEC) arm, and SBCLD, which provides long distance services, both inside and outside of SBC's 13 state region. (Jnt. App. Stmt. No. 3 at 10 (Carlton and Sider Direct)). SBC has no significant network assets, human assets or customer relationships in Pennsylvania that, in the absence of the

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[3] The Commission received notice that the consolidation of SBC Telecom, Inc. and SBC Long Distance, Inc. into SBC Long Distance, LLC was consummated on May 4, 2005.

proposed merger, would make it a more likely entrant than any other potential suppliers of traditional mass market services in Pennsylvania. (Jnt. App. Stmt. No. 3-R, at 5 (Carlton and Sider Rebuttal)).

SBC has only limited network facilities in Pennsylvania (Jnt. App. Stmt. No. 2-R, at 3 (Rice Rebuttal)(citations omitted)). (Jnt. App. Stmt. No. 2-R, at 3 (Rice Rebuttal)(citation and footnote omitted)). (Jnt. App. Stmt. No. 2-R, at 3 (Rice Rebuttal)).

AT&T Corp. is a New York holding corporation with headquarters in Bedminster, New Jersey 07921. AT&T Corp., through its subsidiaries, is authorized to provide domestic and international telecommunications services throughout the United States. It operates the world's largest communications network and offers a global presence in more than 50 countries, national and global IP [Internet Protocol]-based networks, a portfolio of data and IP services, hosting, security and professional services, technology leadership through its AT&T Labs, skilled networking capabilities, and a significant base of government and large business customers. (Jnt. App., ¶ 6).

AT&T Communications of Pennsylvania, LLC (AT&T-PA) is a Pennsylvania corporation also headquartered in Bedminster, N.J. 07921 and is a wholly owned subsidiary of AT&T Corp. By Commission Order entered May 14, 2002 at Docket No. A-311163, AT&T-PA became authorized to provide resold and facilities-based interexchange and competitive local exchange services and to supply services as a CAP in Pennsylvania. (Jnt. App., ¶ 7).

Pursuant to Commission Order entered May 29, 1990, at Docket No. M-00900239, AT&T-PA is certificated by the Commission to provide TRS and has served as the relay service provider in the Commonwealth since certification. (Jnt. App., ¶ 7).

TCG Delaware Valley, Inc. f/k/a Eastern Telelogic Corporation (TCG- DV) and TCG Pittsburgh are wholly owned subsidiaries of Teleport Communications Group, Inc. (a wholly owned subsidiary of AT&T Corp.). They are authorized to provide facilities-based local exchange and intrastate, interexchange telecommunications services in Pennsylvania pursuant to certification originally granted by this Commission on October 4, 1995, at Docket No. A-310258F0003 and No. A-310213F0002, respectively. (Jnt. App.,¶ 8). Both TCG-DV and TCG Pittsburgh are currently authorized to provide competitive local exchange services in the service territories of Verizon Pennsylvania Inc. (Verizon PA) and Sprint/United Telephone of Pennsylvania, Inc. *Id.*

2. The Merger Transaction

On February 28, 2005, the Joint Applicants filed a Joint Application with the Commission, requesting the issuance of a certificate of public convenience evidencing approval of the merger of SBC and AT&T in accordance with the Merger Agreement) executed January 30, 2005. 66 Pa. C.S. §§ 1102(a),

1103; *see also* 52 Pa. Code § 69.901(b). The Merger Agreement was attached to the application as Exhibit B. (Jnt. App. Stmt. No. 1, at 2 (Kahan Direct) and Jnt. App. ¶ 1). The proposed merger will result in AT&T Corp. becoming a wholly owned, first-tier subsidiary of SBC. (Jnt. App., ¶ 2).

The Merger Agreement provides that, upon the merger of SBC and AT&T, shareholders of AT&T will exchange their stock for SBC stock. (Jnt. App., ¶ 9). There will be no change in the ownership structure of any SBC-affiliated entity subject to the Commission's regulatory authority. Likewise, the transaction will result in no change in the ownership of any AT&T subsidiary certificated in Pennsylvania. (Jnt. App., ¶ 9).

In connection with the merger, AT&T shareholders will receive 0.77942 shares of SBC stock for each share of AT&T stock they own, as well as a one-time cash dividend from AT&T of $1.30 per AT&T share. SBC shareholders will continue to own SBC stock and otherwise will not be affected by the transaction. Upon completion of the transaction, former AT&T shareholders will hold approximately 16% of SBC's outstanding shares. (Jnt. App., ¶ 10).

3. Asserted Public Benefits of the Merger

(a) Positions of the Parties

i. Joint Applicants

The Joint Applicants testified that the merged organization will compete in the enterprise,[4] small-business and residential markets. (Jnt. App. Stmt. No. 1, at 13 (Kahan Direct) and No. 2, at 6 (Rice Direct)).

The Joint Applicants explain that the merged firm will be a financially stronger competitor in the telecommunications market, better able to offer integrated, innovative, high quality and competitively priced telecommunications services to all customers. (Jnt. App. Stmt. No. 1, at 18-19 (Kahan Direct)). The merged organization will continue research and product development but will seek applications and implementations on a diverse customer base. (Jnt. App. Stmt. No. 1, at 18-19 (Kahan Direct)).

The Joint Applicants state that the merged company will more efficiently and effectively deploy VoIP (Voice Over Internet-Protocol) services to all customer segments, including the mass market,[5] than either company could standing alone. (Jnt. App. Stmt. No. 1, at 20 (Kahan Direct)).

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[4] The term "enterprise" customer as used in this Order refers to medium and large business customers. SBC's definition of an "enterprise" customer is a business that generally purchases annually more than $48,000 in telecommunications services. Jnt. App. Stmt. No. 1 at 13 (Kahan Direct).

[5] The term "mass market" as used throughout this Order refers to residential and small business customers.

The Joint Applicants' witness testified that the merged organization will deploy VoIP services to enterprise and mass market customers to Pennsylvania customers more rapidly than the entities, pre-merger. SBC intends to continue AT&T's "CallVantage" VoIP product both in and outside of SBC's existing service territory. (Jnt. App. Stmt. No. 1, at 21 (Kahan Direct)). Today, CallVantage trails other VoIP providers in market penetration. Combining AT&T's and SBC's IP backbones will permit the merged company to more efficiently deploy VoIP. (Jnt. App. Stmt. No. 1, at 21 (Kahan Direct)).

The Joint Applicants testified that the merger will result in cost savings in both fixed and variable costs of operations. Anticipated synergies are over and above benefits expected from each company's on-going productivity initiatives in the absence of the merger transaction. Improved efficiencies and cost savings will be derived from areas such as: elimination of duplicate facilities; elimination of overlapping staff and related administrative expenses; consolidation of billing and operating support systems, greater utilization of network assets by combining the companies' traffic streams (especially as applications increasingly become IP-based); greater scalability from business process improvements (including mechanization functions and higher flow-through rates); greater scalability from standardization and automation of IT systems and elimination of duplicative IT development projects; and reduction of off-net, third party network expenses. The synergies are anticipated to commence immediately and reach an annual run rate of $2 billion by 2008. SBC estimates the net present value of these synergies, net of costs to achieve, is approximately $15 billion. (Jnt. App. Stmt. No. 1, at 23.24 (Kahan Direct, footnotes omitted)).

The Joint Applicants additionally alleged that the merger will provide: (a) benefits from network integration, (b) more innovation in networks and services and faster roll-out of new and existing services to customers, (c) the

ability to make available to small-and medium-sized business customers, as well as to residential customers, services that AT&T now offers only to enterprise customers, and (d) new services that the merged company will be able to offer with AT&T's network assets. (Jnt. App. Stmt. No. 2, at 1-2 (Rice Direct)).

The Joint Applicants further testified that the post-merger company will offer a broader array of services to a broader spectrum of customers than either company did on its own. (Jnt. App. Stmt. No. 4-R at 12 (Morrissey Rebuttal) and No. 2 at 7 (Rice Direct)). The merged entity will be a global competitor, capable of innovating and providing next generation services to a broad array of customers and customer types. (Jnt. App. Stmt. No. 2 at 8 (Rice Direct)).

The merged company expects to increase capital expenditures in order to achieve innovations for all customers. While AT&T has budgeted $200 million dollars per year for five years for research, the post-merger company expects to spend $2 billion dollars, before synergies, over the first several years which is more likely greater than what the two companies would spend absent the merger. (Jnt. App. Stmt. No. 2 at 7 (Rice Direct)).

SBC expects customers in Pennsylvania, including both mass-market customers and the many enterprise customers located in the state, to reap the benefits. (Jnt. App. Stmt. No. 2, at 9 (Rice Direct)). SBC's competitive presence in Pennsylvania as of April 2005 consisted of, SBCLD with. (Jnt. App. Stmt. No. 1, at 19-20 (Kahan Direct)). The combined company intends to

compete aggressively for all customers in Pennsylvania and elsewhere outside of SBC's 13-state region. (Jnt. App. Stmt. No. 1-RJ, at 2 (Kahan Rejoinder)).

Based on the foregoing, the merged company will be a more enduring U.S.-based global competitor than either company could be alone, intending to deliver the advanced network technologies necessary to offer integrated, innovative high-quality and competitively priced telecommunications services to meet the national and global needs of all classes of customers worldwide. (Jnt. App. Stmt. No. 1-RJ, at 2 (Kahan Rejoinder)).

The merged company intends to use the combined resources, expertise, and incentives to adapt the sophisticated products (including VoIP) that AT&T has developed for its enterprise customers to the needs of small and medium businesses and mass-market consumers, and implement the marketing expertise and infrastructure to reach those customers. (Jnt. App. Stmt. No. 1-RJ, at 2 (Kahan Rejoinder)). Pennsylvania customers will benefit from the integration of SBC's and AT&T's networks. The merged company will re-deploy network equipment or facilities that are no longer necessary in their current application or location, thereby utilizing existing capital more efficiently. The merged company will retire other network facilities, thereby saving the recurring costs of maintaining and operating those facilities. (Jnt. App. Stmt. No. 2-R, at 4 (Rice Rebuttal)).

ii. The OCA

The OCA took the position that the application should be rejected, or in the alternative, the Commission should, as a condition of approval, require a binding commitment from the merged company to aggressively compete in the mass market in Pennsylvania. (OCA Stmt. 1 at 2 (Johnson Direct)). Without a

binding, enforceable, and verifiable commitment from the merged company, the OCA suggests that the merged company should divest its mass market operations and facilities in Pennsylvania to be sold to another telecommunications provider in Pennsylvania that has committed to competing in the mass market. (OCA Stmt. 1 at 2 (Johnson Direct)). The OCA suggests that without conditions of commitment of divestiture, the merger fails to provide an affirmative public benefit and is contrary to the public interest. (OCA Stmt. 1 at 2-3 (Johnson Direct)).

The OCA witness testified that barriers to entry to the local telecommunications service market exist and evidence of the barriers is that incumbent local exchange carriers (ILECs) are not entering into other ILECs' service territory. (OCA Stmt. 1 at 16-17 (Johnson Direct)). The OCA goes on to point out that ILECs have limited or eliminated the use of unbundled network elements (UNEs)[6] as a form or method of competitive entry into the local telecommunications exchange market. (OCA Stmt. 1 at 17 (Johnson Direct)).

Based on the foregoing, the OCA states that the result of the merger will expand the gap between the merged companies and the next largest competitor, strengthen the dominance of the merged company, and make it harder for small firms and new entrants to compete against these telecommunications carriers. (OCA Stmt. 1 at 27 (Johnson Direct)). The OCA observes that SBC and Verizon are the nation's two largest telecommunications providers and have, to-date, avoided competing against each other. (OCA Stmt. 1 at 26 (Johnson Direct)). AT&T has been aggressive in applying competitive pressure on Verizon in Pennsylvania. (OCA Stmt. 1 at 26-27 (Johnson Direct)). SBC and AT&T currently compete against each other in Pennsylvania with the potential to

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[6] 47 U.S.C. § 251(c)(3).

compete more aggressively against each other if the merger is not approved. (OCA Stmt. 1 at 26 (Johnson Direct)).

The OCA adds that AT&T and MCI have served as a counterbalance against the RBOCs in the legislative, regulatory and judicial processes. The OCA testified that RBOCs are not in the local exchange telecommunications market outside of their own service territory perhaps because: (1) barriers to entry remain; (2) the local exchange market is a natural monopoly; and (3) aggressive competition would lead to a retaliatory strike within their own territory. (OCA Stmt. 1 at 43 (Johnson Direct)). The risk of an industry dominated by two firms, potentially in this case, a merged Verizon and MCI entity and the merger of SBC and AT&T, can evolve to a shared monopoly structure and therefore avoid disrupting status quo and concentrate on maximizing profits. (OCA Stmt. 1 at 48-53 (Johnson Direct)). Consequently, if pending mergers are approved, there is the potential of RBOCs dominating policymaking with no counterbalance. (OCA Stmt. 1 at 28 (Johnson Direct)).

Also, according to the OCA, the merger will result in the merged entity's immediate dominant position in two markets and enhanced shareholder value. (OCA Stmt. 1 at 30-31 (Johnson Direct)). The OCA criticizes the proposed merger as based on the implicit assumption that a mere strengthening of SBC's competitive position will translate into public benefits. *Id.*

iii. The OSBA

The OSBA took the position that it is injurious to the public interest to permit mergers that enhance the ability of the dominant regional market monopolist to defeat competition and maintain market posture. (OSBA Stmt. No. 1 at 17-18 (Buckalew Direct)). The OSBA observed that SBC and AT&T are

potential competitors to provide facilities-based local competition in Pennsylvania. (OSBA Stmt. No. 1 at 19 (Buckalew Direct)). The OSBA witness suggests the following is indicative of effects on competition and new entry into the market: (1) changes in market concentration; (2) changes in potential competition; (3) changes in pricing and product offerings. (OSBA Stmt. No. 1 at 8 (Buckalew Direct)). The OSBA acknowledged that the trend is to merge, acquire, or form an alliance to capture market share and customers before other carriers enter the service territory as another provider. (OSBA Stmt. No. 1 at 16 (Buckalew Direct)).

Additionally, the OSBA discounted the claimed benefits of the merger of $2 billion in additional capital expenditure espoused by the Joint Applicants. The OSBA stated that this representation is not a benefit because the Joint Applicants do not know on what or where this capital will be spent, *i.e.*, whether it will be spent in Pennsylvania. (OSBA Stmt. No. 1 at 21 (Buckalew Direct)).

B. Applicable Legal Standards

The Initial Decision correctly sets forth the applicable legal standards which are to be applied to the present case. (I.D. at 24-28). Sections 1102 and 1103 of the Public Utility Code, 66 Pa. C.S. §§ 1102, 1103, provide the primary statutory basis for this Commission's authority. These statutory provisions and predecessor enactments as they have been interpreted by the Pennsylvania Supreme Court in *City of York v. Pa. PUC*, 295 A.2d 825 (Pa. 1972), provide the controlling legal standards that are applicable to the Commission's review of the proposed transaction.

In order to obtain a certificate of public convenience, the Joint Applicants have the burden of proving by a standard of proof of a preponderance

of the evidence, that the proposed transaction is in the public interest because it will affirmatively promote the service, accommodation, convenience or safety of the public in some substantial way. *See City of York*, 295 A.2d at 828.

Section 1103 of the Code specifically permits the Commission to impose conditions in granting a certificate of public convenience to ensure that a proposed merger is in the public interest. By the imposition of conditions, the Commission can approve a merger that would not otherwise meet the *City of York* legal standards. *See, Application for Authority to Transfer Control of Trigen-Philadelphia Energy Corporation by the Sale of All of its Stock, Currently Owned by Trigen Energy Corporation, to Thermal North America, Inc.*, Docket No. A-130375F5000 (Opinion and Order entered April 7, 2005), slip op. at 5, citing December 16, 2004, Recommended Decision of ALJ Marlane R. Chestnut.

C. ALJ Recommendation

ALJ Jones concluded that the Joint Applicants established public benefits to the proposed transaction. She found it beneficial to the public that the merger would have no adverse effect on the rate paid by customers affected by the transaction. Also, the ALJ found it beneficial that the merger would be seamless to the segment of the public using TRS. (I.D. at 34-35).

However, ALJ Jones concluded that certain of the asserted benefits were lacking in specificity. She was of the opinion that there was a need for more evidentiary support to affirm the proposition put forth by the Joint Applicants that the merger would produce a benefit because it will result in a stronger and more competitive telecommunications entity in Pennsylvania. (I.D. at 34). Consequently, the ALJ recommended that the application be approved, albeit with certain conditions. The ALJ was most persuaded by the position advocated by the

OSBA, that approval of the merger should be conditioned on the post-merged company's commitment to a specific level of capital investment in Pennsylvania infrastructure. (I.D. at 37). The ALJ reasoned that this condition would remedy the perceived deficiencies in the Joint Applicants' presentation of proposed benefits regarding capital spending in Pennsylvania and quality of service to Pennsylvania consumers. *Id.* The ALJ's pertinent reasoning is reprinted, below:

> . . . I find the OSBA's suggestion to condition the approval of the merger on the post-merged company's commitment to a specific level of investment in Pennsylvania infrastructure appealing. This condition remedies the deficiencies in proposed benefits by the Joint Applicants regarding capital spending in Pennsylvania and quality of service to Pennsylvania customers. The OSBA also finds that it will remedy the post-merger entity's activity concerning Pennsylvania's mass market customers. (OSBA M.B. at 20.) Additionally, I find that the condition promotes the public interest as mandated by statute at 66 Pa. Code § 1103(a). I find it reasonable and appropriate for the Joint Applicants to commit to a certain level of capital spending in Pennsylvania to obtain the requisite certificate of convenience as evidence of approval of the merger application.

(I.D. at 37-38).

ALJ Jones reached 109 Findings of Fact and drew 18 Conclusions of Law. Said Findings of Fact and Conclusions of Law are, hereby, adopted, unless expressly modified, or modified by necessary implication from our discussion in this Opinion and Order. We further note that in our consideration of the Recommended Decision, Exceptions, and Replies, any argument or contention raised by a party which is not specifically addressed should be deemed to have been duly considered and rejected. *Consl. Rail Corp. v. Pa. PUC*, 625 A.2d 741

(Pa. Cmwlth. Ct. 1993); *see also*, generally, *Univ. of Pa. v. Pa.PUC*, 485 A.2d 1217 (Pa. Cmwlth. Ct. 1984).

The ALJ's recommended Ordering Paragraphs are set forth, below:

1. That the Joint Application of SBC Communications, Inc., and AT&T Corp., together with its certificated Pennsylvania subsidiaries for approval of a merger having been filed with the Pennsylvania Public Utility Commission on February 28, 2005, within thirty (30) days of the entry date of the Commission's Order file their written acceptance of the following:

   (a) the post-merger entity spend at a minimum of four to five percent (4-5%) of $2 billion dollars per year investing in Pennsylvania's infrastructure for telecommunications over the five-year period following the issuance of the merged entity's certificate of convenience.

   (b) the post-merger entity will report annually to the Commission's Bureau of Fixed Utility Services, its itemized compliance with ordering paragraph 1(a) over the five-year period following the issuance of the merged entity's certificate of convenience.

2. That upon compliance with ordering paragraph 1, a certificate of public convenience be issued evidencing the Pennsylvania Public Utility Commission's approval of the transaction occurring as a result of the Agreement and Plan of Merger dated January 30, 2005, between SBC Communications, Inc. and AT&T Corp. and the AT&T subsidiaries certificated to provide telecommunications services in the Commonwealth of Pennsylvania, AT&T

Communications of Pennsylvania LLC, TCG Pittsburgh Inc. and TCG Delaware Valley, Inc., f/k/a Eastern Telelogic Corporation, and the record at Docket Numbers A-311163F006, A-310213F0008 and A-310258F0005 be marked closed.

3. That should SBC Communications, Inc. and AT&T Corp. and the AT&T subsidiaries certificated to provide telecommunications services in the Commonwealth of Pennsylvania, AT&T Communications of Pennsylvania LLC, TCG Pittsburgh Inc. and TCG Delaware Valley, Inc., f/k/a Eastern Telelogic Corporation not comply with ordering paragraph 1 above, the Joint Application of SBC Communications, Inc., and AT&T Corp., together with its certificated Pennsylvania subsidiaries for approval of a merger filed February 28, 2005, is dismissed and the record at Docket Numbers A-311163F006, A-310213F0008 and A-310258F0005 be marked closed.

(I.D. at 42-43).

D. Exceptions and Replies

1. Joint Applicants' Exceptions

(a) Exception 1: The ALJ's finding that the merger will lead to specific affirmative benefits satisfies the applicable legal standard for approving the merger without conditions.

The Joint Applicants filed four Exceptions to the Initial Decision of ALJ Jones. The Joint Applicants' first and second Exceptions address their position on the affirmative benefits of the merger under the standards of *City of York*. Exceptions 3 and 4 criticize the appropriateness of the ALJ's recommendation that conditions be imposed.

In Exception 1, the Joint Applicants object to the ALJ's conclusion that the proposed merger be approved, subject to conditions. They argue that the ALJ's finding that the merger will lead to two specific, affirmative, benefits satisfied the applicable legal standard for approving the merger without the imposition of conditions. (Exc. at 6).

Specifically, the Joint Applicants rely on the *City of York* and *Middletown Twp. v. Pa. PUC*, 482 A.2d 674, 682 (Pa. Cmwlth. Ct. 1984), for the proposition that they were not required and the Commission is not entitled to hold them to a standard by which they must prove that every one of the anticipated benefits will come to pass before a merger may be approved. (Exc. at 8). The Joint Applicants argue that the statute and caselaw contemplates a weighing of the benefits and detriments of the acquisition as it impacts on all affected parties. Thus, the Joint Applicants take the position that the burden to show positive benefits to the public has been met by their testimony that (1) in the absence of the merger, AT&T's rates for local service would continue to rise; (2) that AT&T would exit the "mass market," and (3) with respect to TRS service, the possible withdrawal of AT&T from the mass market would negatively impact the continued provision of this service. The Joint Applicants also note that the record does not indicate that the merger would have any adverse effect on the public interest.

In its Replies, the OCA submits that it established that Joint Applicants' reliance on the fact of maintaining TRS obligations through 2007, maintaining the status of competition, and no adverse affects on rates, are not benefits. It suggests that these are pre-existing obligations and are not affirmative benefits sufficient to sustain the Joint Applicants' burden of proof in this proceeding. (R.Exc. at 3).

The OCA further attacks the Joint Applicants' evidentiary presentation as a "do no harm" standard which is contradicted by evidence showing that adverse impacts will result from the merger. Those adverse impacts, according to the OCA, were found by ALJ Jones at Finding of Fact 96 and 97, which state, respectively:

> 96. The result of the merger will expand the gap between the merged companies and the next largest competitor, strengthen the dominance of the merged company and make it harder for small firms and new entrants to compete against these telecommunications carriers. (OCA Stmt. 1 at 27 (Johnson Direct)).
>
> 97. AT&T and MCI have served as counterbalance against the regional bell operating companies ("RBOCs") in the legislative, regulatory and judicial processes. If pending mergers are approved, there is the potential of RBOCs dominating policymaking with no counterbalance. (OCA Stmt. 1 at 28 (Johnson Direct)).

(I.D. at 20).

The OCA extensively details its overall concerns with the instant merger. (R.Exc. at 5-9). The OCA views this proceeding as indicative of an ominous return to the establishment of a shared oligopoly with two, former RBOCs, returning to market dominance, to the detriment of new market entrants and the consuming public.[7] The OCA argues in support of the imposition of conditions for approval of the merger and relates back to the last significant merger involving SBC. This was the SBC/Ameritech merger. *See In re Application of Ameritech Corp and SBC Communications, Inc. . . .*, 14 FCC Rcd

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[7] The OCA, as noted by presiding ALJ Jones, cross-references the pending merger proceedings involving Verizon Communications and MCI for its premise in this regard. *See* I.D. at 31-32.

14717 CC Docket No. 98-141 (rel. October 9, 1999) (*SBC/Ameritech Order*). The significance of the SBC/Ameritech Order, as explained by the OCA, is that the Federal Communications Commission (FCC) approved the merger subject to the express condition that SBC enter at least 30 major markets outside SBC's and Ameritech's incumbent service area. (R.Exc. at 7). One of the 30 major markets in which SBC was supposed to compete was Philadelphia. There was, explains the OCA, hope that the commitment by SBC to enter out-of-region markets would create irreversible momentum towards deployment of advanced broadband services and the advancement of local residential telecommunications competition. *Id.* referencing OCA Hrg. Exh. 1. Regrettably, meaningful competition for the mass market has not come about given the "minuscule" presence of SBC in Pennsylvania despite the condition placed on the company by the FCC. (R. Exc. at 8).

In its Replies, the OSBA, as a threshold consideration, repeats its position that the showing of no adverse effects of a merger (or preservation of the status quo) is the incorrect legal standard to apply. This showing, argues the OSBA, is not affirmative. Rather, this type of showing is the same showing of no adverse affects of a merger as the standard of *Northern Pa. Power Co. v. Pa. PUC*, 5 A.2d 133 (Pa. 1939), which case was overruled by *City of York*. (R. Exc. at 5-6). The OSBA continues to maintain that the Joint Applicants have not shown affirmative benefits of the merger and, to the extent the preservation of the status quo is arguably accepted for this purpose, such benefits are not substantial. (R.Exc. at 7-8).

Disposition

On consideration of the Joint Applicant's first Exception, it shall be granted, solely to the extent consistent with our discussion, below. For reasons

which are discussed further in this Opinion and Order, we generally agree that the Joint Applicant's evidence supports the view that the public would be more advantaged by the grant of the merger, than its denial. This conclusion, however, does not end the inquiry. As readily acknowledged by all parties, the public interest considerations are broad and are not foreclosed by a finding of the benefits to outweigh the detriments of a merger, by even the slightest degree. *See Middletown Twp. v. Pa. PUC; Bell/GTE Merger.*[8]

(b) Exception 2: The ALJ clearly erred in ignoring Joint Applicants' evidence showing a wide variety of affirmative benefits from the merger.

In their second Exception, the Joint Applicants make the argument that in assessing the evidence, the ALJ failed to acknowledge the affirmative benefits of the merger and failed to afford sufficient weight to the potential detrimental effects on competition in Pennsylvania in the absence of the merger.

The Joint Applicants assert that the merger is likely to enhance competition and improve the quality of service in the Commonwealth and believe they have demonstrated that: the combined company will have an enhanced financial capacity, thereby permitting it to invest and to innovate; the companies are committed to aggressive deployment of VoIP to Pennsylvania's mass market; the integration of the merging company's networks will increase efficiency and, therefore, improve the quality of service for any Pennsylvania customer who uses the Internet or makes long-distance telephone calls; and IP-based solutions for

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[8] *Joint Application of Bell Atlantic Corporation and GTE Corporation for Approval of Agreement and Plan of Merger*, Docket Nos. A-310200F0002, et al. (Order entered November 4, 1999).

enterprise customers will become possible and will provide for the expansion to the mass market, innovations developed at AT&T labs. (Exc. at 9).

The Joint Applicants further object that the manner in which the ALJ evaluated their record evidence is at odds with the manner in which the Commission has evaluated prior mergers. (Exc. at 10). The Joint Applicants assert that they presented precisely the sort of evidence that this Commission has accepted as sufficient to demonstrate affirmative benefits in the Trigen-Philadelphia Energy Corporation and Thermal North America, Inc., merger.[9] Additionally, the Joint Applicants point to the Commission's recent approval of water industry mergers as support for the nature of the evidence they have provided in the instant proceeding. They argue that the evidence in this proceeding is the sort of evidence that has been consistently accepted as sufficient to demonstrate the affirmative benefits of a merger. (Exc. at 10, 11).

The Joint Applicants finally contend that the ALJ's insistence on greater quantification of the beneficial effects of the merger is misplaced and particularly inappropriate when the combination of SBC and AT&T is viewed in context. They believe that the ALJ failed to attach significance to what is likely to happen in the absence of this merger. (Exc. at 12). The Joint Applicants point out that, in the absence of the merger, AT&T has begun a continued withdrawal from the mass market and, the Pennsylvania presence of SBC, characterized as "minimal," would not expand. Thus, the Joint Applicants argue that when the merger is viewed in this context, there are substantial affirmative benefits to the public which render greater quantification than was shown inappropriate.

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[9] Opinion and Order, *Application for Authority To Transfer Control of Trigen-Philadelphia Energy Corp.*, Docket No. A-130375F5000 (Order entered April 7, 2005), slip op. at 7.

The OCA, in its Replies, takes the view that the ALJ correctly determined that the benefits asserted by the Joint Applicants were general, illusory, uncertain, and wanting in affirmation. (R.Exc. at 9). The OCA criticizes the evidence presented by the Joint Applicants to support approval. It highlights that the evidence is lacking in commitment, but merely represents expectations on the part of the Joint Applicants that may work to the benefit of Pennsylvania consumers. (R.Exc. at 11). The OCA is additionally skeptical of the incentive for SBC to provide any real competition outside its incumbent "footprint" if this merger is approved. This is so, based on the OCA's observations, *inter alia*, that SBC would want to avoid triggering a price war with other large incumbents like Verizon. (R.Exc. at 11 referring to OCA Stmt. 1 at 52).

The OCA, in its Replies, also distinguishes this Commission's ruling in the *Tri-Gen Merger* from the instant case. It points out that in the *Tri-Gen Merger*, the applicants entered into an agreement where certain services would be provided at a fixed price, committed to fund the removal, disposal, or encapsulation of asbestos containment material at no cost to ratepayers, and further committed to improvement of customer service through entering into contracts with entities having expertise in certain fields. (R.Exc. at 13-14).

In its Replies to Exceptions, the OSBA emphasizes that the Joint Applicants have not, in their view, made any specific commitments or provided any details which would support a finding that the alleged benefits of the merger are likely to occur. (R.Exc. at 10). It recognizes that the Joint Applicants cannot guarantee that their efforts will produce future benefits. *Id.* The OSBA recites its efforts to obtain details regarding the impact on specific services, on the specific level of investment to be committed to Pennsylvania, or the improved capabilities which would be made available to small business customers, the Joint Applicants' responses were vague and non-committal. (R.Exc. at 10-11). Finally, the OSBA

finds no support in the determination of AT&T to exit the mass market in the absence of merger approval. The OSBA considers this statement to reflect a change in market focus by AT&T and states that it is reasonable to infer that a stand-alone AT&T would change its focus in response to market demand regardless of a merger. (R.Exc. at 9-13).

Disposition

On consideration of the record and the positions of the parties, we shall grant the Joint Applicants' Exception 2 consistent with our discussion. We find the evidence and several of the arguments of the Joint Applicants to be persuasive on the question of affirmative benefits shown.

When we view the merger in context, we would agree with the Joint Applicants that the standards of the *City of York* need not only be addressed by a quantification of the specific effects of alleged savings, particularly a specific level of capital investment by the merged entity in Pennsylvania. (*See* Joint App. MB at 10). Rather, we must view the public interest benefits in the context of the telecommunications industry in Pennsylvania, as a whole. In this regard, we would agree with the observation of ALJ Jones that, as a matter of law and policy, "a benefit can be to maintain the status quo of competition rather than to digress." (I.D. at 30).

Also, as noted in our discussion contained in the *Bell/GTE Merger Order*, the public interest standard is a broad standard that encompasses examining ". . . whether, for example, the "merger will have an anti-competitive effect or will impair the technical, managerial or financial fitness" of the jurisdictional utilities affected to continue to provide adequate telecommunications services to Pennsylvania customers at just and reasonable rates." *Bell/GTE Merger Order*

citing Joint Application of PG Energy, Inc., et al. for Approval of the Merger into Southern Union Company, Docket Nos. A-120011 et al. (Opinion and Order entered September 15, 1999) (*PG Energy Order*).

In light of the foregoing, when we examine the merger in the broad context of the telecommunications industry in Pennsylvania, we find that the merger will affirmatively benefit the consuming public in a substantial way. We make this finding by observing that the Joint Applicants have shown, by a preponderance of the evidence, that the merger will enhance the likelihood of competition both in the mass market and enterprise market (as those terms are used in this proceeding) by retaining a CLEC market participant in the mass market (*See* Finding of Fact 45) and strengthening this CLEC's capacity to provide a competitive alternative in the enterprise market (Finding of Fact 101).

Prior to the Merger Agreement, AT&T had expressed its intent to withdraw from the mass market. This business determination was reached independent of the transaction before this Commission. As a result of the merger, we find that the incentive to remain in this market and to compete has been established. The likely alternative, in the absence of the merger, is a diminution of competition in the mass market and the exit of an actor in this market.

We are also able to conclude on this record that the merger will, in all likelihood, facilitate the synergies of two corporate networks which are compatible for integration. There is minimal horizontal overlap between SBC and AT&T's business customers in Pennsylvania. (Jnt. App. Stmt. No. 3, at 29-30 (Carlton and Sider Direct, footnotes omitted)). The compatibility of these networks will, in turn, render the "roll-out" of VoIP, other IP-based services, and innovative applications involving those technologies and developing "next generation" technologies, imminently more practical and commercially feasible

than in the absence of a merger. The record shows affirmative benefits to competition in recognizing that the merger would produce a larger, more competitively and financially viable CLEC in Pennsylvania.

Additionally, we note the commitment to the provision of TRS to be a benefit which cannot be overlooked.

We do not find the OCA or the OSBA's positions in opposition to approval of the merger to be based on the likely scenario for competition in Pennsylvania.

The OCA has argued that we should require a binding commitment from the merged company to aggressively compete in the mass market in Pennsylvania and that without such commitment from the merged company, we should direct, as a condition, the divestiture of mass market operations and facilities in Pennsylvania to another telecommunications provider in Pennsylvania that will commit to competing in the mass market. (OCA Stmt. 1 at 2 (Johnson Direct)). The focus of the OCA's position, as we understand it, is grounded in its observations pertaining to barriers to entry to the local telecommunications market for new (CLEC) entrants. Its position is also focused on the prospect of eliminating two entities which would, absent the merger, compete with each other in Pennsylvania. (OCA Stmt. 1 at 33; Finding of Fact 96, 97).

While the OCA observes that SBC and Verizon are the nation's two largest telecommunications providers and have, to-date, avoided competing against each other (OCA Stmt. 1 at 26 (Johnson Direct)), its position on the instant merger appears at odds with this concern. The OCA, through its witness, Dr. Ben Johnson, has presented data regarding current revenues of the combined SBC and

AT&T which are worthy of concern.[10] However, the OCA concedes that AT&T has been aggressive in applying competitive pressure on the largest incumbent, Verizon, in Pennsylvania. (OCA Stmt. 1 at 26-27 (Johnson Direct)). We find no indication that, upon merger, the interests of the merged company in presenting an aggressive, competitive alternative to the dominant ILEC in Pennsylvania, in all markets, would change. As noted by the Joint Applicants in their Replies to the Exceptions of the OCA, there is no record that a hypothetical new entrant would face incentives that differ substantially from those considered by AT&T when it made the business decision to cease actively marketing its mass-market services. (R.Exc. at 6, citing Jnt. App. Stmt. 3-R, at 8:14-16). We take official notice that the FCC's implementation of revised unbundling rules in its *Triennial Review Order*[11] and the FCC implementation of applicable court mandates resulting from appeals of the *Triennial Review Orders*[12] have substantially revised ILEC requirements for providing access to UNEs, particularly, unbundled local

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[10] At OCA Stmt. 1, at 49-52, the OCA observes that based on total revenues, SBC was the second largest "player" in the telecommunications industry with $40.8 billion dollars, with Verizon number one at $67.6 billion. The third largest telecommunications entity would be AT&T at $34.5 billion. Thus, the OCA complains that approval of the instant merger results in the second largest telecommunications company merger with the 3rd largest firm, with the possibility of the first and fourth largest, MCI at $27.3 billion, later. (OCA Smt. 1, at 49).

[11] *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*; *Implementation of Local Competition Provisions of the Telecommunications Act of 1996*; *Deployment of Wireline Services Offering Advanced Telecommunications Capability*, CC Docket Nos. 01-338, 96-98, 98-147, Report and Order and Further Notice of Proposed Rulemaking, FCC 03-36 (rel. August 21, 2003), 18 FCC Rcd 16978 (2003); corrected by Errata, 18 FCC Rcd 19020 (2003) (Triennial Review Order) *affirmed in part, USTA v. FCC*, 359 F.3d 554 (D.C. Cir. 2004) (*USTA II*); *petitions for certiorari denied* 125 S. Ct. 316.

[12] Final rules to implement the *USTA II* mandates were promulgated at WC Docket No. 04-313, CC Docket No. 01-338, Order on Remand, FCC 04-290 (rel. Feb. 4, 2005) (*TRO Remand Order).*

switching and unbundled network element platform (UNE-P). Because of changes in the telecommunications market and court and regulatory decisions, AT&T decided to cease actively competing in the traditional local and long distance mass markets. Beginning July 2004, AT&T ceased actively competing in the traditional local and long distance mass markets (although AT&T continues to accept new "demand" orders), stopped marketing to those customers, and stopped attempting to compete with other mass market entrants on the basis of price. (Jnt. App. Stmt. No. 4-R at 6 (Morrissey Rebuttal)).

The number of Pennsylvania residential customers taking AT&T's UNE-P based local exchange service as of the end of March 2005 dropped by nearly 11 percent from its peak in August 2004, to approximately and continues to decline through attrition. (Jnt. App. Stmt. No. 4 at 17 (Morrissey Direct)). From August 2004 to March 2004 small business customers on UNE-P based service dropped by nearly 6 percent to approximately (Jnt. App. Stmt. No. 4 at 17-18 (Morrissey Direct)).

In June 2004, AT&T announced a decision to end competitive activities in the mass market. This announcement was made several months prior to the merger decision. (Jnt. App. Stmt. No. 4-R at 5 (Morrissey Rebuttal)). Since AT&T's announcement in June, 2004, AT&T has been losing residential customers at an annualized rate of AT&T expects that trend to continue. (Jnt. App. Stmt. No. 4-R at 6 (Morrissey Rebuttal)).

In February 2001, AT&T had nearly

(Jnt. App. Stmt. No. 4-R at 6 (Morrissey Rebuttal)).

The above developments concerning AT&T's market presence in Pennsylvania, precipitated by federal policy, are likely shared by other CLECs.[13] Recent federal policy determinations have, for CLEC entrants, cumulatively increased the capital investment required for entry and viable presence into the local telecommunications market.

We conclude that the merger will better position the merged entity to compete. While AT&T has retained sufficient manpower and infrastructure to continue to provide quality services to its existing mass market customers, AT&T could not today re-enter the mass market. If AT&T, for some reason, made a decision to reenter that market, implementing that decision would require much the same effort, financing and ramp-up time as a new start-up company. (Jnt. App. Stmt. No. 4, at 18 (Morrissey Direct)). While the OCA has observed that mere economies of scale resulting from the merger do not, in and of themselves, translate into public benefits, we are hard-pressed to envision any new CLEC entrant into the Pennsylvania telecommunications market which would have the financial and competitive viability of a merged SBC and AT&T. (*See* Jnt. App. Exc. at 13).

Based on the foregoing, in light of significant recent federal policy determinations, including the FCC's recognition of intermodal competition, the OCA and the OSBA overlook the fact that the likely scenario with the exit of a major telecommunications actor from the mass market is not replacement with a

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[13] The Pennsylvania trends are consistent with national trends. In just the first seven months after AT&T stopped efforts to obtain mass market customers, AT&T lost nationally. (Jnt. App. Stmt. No. 4-R at 7 (Morrissey Rebuttal)).

hypothetical new market participant. But for smaller, "niche" markets, the capital investment to enter the telecommunications mass market has substantially increased and does not present the likelihood for a competitive alternative as the OCA and OSBA would argue. A merger such as the one under consideration provides an opportunity for two CLEC carriers with minimal presence and market share in Pennsylvania, to provide a viable competitive presence. Accordingly, we find no basis on which to reject the Joint Applicants' position that the merged company will have greater incentives and capacity to retain AT&T's mass market customers than AT&T standing alone. *See* Jnt. App. R.Exc. at 6-7.

We are sensitive to the concern of the OCA that the mass market customers could have less competitive alternatives than the enterprise market customers and that the "gap" between the merged companies and the next largest CLEC will expand. However, we view the competitive alternatives available to mass market customers to be a short term potential detriment as this is function of how we have observed competition to have developed, generally, in the telecommunications industry. *See Application of MFS Intelenet of Pennsylvania, Incorporated* . . . , Docket No. A-310203F0002 (Order entered June 6, 1995). With regard to the latter concern over the widening gap between other CLECs and the merged entity, we note that the merger presents no concern regarding market power in Pennsylvania. *See* Jnt. App. R. Exc. at 9.

The OSBA's focus, which is on the competitive aspects of the merger and the quantification of benefits to Pennsylvania, as the OCA's, continually draws into play the out-of-region dominance of SBC. (OSBA Stmt. 1, at 9). Yet, the OSBA witness concedes that SBC and AT&T have limited direct competition in Pennsylvania (Stmt. 1 at 12); that the merger has no appreciable direct effect on concentration in any relevant Pennsylvania market (*Id.*); and that SBC and AT&T are probably the most capable of all potential competitors to

provide facilities-based competition in Pennsylvania (Stmt. 1 at 19). The OSBA, therefore, invites this Commission to view the instant Application in the context of broad national trends, rather than as a "stand alone proposition." (Stmt. At 17).

The greatest anticompetitive effect of the merger identified by the OSBA is the elimination of competition between SBC and AT&T. (Stmt. 1 at 20). However, this perceived anticompetitive effect is belied by the record.

Currently, SBC on its own lacks the necessary array of enterprise services and the national network needed to support a broad array of services and customers outside the areas where SBC is the incumbent local exchange company. Although AT&T has had success in the enterprise market, its business decisions made its long term viability questionable. (Jnt. App. Stmt. No. 4-R at 12; No. 4-RJ at 1-2 (Morrissey Rebuttal & Rejoinder)).

SBC Telecom reports that in Pennsylvania (Jnt. App. Stmt. No. 3, at 10 (Carlton and Sider Direct, footnotes omitted)).

As of April 30, 2005, (Carlton and Sider Direct, footnotes omitted)).

According to the FCC, the total number of access lines provided by all CLECs to residential and small business customers in Pennsylvania in 2004 is roughly 887,000. (Jnt. App. Stmt. No. 3, at 10 (Carlton and Sider Direct, footnotes omitted).

SBC Telecom provides service to while, as noted above, the total number of access lines provided by all CLECs to residential and small business customers in Pennsylvania is roughly 887,000. (Jt. App. Stmt. No. 3, at 24 (Carlton and Sider Direct)).[14]

SBC markets wireless and other services to its telephone subscribers and will have an incentive to retain AT&T's current customers to facilitate marketing additional services to them. (Jnt. App. Stmt. No. 3, at 25 (Carlton and Sider Direct)).

The Joint Applicants testified that post merger SBC will not be expected to increase prices for any service. (Jnt. App. Stmt. No. 3, at 25 (Carlton and Sider Direct)).

(Jnt. App. Stmt. No. 3, at 29-30 (Carlton and Sider Direct, footnotes omitted)).

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[14] ILECs and CLECs together provide 5.9 million access lines to residential and small business customers in Pennsylvania. (Jnt. App. Stmt. No. 3, at 24 (Carlton and Sider Direct, footnotes omitted)).

CLECs serve approximately 820,000 business lines in Pennsylvania, and ILECs and CLECs together provide over 2.4 million business lines. (Jnt. App. Stmt. No. 3, at 29-30 (Carlton and Sider Direct, footnotes omitted)).

SBC has a minimal presence in Pennsylvania; there are virtually no horizontal effects from the transaction. (Jnt. App. Stmt. No. 3, at 30 (Carlton and Sider Direct)).

We do not agree that the Joint Applicants have failed in their proof, with sufficient specificity, of the public benefits of the merger. As recognized in our discussion of the Joint Applicant's Exception 2, the prospects for competition in the mass market by a "stand-alone" AT&T are dire.

AT&T's 2005 business plan assumes a further decline of more local customers – to about 50 percent of the total that had been in service when AT&T ceased active marketing – by the end of this year. (Jnt. App. Stmt. No. 4-R at 7 (Morrissey Rebuttal)). Nationally, AT&T's residential stand-alone long distance customer base continues to decline by each month. (Jnt. App. Stmt. No. 4-R at 7 (Morrissey Rebuttal)). AT&T lost almost [stand-alone long distance customers in 2004. At the end of January 2005 AT&T had fewer than such customers, a reduction of nearly two-thirds from January 2001. (Jnt. App. Stmt. No. 4-R at 7 (Morrissey Rebuttal)).

Further, AT&T's Consumer Services revenue fell. (Jnt. App. Stmt. No. 4-R at 7 (Morrissey Rebuttal)).

AT&T expects Consumer Services revenue to fall to, a reduction of over 57% from 2003 levels. (Jnt. App. Stmt. No. 4-R at 7 (Morrissey Rebuttal)).

As a result of its decision to cease actively competing in the mass market, AT&T has reduced the number of employees devoted to marketing and customer care, and retired much of the physical infrastructure necessary to support AT&T's mass market efforts. (Jnt. App. Stmt. No. 4 at 18 (Morrissey Direct)).

AT&T's telemarketing division (including outsourcing) which handled telemarketing for local and long distance services, was cut from by the end of this year. (Jnt. App. Stmt. No. 4-R at 8 (Morrissey Rebuttal)).

The sales and customer care force for domestic long distance was reduced from Similar employee reductions are occurring throughout the Consumer Services division. (Jnt. App. Stmt. No. 4-R at 8 (Morrissey Rebuttal)).

The Commission will retain the same regulatory authority over the AT&T subsidiaries that it possessed pre-merger and the AT&T PA-Companies

will be owned by the same entity, AT&T Corp., that owned those subsidiaries pre-merger. (Exh. C of Jnt. App. and Jnt. App., ¶ 2).

Based on the foregoing, we shall reject the ALJ recommendation which adopted the imposition of conditions as advocated by the OSBA in this proceeding. We conclude that the likelihood of mass market competitive alternatives is promoted, rather than harmed, by approval of the merger. We shall, therefore, modify the Initial Decision consistent with discussion. As discussed later in this Opinion and Order, we find approval of the merger to present substantial public benefits to Pennsylvania consumers and, therefore, will reject the recommendation to approve the Application subject to the condition of a specified level of capital expenditures in Pennsylvania.

(c) The Joint Applicant's Exception 3 and 4:

Exception 3: The proposed condition – that SBC/AT&T spend $80-$100 million per year investing in Pennsylvania's infrastructure – is unprecedented and unlawful.

Exception 4: The proposed condition is arbitrary, capricious and unsupported by the record.

The Joint Applicants presented testimony that the merged company expects to increase capital expenditures in order to achieve innovations for all customers. They claimed that while AT&T has budgeted $200 million dollars per year for five years for research, the post-merger company expects to spend $2 billion dollars, before synergies, over the first several years. This amount is more likely greater than what the two companies alone would spend absent the merger. (Jnt. App. Stmt. No. 2 at 7 (Rice Direct)).

The Joint Applicants explained that the additional spending is expected to lead to higher service quality and new and better products. More specifically, the combined company will develop and deploy new, innovative services, including security and IP-based services beneficial to mass-market and enterprise customers. (Jnt. App. M.B. at 6).

The OSBA submitted that the Commission should "require the merged company to commit to a specific level of investment in their Pennsylvania infrastructure . . . [and] require the Joint Applicants to pay a financial penalty if they fail to make that specified level of investment" as a condition for approval of the merger application. (OSBA MB at 21). The OSBA opines that if the Commission does not impose conditions requiring quantifiable and enforceable affirmative benefits and the merged company subsequently concludes that market forces make investment in some other state more attractive than investment in Pennsylvania, the Commission will have no recourse and the ratepayers will suffer. (OSBA RB at 8).

The Joint Applicants reply that the record evidence is clear that the combined company fully intends to invest in infrastructure in Pennsylvania to compete aggressively for enterprise customers in the state, to offer VoIP throughout the state, and to continue to provide a high level of service to AT&T's existing mass-market customers.[15] At the same time, the Joint Applicants adamantly object to being required to divest assets or commit to specific market-share targets because. They are of the opinion that committing to specific targets or other conditions would lead to inefficiencies and other harm. (Jnt. Apps. M.B. at 28). The Joint Applicants argue that such conditions would undermine the combined company's ability to respond to marketplace conditions, to deploy new

[15] *See* Joint Applicants' Statement No. 1 at 20 (Kahan Direct).

products and to make those products available across the full range of customers that the company intends to serve. (Jnt. App. RB at 5)

Based on the conclusion that the Applicants failed to prove by record evidence that its proposed $2 billion in capital expenditures would be beneficial to the merged companies' customers in Pennsylvania (I.D. at 33), and that the Company provided no reasonable time frame for the expectation of when improvements resulting from the capital expenditure will be realized in Pennsylvania, (I.D. at 34), the ALJ found the imposition of conditions were appropriate. In finding that some of the benefits asserted by the Joint Applicants were general in nature, the ALJ prefer approval with certain conditions over a remand of the proceeding to develop a further record to address and remedy the perceived deficiencies of the proclaimed benefits. (I.D. at 35).

In light of the above, the ALJ supported the OSBA's recommendation to condition the approval of the merger on the post-merged company's commitment to a specific level of capital expenditure in Pennsylvania's infrastructure. The ALJ reasoned that this condition would remedy the deficiencies in proposed benefits of the merger regarding capital spending in Pennsylvania and quality of service to Pennsylvania customers. She also agreed with the OSBA that the condition would remedy the post-merger entity's activity concerning Pennsylvania's mass market customers. (OSBA MB at 20). The ALJ additionally noted that the condition would promote the public interest as mandated by Section 1103(a) of the Code, 66 Pa. C.S. § 1103(a).

Based on the foregoing, the ALJ recommended that the Commission require the Joint Applicants to conditionally commit to a certain level of capital spending in Pennsylvania. (I.D. at 38). However, since the record did not yield a reasonable basis to arrive at what that investment level should be, the ALJ used

the following criteria in developing the appropriate portion of investment level for Pennsylvania:

> The record does reveal that the investment level could take place over a five (5) year period. (See Joint Applicants' Stmt. No. 2 at 7. (Mr. Rice discusses AT&T's budgeted investment per year over five years for research initiative and states the post-merger entity's expectation of higher capital spending to achieve innovations.)) Also, taking judicial notice of FCC's Statistics of Communications Common Carriers 2003/2004 edition (the latest data available), an allocator can be developed indicating the size of Pennsylvania divided by the amount of activity in the US to find the portion of investment level for Pennsylvania ... .

(I.D. at 38).

The ALJ then calculated various scenarios of what a proper allocation of the $2 billion dollars to Pennsylvania might be, based on Plant in Service (4.25%), Total Operating Revenues (4.23%) and Switched Access Lines (4.88%). (*See* I.D. at 38-39).

In light of the above, the ALJ recommended that the Commission impose a condition for approval of the Joint Application by requiring the post-merger entity to spend at a minimum of four to five percent of the total $2 billion dollars investment in Pennsylvania's infrastructure for telecommunications to be spread out over a five-year period following the issuance of the merged entity's certificate of convenience. (I.D. at 39; I.D. Ordering Paragraph 1(a) at 42). This would result in the merged entity spending an average of between approximately $16 to $20 million per year in Pennsylvania infrastructure each year during the next five years. The ALJ also recommended that the post-merger entity be

required to report annually to the Bureau of Fixed Utility Services, its itemized compliance over the five-year period. (I.D. Ordering Paragraph No. 1(b) at 42).

With regard to the OSBA's suggestion to require the Joint Applicants to pay a financial penalty if they fail to make the specified level of investment necessary, the ALJ declined to recommend such a requirement. Rather, the ALJ reasoned that the Commission can monitor the investment through reports submitted by the post-merger entity to the Commissions' Bureau of Fixed Utility Services. Depending on the circumstances, the Commission may then use its discretion to invoke a fine pursuant to Section 3301 of the Code, 66 Pa. C.S. § 3301(a), if it is revealed that the merged company failed to comply with the capital spending investment condition. (I.D. at 39).

The Joint Applicants excepted to the ALJ's proposed condition to require the merged company to invest between $80 to $100 million per year in Pennsylvania's infrastructure.[16] The Joint Applicants argue in two separate Exceptions (Exceptions 3 and 4) that the proposed expenditure condition is: (1) unprecedented and unlawful (Jnt. App. Exc. No. 3 at 14-19), and (2) arbitrary, capricious and unsupported by the record. (Jnt. App. Exc. No. 4 at 19-21).

With regard to the proposed condition being "unprecedented and unlawful," the Joint Applicants reiterate their argument that, pursuant to the standards established in the *City of York*, the Commission has no authority to impose conditions merely because it desires to "remedy" perceived deficiencies in other benefits that are not necessary to satisfy the *City of York* standard. As such, the Joint Applicants take exception to the ALJ's rationale that the capital

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[16] As will be discussed later, the ALJ actually only recommended that the merged entity be required to invest between $16 to $20 million annually in Pennsylvania's infrastructure.

expenditure condition "remedies the deficiencies in proposed benefits . . . regarding capital spending in Pennsylvania and quality of service to Penn customers."[17] The Joint Applicants argue that, contrary to the ALJ's reas the establishment of conditions are not appropriate to "remedy the deficiency in proposed benefits." Rather, as expressed by the Commission in the *Pennsylvania-American/Thames Order*, the Joint Applicants assert that conditions are only appropriate in those instances when "the Commission can approve a merger that would not otherwise meet the *City of York* legal standard."[18] Since conditions in this instance are not necessary to satisfy the *City of York's* legal standard for approval, the Joint Applicants request that the Commission reject the ALJ's capital investment condition. (Jnt. App. Exc. at 1 and 14).

The Joint Applicants also believe it is important to note that, in the past, this Commission imposed conditions on the merging companies that were either established incumbents or monopoly utilities and only when it was determined that the merged company would possess a significant market advantage. For example, the Joint Applicants reference the *Bell/GTE Merger* wherein the Commission established conditions for approval. The Joint Applicants refer to the Statement of former Commissioner Brownell, that the *Bell/GTE Merger* "permits two incumbent local exchange carriers to combine to produce significant market advantage in Pennsylvania's local exchange market."[19] In the instant merger proceeding, however, the Joint Applicants note that the SBC/AT&T merged company will be a CLEC rather than an incumbent LEC. In

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[17] I.D. at 37.

[18] *See Pennsylvania-American/Thames Initial Decision*, 2002 Pa. PUC LEXIS 32, at *34-*35.

[19] *See* Joint Applicants' Reply Brief at 4-5 and n. 10 (citing *Bell Atlantic/GTE Order*, 1999 Pa. PUC LEXIS 86, at *44-*65; *id.* at *75-*76 (recognizing "that this transaction permits two incumbent local exchange carriers to combine to produce significant market advantage in Pennsylvania's local exchange market") (separate statement of Commissioner Brownell).

contrast to an ILEC, the merged company would be competing with other Pennsylvania CLECs, wireless providers, and cable companies throughout Pennsylvania. (Jnt. App. Exc. at 15).

The OSBA, in its Reply Exceptions, states that the Joint Applicants' implication that the Commission may impose conditions only when the merging parties fit within the category of incumbent local exchange carriers is inconsistent with Section 1103(a) of the Code. This section provides that "[t]he commission, in granting such certificate [of public convenience], may impose such conditions as it may deem to be just and reasonable." (OSBA R.Exc. at 14-15).

The Joint Applicants also note that the ALJ correctly rejected the OCA-proposed conditions because: (1) those conditions would "subject the combined company to regulator costs and disadvantages that no other provider in the . . . telecommunications market incurs,"[20] and (2) "it is not in the province of the Commission to interfere with the management of the utility unless abuse of discretion or arbitrary action is established. *Id.* The Joint Applicants argue that the ALJ's rationale in rejecting the OCA's proposed conditions should also apply to the ALJ's proposed capital investment condition because requiring the Company to invest up to $100 million per year in Pennsylvania infrastructure is as much as an unfair regulatory cost and disadvantage to the merged company as any of the OCA conditions that she rejected.[21] (Jnt. App. Exc. at 15-16).

The Joint Applicants further argue that the ALJ's proposal will greatly affect the merged company management's discretion on how to allocate

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[20] I.D. at 36 (quoting Joint Applicants' M.B. at 6-7) (ellipsis in original).

[21] Again, we note that the ALJ actually recommended that the merged entity be required to invest between $16 to $20 million annually in Pennsylvania's infrastructure.

and invest resources to respond to marketplace demands. This would be entirely contrary to the well-established precept cited by the ALJ that "it is not within the province of the Commission to interfere with the management of the utility unless the abuse of discretion or arbitrary action is established."[22] The Joint Applicants also object to the ALJ's proposed capital investment condition because it may not be necessary for the merged company to make such large annual investments in Pennsylvania and no guarantees exist that the merged company would be able to recoup the required annual Pennsylvania investments from its customers. (Jnt. App. Exc. at 17). The Joint Applicants assert that this would be contrary to the Commerce Clause, which prevents a state from seeking a benefit for its own consumers or producers at the expense of those of other states. (Jnt. App. Exc. n. 42 at 17).

In Reply Exceptions, the OSBA finds that it is significant to note that the ALJ concluded that, without her recommended capital investment condition, the Joint Applicants have not met their burden of proof under *City of York*. Furthermore, the OSBA submits that although the condition would require an aggregate investment of $80 million to $100 million in Pennsylvania's telecommunications infrastructure, the management of the merged entity, rather than the Commission, would retain considerable discretion in choosing the particular items in which to invest and in determining how much to invest in each of those items. (OSBA R.Exc. at 15). The OSBA contends that the Joint Applicants' arguments are similar to arguments that the commission previously rejected when imposing merger conditions in the GPU/FirstEnergy merger.[23]

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[22] *See Metropolitan Edison Co. v. Pennsylvania Pub. Util. Comm'n*, 437 A.2d 76, 80 (Pa. Commw. Ct. 1981) (emphasis added).

[23] *See Joint Application for Approval of the Merger of GPU, Inc. with FirstEnergy Corp.*, 2001 Pa. PUC LEXIS 23, at 67-68.

The Joint Applicants further argue that the ALJ's logic that Pennsylvania consumers can benefit *only* if investment dollars are spent in Pennsylvania is flawed in light of the fact that research and development investments made in other states are just as likely to benefit Pennsylvania. (Jnt. App. Exc. at 17-18).

With regard to the Joint Applicants' argument that the ALJ's proposed capital investment condition is arbitrary, capricious and unsupported by the record, the Joint Applicants argue the following:

> 1. The ALJ's assumption, on page 38 of the Initial Decision, that the $2 billion in higher capital spending will occur over a period of five years is unsupported by the record. The Joint Petitioners argue that the ALJ incorrectly assumed that the $2 billion spending (which the record shows would be spent "over the first several years") would occur over the same five-year period that AT&T budgeted for research on a number of initiatives. (Joint Applicants Exc. at 20);
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> 2. The four to five percent allocator calculated by the ALJ to determine the amount that the merged company should expend in Pennsylvania is irrational and completely unrelated to the assets that the merged company actually has in Pennsylvania or nationwide. The Joint Applicants argue that the ALJ's percentage would be meaningful only if it was assumed that the merged company would spread its $2 billion investment throughout the country in direct proportion to other carriers' nationwide plant in service, operating revenues, and/or switched access lines. (Jnt. App. Exc. at 20);
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> 3. The Initial Decision is not clear with regard to the total amount of investment the ALJ is purporting to require because Ordering Paragraph No. 1 proposes that the post-merger entity spend a minimum of four to five percent (4-5%) of $2 billion, or $80-$100 million,

in Pennsylvania's infrastructure[24] whereas in other areas of the Initial Decision, the ALJ calculated different allocated portions of $2 billion based on the FCC's data on plant in service, total operating revenue and switched access lines as discussed on pages 38-39 of the Initial Decision. (Jnt. App. Exc. at 20).[25]

4. The ALJ made no attempt to justify whether the required capital investment in Pennsylvania is necessary or appropriate. (Jnt. App. Exc. at 20).

In its Reply Exceptions, the OSBA further oppose the Joint Applicants' arguments that the ALJ's capital investment recommendation is arbitrary, capricious and unsupported by the record. The OSBA argues that the ALJ appropriately determined the amount of Pennsylvania's share of the investment and the number of years over which the merged entity would be required to make the investment for the following reasons: 1) the ALJ began her calculation with the same $2 billion investment projection that the Joint Applicants placed into the record; 2) the ALJ drew on testimony of one of the Joint Applicants' witnesses to arrive at five years s the period over which the investment should be made (*i.e.*, the five-year period selected by the ALJ is

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[24] I.D. at 42.

[25] Although the Joint Applicants believe that the wording in the ALJ's Initial Decision is ambiguous, it appears based on our reading, in the context of the ALJ's discussion on pages 38-39, that she intended that the merged entity be required to spend a minimum of four to five percent of the total $2 billion dollar investment in Pennsylvania over a five year period. In other words, assuming that the merged entity would spend exactly 1/5 of the $2 billion dollars, or $400,000,000 per year nationwide during the next five years, the ALJ's requirement would require that the merged entity spend four to five percent of that $400,000,000, or between $16,000,000 to $20,000,000, in Pennsylvania's infrastructure. Of course, there is a possibility that the merged entity may not expend the estimated $2 billion in equal annual amounts; in those cases, it appears that the ALJ probably intended that the merged entity spend four to five percent of that amount in Pennsylvania. Nevertheless, as will be discussed below, this issue is rendered moot in light of the fact that we will not recommend adoption of the ALJ's proposed capital investment condition.

consistent with the Joint Applicants' statement in their original Application that the $2 billion will be spent "over the first several years after closing;" and 3) Rather than relying on only one of the allocation factors pertaining to Pennsylvania's plant in service, total operating revenues and switched access lines, the ALJ used all three in establishing a reasonable range of required investment of four to five percent. The OSBA further asserts that if the Commission agrees with the Joint Applicants' criticism of the required investment period or any alleged ambiguity over the amount of investment recommended by the ALJ, the appropriate remedy would be to remand the matter to the ALJ for further development of the record. (OSBA R.Exc. at 17-19),

Although the OSBA noted in its Exception No. 2 that it agreed with the ALJ that the proposed merger should be approved with the condition that the merged entity commit to a specific level of investment in Pennsylvania, the OSBA takes the view that the ALJ erred by failing to prescribe an effective penalty that can be imposed in the event that the post-merger entity does not make the required investment. (OSBA Exc. No. 2 at 9-10). The OSBA opines that the rationale to reject imposition of a civil penalty pursuant to Section 3301 of the Code, 66 Pa. C.S. § 3301, if the merged company does not comply with the specified level of investment, is not a sufficient incentive to assure that the Company will invest the required $16 to $20 million per year in Pennsylvania. This is especially so in light of the fact that the civil penalty may not exceed $365,000 per year. The OSBA asserts that the Commission should design a penalty commensurate with the $16 to $20 million required investment because the difference between the required investment and the potential penalty is so great that the merged entity may opt to only pay the penalty.

The Joint Applicants reply to the OSBA's position on a civil penalty by explaining that this position ignores the fact that, pursuant to Section 501(b) of

the Code, 66 Pa. C.S. § 501(b), the Commission has authority to supervise and regulate all public utilities doing business in Pennsylvania. In addition, pursuant to Section 502 of the Code, 66 Pa. C.S. §502, the Commission has the authority to institute "appropriate legal proceedings . . . to enforce obedience" to "any lawful requirement, regulation or order." As such, the Joint Applicants argue that the civil penalty provisions are an enforcement mechanism in addition to, and not in lieu of, the Commission's authority to enforce the underlying terms of its orders. In light of the above, the Joint Applicants aver that the ALJ correctly concluded that there is no need to prescribe an additional penalty. (Jnt. App. R.E. at 11-12). They also note that if the Commission rejects the ALJ's capital investment recommendation, then the OSBA's argument, that the ALJ should have imposed a penalty for failure to comply with the required intrastate capital investment, would be rendered moot. (Jt. App. R.Exc. at 11).

Disposition

Based on our rejection of the recommendation to impose a capital spending requirement on the Joint Applicants as a condition of our approval of the instant merger, we conclude that this issue is moot. We clarify, however, that requiring conditions in this instance is not necessary in light of the fact that the proposed merger provides affirmative public benefits under the *City of York* standards. Notwithstanding the affirmative benefits of the merger, however, were the record to indicate service deficiencies or infrastructure deterioration to the point of impairing the technical, managerial, or financial fitness of the merging companies, our consideration of analogous condition would be pertinent.

Finally, we also agree with the Joint Applicants argument on pages 17-19 of their Exceptions, that the $2 billion anticipated investment, which will be used, in part, to integrate SBC's and AT&T's networks, will benefit Pennsylvania

consumers even in those instances where such investment takes place outside of the Commonwealth and demonstrates the imminent likelihood of maintaining the AT&T infrastructure presence in Pennsylvania.

For the reasons discussed above, we are not persuaded by the ALJ's finding that it is reasonable and appropriate to require the Joint Applicants to conditionally commit to a certain level of capital spending in Pennsylvania. As such, we shall grant the Joint Applicants' Exceptions and reverse the ALJ, consistent with our discussion, on this matter.

2. **The OCA's Exceptions**

(a) **OCA's Exception 1: The ALJ erred in determining that the Commission does not have the authority to direct the merged company to divest its duplicative assets to a carrier that will commit to compete aggressively for mass market customers as a part of this proceeding.**

The OCA supports the overall result established by the Initial Decision of ALJ Jones. (Exc. at 2). However, it filed Exceptions to that portion of the ALJ recommendation which rejected its proposal to direct, as a condition of the grant of a certificate of public convenience, the divestiture of assets to a carrier that would commit to compete "aggressively" in the mass market. (Exc. 4-11).

In this proceeding, the OCA opposed the Joint Application based on its observation that the merger of the two entities represented a "significant step in the direction of reassembling the old Bell monopoly but without the concomitant regulatory oversight." (Exc. at 4 referring to OCA MB at 20-23). In the alternative, the OCA argued for the direction that the merger be conditioned on the merged company's strong commitment to compete "aggressively" for mass market customers in Pennsylvania, or that the merged company divest its duplicative

assets to a carrier that will provide such aggressive competition. (Exc. at 4). What is of concern to the OCA, is that the ALJ rejected its proposal and provided the following rationale regarding the Commission's authority to issue such a directive:

> To order the merged entity to transfer its Pennsylvania mass market operations to a competitive carrier seems analogous to forcing the merged entity to conduct a fire sale of its assets to a competitor. I find that this action may be inconsistent with the powers of the Commission. 66 Pa. C.S. § 501(b). It is not within the province of the Commission to interfere with the management of the utility unless abuse of discretion or arbitrary action is established. *Pennsylvania R. Co. v. Pa. Public Utility Comm'n*, 146 A.2d 352, 187 Pa. Super. 590 (1958), *vacated* 152 A.2d 422, 396 Pa. 34. *See also, Northern Pennsylvania Power Co. v. Pa. Public Utility Comm'n*, 333 Pa. 265, 5 A.2d 133 (1939); *National Fuel Gas Distribution v. Pa. Public Utility Comm'n*, 76 Pa. Commw. 102, 464 A.2d 546 (1983); *and Pa. Public Utility Comm'n v. Phila. Electric*, 501 Pa. 153, 460 A.2d 734 (1983). No evidence was provided to conclude that the Joint Applicants abused their discretion or acted arbitrarily. Because of case law, I find that the Commission does not have the authority to implement this request.

(I.D. at 36-37).

In its Exceptions, the OCA engages in a passionate defense of this Commission's authority to order a divestiture of duplicative assets as a condition of our approval of the merger in this proceeding. The OCA distinguishes an impermissible interference in the managerial discretion of a utility from the issues pertinent to this case. It cites Section 501 of the Code, 66 Pa. C.S. § 501, and *Pa. PUC v. Phila. Elec. Co.*, 460 A.2d 734 (Pa. 1983), to maintain that the applicable statutory provision and caselaw support the authority of the Commission to issue

orders and regulations to assure that the provisions of the laws governing public utilities in Pennsylvania are enforced. (Exc. at 5).

More specifically, the OCA references recent decisions of the Commission, citing, *inter alia*, the Commission's *Global Order*, 93 PAPUC 172 (1999), *aff'd Bell-Atlantic-Pa. v. Pa. PUC*, 763 A.2d 440 (Pa. Cmwlth. 2000) (complete subsequent history omitted), and *ReDQE. Inc.*, 88 PAPUC 46 (1998), and distinguishes those cases cited by the presiding ALJ, to argue that it is error to conclude that the Commission does not have authority to direct the merged company to divest its duplicative assets to a carrier that will commit to compete aggressively for mass market customers as part of this merger approval. (Exc. at 10-11).

In Replies, the Joint Applicants respond that because the record does not support any requirement that the Joint Applicants divest their mass market assets, the Commission need not address the issue in this proceeding. (R.Exc. at 7). The Joint Applicants disagree with the OCA's explanation of the holdings in the Commission's *Global Order* and *In re DQE* as those cases would apply to the instant proceeding. (R.Exc. at 8-9).

Disposition

The Joint Applicants provide two responses to the OCA's Exceptions which we find helpful. First, the Joint Applicants refer to the testimony of their witnesses, Professor Carlton and Dr. Sider. These witnesses observed that, if one were to assume a divestiture of duplicative assets, there is no evidence of record that would suggest that a buyer of these divested assets would face incentives that differ substantially from those that AT&T faced when deciding to cease actively marketing its mass-market services. (R.Exc. at 6, citing

Jnt. App. Stmt. 3-R, at 8:14-16). In contrast, the Joint Applicants assert that the merged company will have greater incentives and capacity to retain AT&T's mass market customers than AT&T standing alone. (R.Exc. at 6-7).

Second, the Joint Applicants emphasize that the merger between SBC and AT&T presents no concern about market power. (R.Exc. at 9 citing Jnt. App. Stmt. 3-RJ, at 2L11-20). Based on the foregoing, the Joint Applicants reply that the ALJ was correct that a divestiture is an unwarranted remedy under the circumstances presented in this record.

On consideration of the Exceptions of the OCA, we shall grant them solely for the purpose of acknowledging that divestiture of assets as a condition to the grant of a certificate of public convenience is an extraordinary remedy. However, it is a remedy which has its basis in express and implied provisions of the Public Utility Code. *See, generally Bell v. Pa.PUC*, also *Re: Structural Separation of Bell Atlantic-Pennsylvania, Inc. Retail and Wholesale Operations*, Docket No. M-00001353 (Order entered April 11, 2001). However, we find no need to engage in a more definitive analysis of the applicability of this remedy to the present case based on the considerations observed by the Joint Applicants. We conclude that the OCA-proposed conditions, including the divestiture of mass market facilities, is ill-advised under these circumstances.

As a threshold consideration, we agree with the observations of the Joint Applicants that there are no market power concerns involved in the present case. As noted, SBC on its own lacks the necessary array of enterprise services and the national network needed to support a broad array of services and customers outside the areas where it is the incumbent local exchange company. Although AT&T has had success in the enterprise market, its business decisions made its long term viability questionable. (Jnt. App. Stmt. No. 4-R at 12; No. 4-

RJ at 1-2 (Morrissey Rebuttal & Rejoinder)). The compatibility of the two networks is favorable and, notwithstanding that the merged company will widen the "gap" between itself and the next largest Pennsylvania CLEC, it would not present market power concerns.

Based on the foregoing, the Exceptions of the OCA are granted and denied, consistent with the above discussion.

(b) OCA's Exception 2: The ALJ erred in determining that certain benefits will arise as a result of this merger.

In its Exception No. 2, the OCA responds to the ALJ's subsidiary determinations that indicate there may be some benefits as a result of the merger as filed by the Joint Applicants. (Exc. at 11).

First, the OCA excepts to the ALJ's characterization of the provision of TRS, at least to the beginning of 2007, as a benefit of the proposed merger. In support of this Exception, the OCA states that AT&T is obligated and compensated to provide this service, pursuant to prior Commission Orders. Therefore, the OCA argues that this is not a benefit arising as a result of the proposed merger. (Exc. at 11, 12). Next, the OCA excepts to the ALJ's conclusion that benefits of the merger would include: 1) maintaining the *status quo* of competition, and 2) no adverse impact upon the rates paid by consumers. In support of this Exception, the OCA states that the Joint Applicants have not offered any promises, nor made any firm commitments in this merger proceeding, regarding increased competition or lower prices. Rather, the Joint Applicants have only offered vague statements and general claims regarding the combined company's resources and potential. (Exc. at 12).

Disposition

Consistent with our previous disposition of the Joint Applicants' Exception Nos. 1 and 2, we shall grant the Joint Applicants' Exceptions on this matter. In making this determination, we are of the opinion that those benefits cited by the Joint Applicant, although characterized as general in nature, are indeed benefits that may occur as a result of the proposed merger.

We conclude that the OCA's Exceptions should be denied. AT&T's proposed withdrawal from the mass market, a decision which predated and was independent of the merger, strongly calls into question the continued viability of the provision of TRS service by AT&T. The withdrawal from the mass market could have reasonably led AT&T to eventually file for permission to abandon TRS service in Pennsylvania. By committing to providing TRS service in Pennsylvania until the beginning of 2007, this Commission will have sufficient time to properly transition to selecting a new TRS provider, should that be necessary. In addition, maintaining *status quo* of AT&T's existing customer base in Pennsylvania would be a superior alternative to migrating those existing customers to other carriers in the event that AT&T filed to cancel its subsidiary companies' certificates.

Regarding the deployment of VoIP to the mass market in Pennsylvania, the Joint Applicants believe that the ALJ has lost sight of the tightly contested nature of the competitive market, where the Joint Applicants assert the risks are high and success in not assured. We believe that, on this issue the Joint Applicants have not properly interpreted the ALJ's finding as presented at page 33 of the I.D. The ALJ clearly stated that the Joint Applicants did not provide any time frame during which VoIP would be targeted to consumers in Pennsylvania. The ALJ did not presume any level of risk or market success regarding the deployment of VoIP services.

3. The OSBA's Exceptions

(a) OSBA's Exception 1: The ALJ applied the incorrect legal test when she determined that the proposed merger would produce some affirmative benefits.

In its first Exception, the OSBA argues that the ALJ applied the incorrect legal test when she concluded that the merger would produce some affirmative benefits.

The OSBA, citing the *City of York*, and Section 1102 of the Code, finds it objectionable that the ALJ concluded that an affirmative benefit was shown by the merger's preservation of the status quo regarding its affect on rates and the provision of TRS service in Pennsylvania. (Exc. at 3-8).

The Joint Applicants, in their Replies, pointedly observe that the OCA and the OSBA, in arguing against the status quo as sufficient to meet the standards of the City of York, fail to realize that in the absence of the merger, AT&T would impose higher rates on its customers, and would "disappear" altogether from the mass market. (R. Exc. a 3). They state, "[w]hen the alternative to the merger is higher consumer rates, less effective competition, and the serious risk of interrupted TRS service, then ensuring that rates will not rise appreciably and guaranteeing the provision of TRS services by a financially stronger company are clear, affirmative benefits." *Id.*

The Joint Applicants refer to their testimony that AT&T's rates for the mass market have risen consistently and repeatedly in the last year since it made its decision to withdraw from the mass market. It further explains that, in contrast to the business plan of the stand-alone AT&T, the combined company

will not exit from the provision of consumer services and would have strong incentives to retain AT&T's former customers. (R.Exc. at 4).

Also, with respect to TRS services, the Joint Applicants repeat that the withdrawal of AT&T from the mass market could jeopardize its role as the TRS service provider in Pennsylvania. (R.Exc. at 4).

Disposition

We shall deny the Exceptions of the OSBA consistent with our discussion throughout this Opinion and Order. The retention of a CLEC in the mass market, where the CLEC, on a prior, stand-alone basis, had a verifiable intent to exit this market must be viewed as an affirmative benefit to the public. Market considerations determine which companies will enter and which will exit a particular market. We agree with the position of the Joint Applicants where they explain that, ". . . if the merger makes it possible for AT&T to continue . . . " then its continuation is a benefit of the merger. (R.Exc. at 5).

(b) OSBA's Exception 2: The ALJ erred by failing to prescribe an effective penalty that can be imposed in the event that the post-merger entity does not make the investment required as a condition of the merger.

This issue has been resolved, consistent with our discussion, above. The Exceptions of OSBA are denied.

(c) OSBA's Exception 3: The ALJ erred by failing to require the merged entity to flow through revenues from access charge reductions to its customers.

The OSBA advocated that if the Commission approves the proposed merger, the approval should be conditioned upon an agreement that the merged company will not seek further access charge reductions until the FCC completed its ruling in its Unified Intercarrier Compensation proceeding.[26] The OSBA further argued that it has not seen proof in the past that access charge reductions resulted in "dollar-for-dollar reductions in toll rates." Therefore, the OSBA argued that the merged company should be directed to flow through every dollar it receives in access charge reductions to its ratepayers. Otherwise, the OSBA argues, the merger would lack the "real, quantifiable benefit" that would justify approval. (OSBA M.B. at 21-22.)

The Joint Applicants argue that the Commission, in its *Pennsylvania-American/Thames Order*, previously rejected the suggestion that a finding of "quantifiable" benefits is necessary for merger approvals. Furthermore, the Joint Applicants argue that the record in the instant proceeding is insufficient for the Commission to determine whether or not AT&T's Pennsylvania customers are receiving the full benefit of prior Commission-ordered access charges. The Joint Applicants note that the Commission is directly addressing the access charge issue in a separate pending proceeding in which they claim AT&T has already presented substantial evidence that its Pennsylvania customers currently receive the full benefit of prior Commission-ordered access charge reductions.[27] As such, the Joint Applicants are of the opinion that it would be best to address flow-through of access charge reductions in that proceeding. (Jnt. App. R.B. at 10-11).

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[26] *See In the Matter of Developing a Unified Intercarrier Compensation Regime*, CC Docket No. 01-92 (FNPRM Rel. March 3, 2005).

[27] *See AT&T Communications of Pennsylvania, Inc. v. Verizon North Inc. and Verizon Pennsylvania Inc.*, Docket No. C-20027195.

The ALJ agreed with the Joint Applicants that it would be inappropriate in this proceeding to condition approval of the merger on the merged entity's agreement to flow through additional reductions of access charges to Pennsylvania ratepayers. The ALJ specifically cited to the lack of supporting evidence in the instant record pertaining to the reduction of access charges as rationale for her determination and insinuated that the matter would best be addressed in the pending access charge proceeding at Docket No. C-20027195. (I.D. at 37).

In its Exceptions, the OSBA opines that the ALJ erred by failing to require the merged entity to flow through savings from access charge reductions to its customers. The OSBA notes that Section 3017(a) of the Public Utility Code, 66 Pa. C.S. §3017(a) does not allow the Commission to order a local exchange company (LEC) to reduce access charges unless it also allows that LEC to offset the access charge reductions with corresponding increases in other rates. As such, the OSBA is concerned that if the SBC/AT&T and Verizon/MCI mergers are approved, market pressures, which might otherwise have forced AT&T to flow through future access charge reductions, could significantly be diminished. The OSBA argues that AT&T's long distance customers will then be forced to pay higher rates for LEC-provided services but will not enjoy any offsetting savings in rates for their toll services provided by AT&T. The OSBA also asserts that the prospect of higher local exchange rates without comparable reductions in toll rates is inconsistent with the ALJ's conclusion on pages 34-35 of her Initial Decision that the proposed merger would not have an adverse effect on rates. (OSBA Exc. at 11-12).

The Joint Applicants rejoin that, as argued in their Reply Brief on page 11, it is not appropriate to use this proceeding to address "the flow-through

of access charge reductions to customers" because the Commission is already directly addressing access charge issues in a separate proceeding.[28] They further argue that it would be unlawful for the Commission to require such a flow-through pursuant to Section 3018(b)(1) of the Code, 66 Pa. C.S. § 3018(b)(1), which specifically states that "[t]he Commission may not fix or prescribe the rates, tolls, charges, rate structures, rate base, rate of return, operating margin or earnings for interexchange competitive services or otherwise regulate the interexchange competitive services." (Jt. App. R.E. at 10-11).

Disposition

We are not persuaded by the OSBA's Exceptions on this issue. First of all, as we have previously discussed in this Opinion and Order, and as the Joint Applicants appropriately argued on this Exception, this Commission previously determined in *Pennsylvania-American/Thames Order* that a finding of "quantifiable" benefits is not necessary in order to approve a merger such as the one before us.

Furthermore, we agree with the ALJ that making a determination in this proceeding, to require the flow-through of future access charge reduction to the merged company's customers, is inappropriate. As the Joint Applicants appropriately noted, AT&T presented substantial evidence, in the pending access charge proceeding at Docket No. C-20027195, alleging that its Pennsylvania customers are currently receiving the full benefit of prior Commission-ordered access charge reductions. We also take administrative notice that the OSBA is also a Party in the pending access charge proceeding and is also requesting in that proceeding that further access charge reductions be held in abeyance pending a

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[28] *See* Jt. App. R.B. at 11 (citing *AT&T Communications of Pa., Inc. v. Verizon North Inc.*, Docket No. C-20027195).

final ruling in the FCC's Unified Intercarrier Compensation proceeding. In light of the fact that similar issues to those being argued here are also part of the pending access charge proceeding, we are of the opinion that it would be best to address AT&T's requests for further access charge reductions and the pass-through of access charge expense savings to AT&T's or the merged entity's customers in the adjudication stage of the pending access charge proceeding at Docket No. C-20027195. As such, we shall require that the merged company be subject to the outcome of any of our directives and determinations reached in the pending access charge proceeding at C-20027195. Therefore, we shall deny the OSBA's Exceptions on this issue and adopt the ALJ's recommendation, with the understanding that the merged company will be subject to our resolution of the issues at Docket No. C-20027195.

III. CONCLUSION

In light of the foregoing discussion, we shall grant the Parties' Exceptions in part, and deny them, in part, and modify the ALJ's Initial Decision consistent with the body of this Opinion and Order.

IV. ORDER

THEREFORE,

IT IS ORDERED:

1. That the Joint Application of SBC Communications, Inc., and AT&T Corp., together with its certificated Pennsylvania subsidiaries for approval of a merger filed with the Pennsylvania Public Utility Commission on February 28, 2005, is approved, consistent with the determinations and discussion contained in this Opinion and Order.

2. That a certificate of public convenience be issued evidencing the Pennsylvania Public Utility Commission's approval of the transaction occurring as a result of the Agreement and Plan of Merger dated January 30, 2005, between SBC Communications, Inc. and AT&T Corp. and the AT&T subsidiaries certificated to provide telecommunications services in the Commonwealth of Pennsylvania, AT&T Communications of Pennsylvania LLC, TCG Pittsburgh Inc. and TCG Delaware Valley, Inc., f/k/a Eastern Telelogic Corporation, and the record at Docket Numbers A-311163F0006, A-310213F0008 and A-310258F0005.

3. That the Exceptions of the Parties are granted and denied, consistent with the discussion contained in this Opinion and Order.

4. That the Initial Decision of Administrative Law Judge Angela T. Jones is, hereby, modified consistent with this Opinion and Order.

5. That the record shall be marked closed.

BY THE COMMISSION,

James J. McNulty
Secretary

(SEAL)

ORDER ADOPTED: October 6, 2005

ORDER ENTERED: October 6, 2005

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Service Employees International Union Local 686, AFL-CIO	:	
v.	:	Docket Number C-20039160
Philadelphia Gas Works	:	

ORDER DENYING INTERIM EMERGENCY RELIEF

I. PROCEDURAL HISTORY

On January 8, 2003, the Service Employees International Union, Local 686, AFL-CIO (SEIU or petitioner) filed with the Pennsylvania Public Utility Commission (Commission) a Formal Complaint (Complaint) and a Petition for Issuance of Interim Emergency Order (Petition), along with the Affidavit of Dennis J. Kenney (a PGW Field Collector) to support both pleadings. The subject of both the Complaint and the Petition is SEIU's claim that Philadelphia Gas Works (PGW) is in violation of 52 Pa. Code §56.97 by outsourcing inbound call center functions within the Collections Division to NCO Financial Systems, Inc. (NCO) as of January 3, 2003. The Complaint and Petition were jointly docketed on January 10, 2003.[1] The Petition requested "the Chief Administrative Law Judge and the Commission to issue an Interim Emergency Order that requires PGW to immediately cease and desist from using non-employees to receive telephone calls from customers who have received termination notices."

Pursuant to 52 Pa. Code §3.3.9, a hearing on the Petition was scheduled for January 21, 2003 and the matter was assigned to the

[1] It should be noted that on January 7, 2003, PGW filed with the Commission a Petition for a Declaratory Order Regarding Outsourcing of Collection Calls or, in the Alternative, Waiver of 52 Pa. Code §56.97. This Petition, docketed at P-00032018, is not part of this proceeding although it does seem to involve the same issue.

On January 15, 2003, PGW filed an Answer to the Petition (Answer), along with the Affidavit of Randy Gyory, PGW's Vice-President, Customer Affairs.

The hearing was held as scheduled on January 21, 2003. Both parties, represented by counsel, were present. Petitioner SEIU presented the testimony of two witnesses who sponsored one statement and one exhibit. Both of these witnesses were PGW employees and union representatives. Dennis Kenney is a Senior Field Collector and appointed union representative for Group 10; his Affidavit was admitted into the record as PGW St. 1. James Lennox is Senior Customer Service Representative at the Germantown District Office and appointed union representative for Group 12. He sponsored SEIU Exh. 1, the contract between PGW and NCO. PGW presented the testimony of two witnesses. The first witness, William Sullivan, is employed by PECO Energy Company as Director, Accounts Receivable. His Affidavit was admitted into the record as PGW St. 2. The other witness was Randy Gyory, employed by PGW as Vice-President, Customer Affairs. His Affidavit was admitted into the record as PGW St. 1 and the attachments were admitted as PGW Exhs. RG-1, RG-2 and RG-3. A transcript of 110 pages was produced.

Because of the extremely short time period allowed in 52 Pa. Code §3.7(b) for preparation of this Order, as well as the separate certification of the material question concerning the denial of the requested relief required by 52 Pa. Code §3.10(b), my discussion is necessarily abbreviated. This should not be taken as evidence that any position or argument presented by either of the parties was not fully considered.

II. DISCUSSION

A. Summary

As discussed in more detail below, there is no question that the Petition must be denied. SEIU has failed to meet its burden of establishing each of the requirements set forth in 52 Pa. Code §3.7:

First, the right to relief has not been established as (1) petitioner SEIU has no standing to bring this Petition. It cannot represent the general public interest or residential customers, is not aggrieved, is not itself a residential customer, and the Commission cannot address labor or employment matters; (2) PGW's outsourcing does not constitute a violation of §56.97, as no definition of the term "utility employee" is contained in the Commission's regulations, the Commission is aware that other utilities outsource this function, and such a finding is inconsistent with the Commission's own assessment of the limits of its enabling authority over a utility's management and operational decisions.

Second, there is no need for immediate relief. There is no emergency, defined by 52 Pa. Code §3.1 as "A situation which presents a clear and present danger to life or property or which is uncontested and requires action prior to the next scheduled public utility meeting."

Third, there has been no showing of irreparable harm. SEIU presented no evidence that, absent interim emergency relief, PGW's customers will be improperly terminated or subject to onerous and improper payment arrangements. Until that proof is provided, there is no injury to anyone.

Fourth, there has been no showing that the relief requested is not injurious to the public interest. PGW claimed that to grant the relief requested would cause it to incur substantial additional expense and would result in lowered collection activity. While there was some question as to the analysis presented by PGW in Exh. RG-3, which is attachment C to Mr. Gyory's Affidavit, it is beyond dispute that it would be disruptive to PGW's operations to upset the status quo. There was absolutely no evidence presented that any customer has received inadequate service as the result of the outsourcing and therefore no evidence to sustain a conclusion that the situation should be changed.

It should be noted that I am not addressing PGW's contention that Section 56.97 is not applicable to PGW prior to September 1, 2003, as it is not necessary to do so for resolution of the Petition, and I don't have sufficient time to address this issue thoroughly.

B. Legal Principles

The Public Utility Code, 66 Pa.C.S. §332(a), places the burden of proof upon the proponent of a rule or order. As the proponent of a rule or order, petitioner SEIU has the burden of proof in this matter pursuant to 66 Pa.C.S. §332(a); Beisel v. Pennsylvania Power & Light Company, C-00924683, 1993 Pa. PUC LEXIS 45 (March 12, 1993).[2]

The issue raised in the Petition is that PGW is violating 52 Pa. Code §56.97 by outsourcing certain call center collection functions. That regulation states in relevant part:

> (a) *If, after* issuance of the initial termination notice and prior to the actual termination of service, a ratepayer or occupant contacts the utility concerning a proposed termination, an authorized utility employee shall fully explain:
>
> (1) The reasons for the proposed termination.
>
> (2) All available methods for avoiding termination
>
> . . .

The regulation goes on to state in §56.97(b) that "The utility, through its employee, shall exercise good faith and fair judgment in attempting to enter into a reasonable settlement or payment agreement . . ."

The regulations promulgated by the Commission at 52 Pa. Code §3.6-3.16 permit the filing of petitions for interim emergency orders. Specifically, 52 Pa. Code §3.7 provides that a presiding officer may issue an interim emergency order upon finding that the following exist:

(1) The petitioner's right to relief is clear.

(2) The need for relief is immediate.

(3) The injury would be irreparable if relief is not granted.

(4) The relief requested is not injurious to the public interest.

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[2] A copy of this decision is attached as Appendix 1 to PGW's Answer.

These prerequisites for relief are cumulative; all must be met for the grant of relief and the failure of a petitioner to prove any one of them compels the denial of such relief. Crums Mill Associates v. Dauphin Consolidated Water Company, C-00934810, 1993 Pa. PUC LEXIS 90, *4-5 (April 16, 1993). In addition, the Commission has stated that the standards that govern interim emergency relief are substantially similar to the standards that govern preliminary injunctions in civil proceedings, and that a preliminary injunction is a "most extraordinary form of relief which is to be granted only in the most compelling cases." See, as cited in PGW's Answer at fn. 19, TJS Brokerage & Co., Inc. v. Hartford Casualty Insurance Company and Peterman Company, 45 Pa. D.&C. 4th 1; 2000 WL 1060645 (Pa.Com.PL) (April 24, 2000); Goodies Olde Fashion Fudge Co. v. Kuiros, 408 Pa.Super. 495, 597 A.2d 141, 144 (1991).

In the instant proceeding, there is no real factual dispute, other, perhaps, than the cost analysis presented by Mr. Gyory. As explained in PGW's Answer at 5-6, PGW provides call center functions within two of its operating units. The first is the Customer Service Call Center which is dedicated to handling all call center functions outside of the collections function. The second is the Collections Division which includes a call center function specifically related to collections activity. The Commission issued several orders (Tentative Order entered April 20, 2001 and Order entered June 13, 2002) regarding the call center subcontractor issue at Docket No. M-00011464 which focused entirely on the Customer Service Call Center and did not address the call center functions within the Collection Division. The Commission directed PGW to maintain an "80/30" standard (80% of non-emergency calls answered within 30 seconds) and to consider use of outside contractors if it was unable to maintain the standard otherwise.

According to PGW, in order to maintain the standard and to improve collections, it determined that additional resources needed to be devoted to the Customer Service Call Center. As stated in its Answer, citing Mr. Gryory's Affidavit (PGW St. 1), PGW determined that outsourcing of the handling of inbound collection calls was the most efficient and effective means of maintaining reasonable utility service, as the PGW employees currently handling those calls in the Collection Call Center could be reassigned to the Customer Service Call Center, and the field collectors could remain in the field. Tr. 61-62.

As explained in Mr. Kenney's Affidavit (SEIU St. 1), termination notices that are given to customers by him and the other Field Collectors instruct customers to call a particular telephone number (215-235-1777) to make payment arrangements. Prior to January 3, 2003, these calls (to the Collection Call Center) were handled by PGW employees. On and after January 3, 2003, these calls are being automatically transferred to NCO. As shown on SEIU Exh. 2 (the PGW/NCO contract), the contract between PGW and NCO runs from January 3, 2003 through February 28, 2003.

SEIU witness Lennox testified that when the union was informed of the company's intention to outsource, it presented a counter-proposal to PGW to address the company's desire to increase collections. The four elements of this plan involved: (1) fill the four vacancies in the Collection Call Center; (2) transfer twelve field collectors into the Collection Call Center for the duration of the winter moratorium; (3) use management and supervisory personnel in the Collection Call Center; and (4) extend the employment of temporary employees. Tr. 13-15. PGW witness Gyory testified that the company rejected the union's proposal for two reasons: (1) it was not cost-effective, and (2) it would take too long to "ramp up," in terms of training. Tr. 58-64.

C. Right to Relief

SEIU must establish that its right to relief is clear, pursuant to 52 Pa. Code §3.7(a)(1). SEIU asserts that Section 56.97 is clear on its face, and that the Commission in several cases has determined that "these responsibilities cannot be delegated to outside contractors." Petition, ¶¶4, 5. The cases it cites are Johnston v. Peoples Natural Gas Co., Docket No. C-00935240 (March 6, 1995) and Joseph v. Equitable Gas Co., Docket No. C-00015519, 2002 Pa. PUC LEXIS 7 (March 16, 2002).

For the reasons explained in PGW's Answer and discussed here, SEIU has failed to establish that its right to relief is clear.

1. Standing

SIEU lacks standing. The Commission may not grant a petition for interim emergency relief unless the petitioning party has standing to bring the claim. As it stated in Beisel, supra at *9:

> It is well-settled in the law that standing requires a direct, immediate and substantial interest in the proceeding and there must be a causal connection between the act complained of and any harm. Commonwealth of Pennsylvania, Pennsylvania Game Commission v. Pennsylvania Department of Environmental Resources, 509 A.2d 877 (Pa. Cmwlth. 1986). Furthermore, the principle that one does not have standing merely by asserting the common interest of all citizens in procuring obedience to the law lies behind the traditional standing requirement that the would-be "aggrieved" party must have an interest which is "pecuniary" and "substantial." Wm. Penn Parking Garage, Inc. et al. v. City Pittsburgh, 464 Pa. 168, 346 A.2d 269 (1975).
>
> . . . As articulated by the Pennsylvania Supreme Court in Sierra Club v. Hartman, 605 A.2d 309 (Pa. 1992): The essence of the standing requirement as articulated by this is that: [a] plaintiff . . . must allege and prove an interest in the outcome of the suit which surpasses "the common interest of all citizens in procuring obedience to the law. . . To surpass the common interest, the interest is required to be at least, substantial, direct and immediate." Upper Bucks County Vocational Technical School Education Association v. Upper Bucks County Vocational Technical School Joint Committee, 504 Pa. at 421, 474 A.2d at 1122.

Therefore, SEIU cannot acquire standing merely because it alleges that PGW is violating one of the Commission's regulations. It has alleged no interest which is "substantial, direct and immediate" nor has it shown that it is itself aggrieved by PGW's outsourcing.

Nor can SEIU claim standing by asserting that it is attempting to safeguard the interests of PGW's customers. The Pennsylvania Commonwealth Court rejected a party's attempt to represent and litigate the concerns of third parties who themselves had the opportunity

to be heard. In Mid-Atlantic Power Supply Association v. Pa. PUC, 746 A.2d 1196, 1200 (Pa. Cmwlth. 2000), PECO Energy Company challenged an order of the Commission on the grounds that it violated the privacy rights of PECO's customers. PECO averred no harm to itself or any direct, immediate and substantial interest of its own in the challenged action. In finding that PECO lacked standing, the Commonwealth Court held:

> PECO does not assert that the disclosure will spur competition and cause pecuniary harm to PECO. Rather PECO allegedly attacks the PUC's Final Order on the ground that its customers' rights were not fully respected. We are unpersuaded. PECO does not represent the interests of its ratepayers. A party may not claim standing to vindicate the rights of a third party who has the opportunity to be heard.

See also, Pleasant Hills Construction Company, Inc. v. Public Auditorium Authority of Pittsburgh, 782 A.2d 68, 81 (Pa. Cmwlth. 2001).

These decisions clearly apply to this proceeding. As set forth in the Petition at ¶¶13-15, SEIU is seeking to protect the alleged rights of residential customers under Chapter 56 of the Commission's regulations. Clearly, those customers have the opportunity to be heard by their own actions or through the Office of Consumer Advocate ("OCA"), their statutory representative.

Nor is standing conferred by SEIU attempting to promote the interest of its members. If SEIU is appearing in its capacity as a union, then the issue is not within the scope of the Commission's jurisdiction. Cunningham v. Duquesne Light Company, C-00968286, 1997 PA LEXUS 72 (November 25, 1997) citing N.A.A.C.P. v. Pennsylvania Public Utility Commission, 290 A. 2d 704 (Pa. Cmwlth. 1972) and Meyers v. Pennsylvania Public Utility Commission, 65 A. 2d 256 (Pa. Superior 1949). ("[W]hile the Commission's powers are considerable, they do not include plenary power over a utility's employment practices.") In fact, SEIU witness Lennox testified that the union has filed a grievance concerning the outsourcing at issue here. Tr. 38.

Finally, standing cannot be conferred even if SEIU is appearing in its capacity as a customer of PGW. It is not a residential customer (Lennox, Tr. 33), and the provisions of Chapter 56 do not apply.

Since SEIU has failed to establish standing to present the Petition, it has failed to sustain its burden set forth in §3.7(a) and therefore interim emergency relief should not be granted. In an effort to be thorough, however, I will discuss the remaining elements of emergency relief, although it should be noted that this discussion is purely obiter dictum. Even if it is determined that SEIU has established one or more of the remaining elements set forth in 52 Pa. Code §3.7, the Petition still must be denied as each and every element must be satisfied.

2. Application of Section 56.97

As noted above, Section 56.97 does contain the phrase "authorized utility employee." There is no question that "One of the inbound call functions which PGW has outsourced is the inbound calls between issuance of a termination notice and actual service termination" which are the subject of §56.97. PGW Answer at 16.

While, on its face, this subsection may appear to support a finding that PGW is in violation (assuming SEIU had standing, of course), it does not support any conclusion that the petitioner's right to relief is clear.

First, there is no definition of the term "utility employee" in the regulations. As indicated in the Gyory Affidavit (¶12) and his testimony at Tr. 103-104, with the Commission's full knowledge, other major energy utilities in Pennsylvania are outsourcing this function, (and have been for years) without a waiver of the regulation. In fact, PGW witness William Sullivan, PECO's Director of Accounts Receivable, testified not only that PECO uses NCO (and other vendors) to provide exactly the service at issue here, but that BCS is "well-aware" of this outsourcing. PGW St. 2, ¶3 ("For several years, PECO has used independent contractors to discharge several of its obligations under Chapter 56 of the Commission's regulations, including 52 Pa. Code Sections 56.91-57.98."); Tr. 53.

Second, those cases cited by SEIU do not support its position. These cases are Johnston v. Peoples Natural Gas Co., Docket No. C-00935240 (March 6, 1995) and Joseph v. Equitable Gas Co., Docket No. C-00015519, 2002 Pa. PUC LEXIS 7 (March 16, 2002). SEIU relies on pure obiter dicta, as in neither case cited is Section 56.97 directly at issue. In Johnston, the Administrative Law Judge found that there was no violation of §56.94, as the utility used its own employees. In Joseph, the same Administrative Law Judge found that the utility had rendered inadequate service by refusing to negotiate directly with customers. In both cases, the ALJ's decision became final pursuant to 66Pa.C.S. §332(h) without specific Commission action adopting the decision. It is fundamental that obiter dictum is not controlling in any judicial or quasi-judicial decision, and the dicta in these decisions should be assigned even less weight as the discussions are not directly relevant to the issue presented in this proceeding. As PGW states in its Answer at 18:

> As to Johnston, the three-day notice requirement is not at issue. As to Joseph, as demonstrated in the Gyory Affidavit, PGW is and will continue to negotiate payment arrangements with customers in compliance with all applicable requirements between the termination notice and actual termination. Furthermore, at all times, representatives negotiating payment arrangements on PGW's behalf will be fully trained regarding all applicable regulatory requirements, including PGW's tariff and BCS payment arrangement guidelines and be under the supervision of PGW management.

As explained by PGW in its Answer, the dicta mentioned above is inconsistent with the Commission's own articulated position concerning outsourcing of utility functions, including those which require customer contact. There are numerous decisions, discussed in PGW's Answer, in which utilities were permitted to outsource various functions in appropriate situations. The Commission's stated policy is that it will permit outsourcing of all customer service functions unless it finds that the utility has abused its discretion. Furthermore, the Commission has determined that utility subcontracting is an appropriate utility management decision as long as the contractor remains under the direct supervision and control of the utility and maintains adequate safeguards to assure that the public safety is not threatened.

For example, in Meyer v. PECO Energy Company, C-00003176 (January 24, 2001 (a copy of which was attached to PGW's Answer), the Commission stated:

> We are reminded that absent a finding that a utility has abused its managerial discretion and the public interest has been adversely affected, the Commission's power to intervene in the internal management of a public utility is limited. (Metropolitan Edison Co. v. Pa. P.U.C., 437 A.2d 76 (Pa. Cmwlth Ct. 1981). The Commission has previously addressed the issue of whether a utility may retain outside vendors – contractors to provide a particular service such as meter reading. We held that where it is demonstrated that the service provided by the outside contractor is adequate and reasonable to meet the needs of the public, that the contractor remains under the supervision and control of the utility and that the utility maintains adequate safeguards and public safety is not threatened, the Commission will not intervene in the utility's decision to retain an outside vendor-contractor to provide a particular service. Cunningham v. Duquesne Light Company, Docket No. C-00968286, 1997 Pa. LEXIS 72 (Order entered November 25, 1997).

There is no question that the Commission there interpreted the term "utility company personnel" contained in 52 Pa. Code §56.12 to include agents or subcontractors under the utility's direct control and supervision. See also, Re: The Contracting for Service with Bernex, Inc., Docket No. M-00960801, 1996 Pa. PUC LEXIS 143, *14, where the Commission permitted a utility to outsource customer contact functions subject to "safeguards that require the utility to immediately and consistently monitor the activities of Bernex." In Gaige v. AT&T Communications of Pennsylvania, Inc., Docket No. C-00981211, 199 Pa. PUC LEXIS 43, *20, the Commission stated: "We also agree with the ALJ's conclusion that Bernex stands for the proposition that it is the responsibility of the Respondent to ensure reasonable service, including its employees and contractors."

Similarly, in Cunningham v. Duquesne Light Company, C-00968286, 1997 PA LEXUS 72 (November 25, 1997)[3], the Commission discussed the limits of its authority to

[3] A copy of this decision is included in Appendix 3 to PGW's Answer.

intervene in a utility's management and operational decisions, specifically the decision to utilize contractors:

> Further, ALJ Corbett extensively discussed Peoples Cab Company v. Pa. P.U.C., 185 Pa. Superior Ct. 628, 137 A.2d 873 (1958) (Peoples Cab I), Peoples Cab Company v. Pa. P.U.C., 216 Pa. Superior Ct. 18, 260 A.2d 490 (1969) (Peoples Cab II), for the proposition that the focus of the Commission's inquiry with respect to a method or plan or operation must be on the quality of service rendered to the public resulting from the chosen method of operation; and, while the Commission's powers are considerable, they do not include plenary power over a utility's employment practices. (I.D., p. 12 citing N.A.A.C.P. v. Pa. P.U.C., 290 A. 2d 704 (Pa. Cmwlth. Ct. 1972) and Meyers v. Pa. P.U.C., 164 Pa. Superior Ct. 431, 65 A.2d 256 (1949).

The Commission went on to conclude that, absent "factual underpinnings" regarding quality of service which threatens the public safety, the Commission does not have enabling authority to intervene in a utility decision to utilize contractors for utility functions:

> Consequently, we agree with the ALJ that caselaw on this matter empowers the Commission to intervene where there is an appropriate nexus between the use of managerial discretion by the utility in an arbitrary or capricious manner, or where otherwise lawful managerial discretion has the potential to adversely and substantially affect the public interest. See Philadelphia Electric Company where the Commission refused to register securities for a transaction which could affect the financial stability of the utility.
>
> Based upon our review of the Initial Decision, the Complainant's Exceptions, and the Reply Exceptions of the Respondent, we find that the Complainant has not provided any evidence of abuse of discretion or managerial fiat.

In conclusion, SEIU did not establish that its right to relief is clear, as required by 52 Pa. Code §3.7(a)(1).

D. Need for Immediate Relief

The second element which must be established by SEIU is that the need for relief is immediate. SEIU asserts in its Petition at ¶13 that "The need for relief is immediate. The purpose of Section 56.97 is to protect residential customers facing termination of service. . . Each day that PGW is permitted to violate the regulation poses a direct threat to the ability of certain residential customers to receive the type of fair and responsible service that PGW's employees have been providing and that the regulation requires."

In addressing this criterion, the Commission considers whether an "emergency" exists which would justify issuance of an interim emergency order. The Commission explained this in Big Apple Dinner Theater, Inc. v. Bell of Pennsylvania, Docket No. C-00934817, 1993 Pa. PUC LEXIS 212, *3, n2:

> Emergency Orders pursuant to 52 Pa. Code §3.2 are ex parte orders whose issuance authority is restricted. They are only issued in response to an emergency wherein there is a clear and present danger to life or property or in a matter which is uncontested and requires action prior to the next scheduled public meeting. An Interim Emergency Order is an interlocutory Order issued by a presiding officer which is immediately effective and grants or denies injunctive relief during the pendency of a proceeding. (See 52 Pa. Code §3.1, emphasis added). An Interim Emergency Order requires a showing of irreparable injury. [Citations omitted]

Further in that decision at *10-11, the Commission noted that "emergency" is defined by 52 Pa. Code §3.1 as follows: "Emergency – A situation which presents a clear and present danger to life or property or which is uncontested and requires action prior to the next scheduled public utility meeting."

SEIU has not established that there is a clear and present danger to life or property in any respect. The statement in the Petition concerning the adequacy of service being provided should be disregarded for several reasons. First, as explained above, SEIU has no standing to make such a statement and second, there is no record evidence whatsoever to support the

conclusion that only PGW employees can render adequate service. As noted by PGW in its Answer at 21, this type of contention has previously been rejected by the Commission. In Cunningham, supra at 22, the Commission stated: "We find that the Complainant's argument is based solely on his contention that he is safer with the employees of Duquesne performing the meter change on his property instead of those of an outside contractor. We find this contention to be contrary to the facts of this case."

Petitioner SEIU asserted that NCO employees "were permitted to start work" prior to completion of criminal background checks, causing a risk of harm to PGW's customers: "they are dealing with people's bank accounts, credit card numbers, social security number, things of that nature." Lennox, Tr. 18-20. This was convincingly rebutted by Mr. Gyory's testimony that background checks were completed on every NCO employee prior to those employees beginning to interact with PGW's customers. Tr. 56-57.

Also, in terms of adequacy of service, it appears that the quality of service may in fact be enhanced by the use of this outside vendor. First, the terms of the contract (SEIU Exh. 1, Exh. A-1, ¶5, Tr. Lennox, Tr. 42) require that each employee be monitored five times a week. Mr. Gyory stated that while the company tries to monitor its Collection Call Center employees six times a month, that is not always done. Tr. 63. Also, if an NCO employee is unsatisfactory, PGW does not have to do anything other than request that that particular employee be removed from the PGW project. In fact, this happened once. Gyory, Tr. 57, 63-64.

In conclusion, SEIU did not establish that the need for relief is immediate, as required by 52 Pa. Code §3.7(a)(2).

E. Irreparable Harm

The third element which must be established by SEIU pursuant to 52 Pa. Code §3.7(a)(3) is that "The injury would be irreparable if relief is not granted." SEIU in its Petition at ¶14 claims that "If a customer's service is terminated, or if the customer is required to enter into

an onerous payment arrangement to retain service, the inconvenience and financial harm to the customer cannot be restored simply by the subsequent issuance of an order."

Even if SEIU had standing to make such an argument on behalf of PGW's residential customers, there is no evidence that any customer has suffered any harm whatsoever as the result of PGW's decision to outsource this limited Collection Call Center function.

In conclusion, SEIU did not establish that the injury would be irreparable if relief is not granted, as required by 52 Pa. Code §3.7(a)(3).

F. Public Interest

The final element which must be established by SEIU pursuant to 52 Pa. Code §3.7(a)(4) is that "The relief requested is not injurious to the public interest." SEIU in its Petition at ¶15 states that the relief requested is in the public interest because "the action of PGW, to allow non-employees to deal with customers facing termination of service[4] is contrary to the public interest and in direct violation of 52 Pa. Code §56.97."

I find that SEIU has failed to sustain its burden of proof with respect to this element. It is not in the public interest to force PGW to terminate its contract with NCO for numerous reasons. First, it would be upsetting the status quo. As there has been no evidence of any customer receiving inadequate service, there is no reason to do this. More importantly, it is unlikely to enhance the level of service currently provided. While there is some question as to exactly how much money PGW is saving, there is no doubt that its decision to replace the Collection Call Center employees moved to the Customer Service Call Center with NCO employees, rather than its own employees, is reasonable and cost-effective. This is especially so when it is considered that the result would be to replace trained NCO employees with PGW employees who would need to receive additional training. Tr. 59-60, 100-102.

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[4] Actually, residential heating customers are not sent termination notices during the winter moratorium, so they are not affected. Tr. 86-87.

In conclusion, SEIU did not establish that the relief requested is not injurious to the public interest, as required by 52 Pa. Code §3.7(a)(4).

III. CONCLUSIONS OF LAW

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

2. Pursuant to 66 Pa.C.S. §332(a), the burden of proof in this proceeding is upon petitioner SEIU. Beisel v. Pennsylvania Power & Light Company, C-00924683, 1993 Pa. PUC LEXIS 45.

3. Petitioner SEIU failed to sustain its burden of proof.

4. The requirements for issuance of an interim emergency order are contained in 52 Pa. Code §3.7.

5. These requirements are cumulative. All must be met for the grant of relief and the failure of a petitioner to prove any one of them compels the denial of such relief. Crums Mill Associates v. Dauphin Consolidated Water Company, C-00934810, 1993 Pa. PUC LEXIS 90, *4-5. (April 16, 1993).

6. Petitioner SEIU lacks standing in this proceeding.

7. Petitioner SEIU did not establish that its right to relief is clear, as required by 52 Pa. Code §3.7(a)(1).

8. Petitioner SEIU did not establish that the need for relief is immediate, as required by 52 Pa. Code §3.7(a)(2).

9. Petitioner SEIU did not establish that the injury would be irreparable if relief is not granted, as required by 52 Pa. Code §3.7(a)(3).

10. Petitioner SEIU did not establish that the relief requested is not injurious to the public interest, as required by 52 Pa. Code §3.7(a)(4).

11. Denial of the Petition for Issuance of Interim Emergency Order is just, reasonable and in the public interest.

IV. ORDER

THEREFORE,

IT IS ORDERED:

1. That the Petition for Issuance of Interim Emergency Order filed by the Service Employees International Union, Local 686, AFL-CIO, is denied.

Date: January 23, 2003

MARLANE R. CHESTNUT
Administrative Law Judge

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 Initial 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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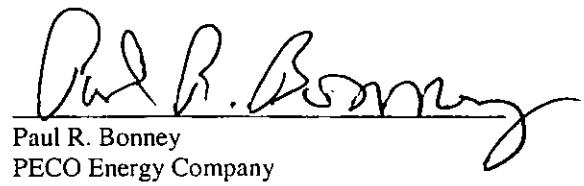

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Date: October 14, 2005