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December 20, 2005

Via Federal Express

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

**DOCUMENT
FOLDER**

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

Dear Secretary McNulty:

Please be advised that PECO Energy Company ("PECO") and Public Service Electric and Gas Companies ("PSE&G") (collectively, "Joint Applicants") will not be filing Exceptions to the Initial Decision in the above-referenced proceeding. PECO and PSE&G reserve the right, however, to file Reply Exceptions, as necessary.

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

Very Truly Yours,

Kent D. Murphy
Kent D. Murphy
Assistant General Counsel

DOCKETED
DEC 27 2005

KDM/yaw
Enclosures

cc: Honorable Marlane Chestnut, Administrative Law Judge (via first class mail)
Certificate of Service

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51

CERTIFICATE OF SERVICE

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

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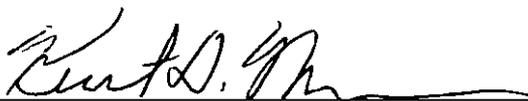
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Dated this 20th day of December, 2005 in Philadelphia, Pennsylvania.



The Reinvestment Fund
Human Interest Compounded Daily

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SECRETARY'S BUREAU

December 20, 2005

James J. McNulty, Secretary
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DOCUMENT
FOLDER

Subject: 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-110550 F0160

Dear Secretary McNulty:

Please be advised that The Reinvestment Fund will not be filing Exceptions to the Recommended Decision of Judge Chestnut issued on November 30, 2005, in the above captioned proceeding. The Reinvestment Fund reserves the right, however, to file Reply Exceptions, if deemed appropriate.

As evidenced by the enclosed certificate of service, all parties have been served with a copy of this letter by email and by first class mail.

Sincerely,

Roger E. Clark, Esq.

DOCKETED
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Enclosures: Certificate of Service
Copies: See attached Certificate of Service

3

**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

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

CERTIFICATE OF SERVICE

I certify that on December 20, 2005, I had served a copy of the foregoing letter of The Reinvestment Fund to the following persons by electronic mail and by first class mail:

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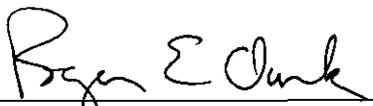
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December 20, 2005

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

Dear Secretary McNulty:

Please be advised that Pennsylvania Power Company, Metropolitan Edison
Company, Pennsylvania Electric Company, and FirstEnergy Solutions Corp. (the
"FirstEnergy Companies") will not be filing Exceptions to the Initial Decision in the
above-referenced proceeding.

All parties to this proceeding are being duly served, as shown on the attached
Certificate of Service.

DOCUMENT
FOLDER

Respectfully submitted,

RYAN, RUSSELL, OGDEN & SELTZER LLP

W. Edwin Ogden
W. Edwin Ogden

WEO:jab

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

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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

CERTIFICATE OF SERVICE

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

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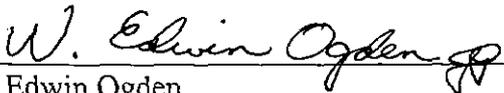
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Dated: December 21, 2005


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December 20, 2005

VIA HAND DELIVERY

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DOCUMENT
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Re: Joint Application of PECO Energy Company and Public Service Electric and Gas Company For Approval of the Merger of Public Service Enterprise Group Incorporated With and Into Exelon Corporation; Docket No. A-110550F0160

Exceptions of the PPL Companies

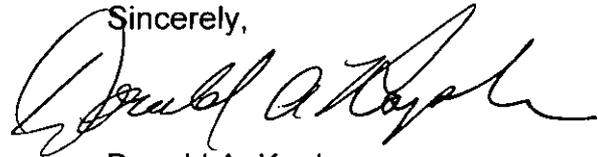
Dear Secretary McNulty:

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

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

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

Sincerely,



Donald A. Kaplan
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Enclosures

cc: Official Service List
Honorable Marlane R. Chestnut
Cheryl Walker Davis

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

EXCEPTIONS OF THE PPL COMPANIES

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Date: December 20, 2005

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I. INTRODUCTION.

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

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

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

Some parties did not settle, however. The market power issues are still fully contested by the PPL Companies¹ and certain other parties, and thus must be decided by the Commission. No amount of unrelated monetary concessions by Joint Petitioners and no settlement agreements among other parties can change the statutory obligation of this Commission to address and decide the market power issues presented in this proceeding.

The Initial Decision approved the merger and the settlement, finding no market power concerns. However, there are at least two fundamental flaws in the Initial Decision that render it useless to the Commission in deciding this case. First, the Initial Decision did not follow the law or precedent. Section 2811 of the Public Utility Code plainly requires the Commission to review the proposed merger to determine if it will significantly lessen competition. The Commission has previously interpreted this provision as requiring such review and has set forth specific standards to be used in applying Section 2811.² Unfortunately, the Initial Decision did not follow Section 2811 or the *DQE* decision. Indeed, the Initial Decision did not decide the market power issues on the merits at all. Rather, it simply refers to and relies upon a prior decision of the Federal Energy Regulatory Commission (“FERC”) approving the merger.³

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

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

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

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

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

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

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

⁴ *DQE*, 186 PUR 4th at 46-47.

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

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

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

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

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

II. STATEMENT OF EXCEPTIONS.

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

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

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

III. STATEMENT OF THE CASE.

A. The Joint Application.

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

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

⁷ Initial Decision at 40.

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

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

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

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

B. The PPL Companies’ Testimony.

The PPL Companies’ March 7, 2005 motion to intervene in this proceeding was granted at the initial pre-hearing conference on March 29, 2005.¹⁴ After several rounds of discovery, in accordance with the procedural schedule, the PPL Companies submitted the written direct and surrebuttal testimony of Dr. Joseph P. Kalt on June 28, 2005, and August 26, 2005, respectively.¹⁵ Dr. Kalt testified that Joint Petitioners’ market concentration analyses are incomplete, inconsistent with widely-accepted competitive principles, and produce erroneous and unreliable results.¹⁶ Joint Petitioners’ analyses omit key markets when attempting to predict the competitive harm of the proposed merger, ignore the Merged Entity’s FTRs when allocating imports; and rely on a virtual

¹¹ Initial Decision at 40.

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

¹³ See *supra* note 8.

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

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

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

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

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

C. The Proposed Partial Settlement.

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

¹⁷ *Id.* at 14-15, 20, 24-25.

¹⁸ *Id.* at 7-10.

¹⁹ *Id.* at 5-6.

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

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

D. The Evidentiary Hearing.

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

E. The Initial Decision.

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

²¹ *Id.* at Section III.I.

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

²³ Initial Decision at 6.

²⁴ *Id.*

IV. ARGUMENT.

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

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

. . . .

(5) Competitive market forces are more effective than economic regulation in controlling the cost of generating electricity.

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

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

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

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

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

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

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

Before analyzing the effectiveness of each of these mitigation proposals in the context of this proceeding, we believe it would be appropriate to review generally the Commission's authority to impose market power remedies on merging parties before approving the transaction. If the Commission finds that a proposed merger 'is likely to result in anticompetitive or discriminatory conduct, including the unlawful exercise of market power,' section 2811(e)(2) provides that the Commission shall not approve a merger 'except upon such terms and conditions as it finds necessary to preserve the benefits of a . . . competitive retail electricity market.

Clearly, the statute gives the Commission broad authority to fashion appropriate remedies to mitigate undue market power created by the proposed transaction. FERC similarly has broad authority under section 203(b) of the Federal Power Act, 16 U.S.C. § 824(b), to approve electric utility mergers and propose 'such terms and conditions as it finds necessary or appropriate' to mitigate market power concerns.²⁶

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

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

²⁶ *DQE*, 186 PUR 4th at 67-68.

²⁷ *Id.* at 69-72.

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

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

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

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

²⁸ Kalt Direct Testimony at 22.

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

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

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

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

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

³⁰ 66 Pa.C.S. § 1103(a).

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

³² 66 Pa.C.S. § 2811.

³³ 66 Pa.C.S. § 332(a).

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

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

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

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

³⁵ Initial Decision at 41.

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

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

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

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

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

³⁷ Initial Decision at 12, 38.

³⁸ *Id.* at 38-49.

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

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

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

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

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

³⁹ *Id.* at 45-46.

⁴⁰ Kalt Surrebuttal Testimony at 2.

⁴¹ *Id.*

⁴² *DQE*, 186 PUR 4th at 61.

⁴³ Kalt Direct Testimony at 4.

⁴⁴ *Id.*

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

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

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

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

⁴⁵ *Id.* at 5-6.

⁴⁶ *Id.* at 6.

⁴⁷ *Id.*

⁴⁸ *Id.*; Tr. 428.

⁴⁹ Joint Petitioners' Initial Brief at 9.

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

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

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

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

⁵⁰ *Id.* at 11.

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

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

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

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

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

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

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

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

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

Thus, the efficacy of the "virtual" divestitures will require continued regulatory oversight for years into the future – a result that undermines the principles and objectives upon which the Commonwealth deregulated electricity markets nine years ago. The Initial Decision completely ignores this fatal shortcoming.⁵⁷ Instead, it relies solely on Joint Petitioners' commitment to FERC to appoint an independent monitor and the creation a public website to help "oversee" their virtual divestiture proposal⁵⁸ – a commitment that even FERC admits will be necessary and difficult.⁵⁹ Neither Joint Petitioners nor the Initial Decision can point to any evidence that rebuts this fact.

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

⁵⁶ See *infra* Section IV.F.

⁵⁷ Initial Decision at 45.

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

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

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

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

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

We do not intend to rely on post-merger review or on new remedies imposed after a merger is approved. We must find that a merger is consistent with the public interest before we approve the merger. . . .

Post-merger review is disfavored because once a merger goes through, undoing the merger at a later date is almost always impossible to do. See, e.g., *Ronson Corp. v. Liquifin Aktiengesellschaft*, 483 F 2d 846, 851 (3d Cir. 1973) (injunctive relief is typically granted in a merger case before consummation so as to avoid having to 'unscramble the eggs' after the merger has occurred). Knowing this

⁶⁰ *DQE*, 186 PUR 4th at 74-75.

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

⁶² *Id.*

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

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

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

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

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

⁶³ *DQE*, 186 PUR 4th at 69-70.

⁶⁴ *Id.* at 62.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

⁷² *See id.* at 45-46.

⁷³ Tr. 426:17 - 427:1.

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

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

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

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

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

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

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

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

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

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

⁷⁷ Initial Decision at 45.

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

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

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

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

⁷⁹ FERC Merger Order at P 123.

⁸⁰ Joint Petitioners' Initial Brief at 25-26.

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

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

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

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

⁸³ Kalt Direct Testimony, Exhibit JPK-3.

⁸⁴ PPL Main Brief at 28.

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

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

sustained price differentials of \$5-10/MWh during the summer and winter months.⁸⁷

Such seasonal price differentials further demonstrate congestion, which isolates the APS zone from the historical PJM Classic market.⁸⁸

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

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

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

⁸⁷ *Id.*

⁸⁸ Kalt Direct Testimony at 18.

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

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

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

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

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

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

⁹¹ Hieronymus Direct Testimony at 4.

⁹² Tr. 413.

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

⁹⁴ Kalt Direct Testimony, Exhibit JPK-7.

⁹⁵ Initial Decision at 45.

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

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

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

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

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

⁹⁷ Kalt Surrebuttal Testimony at 14.

⁹⁸ *Id.*, JPK-13 at 8-9.

⁹⁹ *Id.*

Decision, continue to rely on the hypothetical pro rata or “squeeze down” method for assigning shares of transmission imports. They attempt to justify their reliance on the squeeze down method by turning to the Merger Guidelines established by FERC in Order No. 642.¹⁰⁰ Neither Order No. 642 nor the Merger Guidelines dictate, let alone address, the manner in which FTRs should be factored into an Order No. 642 merger analysis. Both were adopted before FTRs came into widespread use as a means by which congestion costs could be hedged.¹⁰¹

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

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

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

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

¹⁰² Initial Decision at 45.

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

¹⁰⁴ FERC Merger Order at P 112.

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

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

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

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

¹⁰⁶ Tr. 386; Joint Petitioners’ Initial Brief at p. 29.

Period	EEG Post Mitigation Market Share (FTR)	EEG Post Mitigation Market Share (Squeeze Down)	Increase In Market Share Using FTRs	Increase in EEG Import (MW)
S SP1	37%	30.7%	6.3%	2,369
S SP2	36%	29.8%	6.2%	2,008
S P	38%	29.6%	8.4%	1,962
S OP	45%	33.7%	11.3%	1,783
W SP	37%	30.2%	6.8%	2,237
W P	37%	28.8%	8.2%	1,983
W OP	43%	30.8%	12.2%	2,349
SH SP	35%	27.6%	7.4%	1,767
SH P	41%	30.3%	10.7%	1,911
SH OP	45%	32.4%	12.6%	1,787

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

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

¹⁰⁷ Kalt Direct Testimony, Exhibit JPK-7.

¹⁰⁸ *Id.*

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

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

Joint Petitioners next claim that the incentive to withhold generation in PJM East to drive up the value of FTRs would be offset by the fact that such withholding would also drive up the cost to serve load there¹¹³ and, hence, “the incentive effect is washed out.”¹¹⁴ However, as Dr. Kalt explains, “[w]hether the Merging Parties control 1 MW of generation within PJM East or hold a 1 MW FTR that sources from the western hub and sinks in PJM East, a price increase in PJM East benefits the Merging Parties equally in both cases.”¹¹⁵ Moreover, Joint Petitioners’ contention ignores the fact that Dr. Kalt’s FTR analysis is an “economic capacity” analysis.¹¹⁶ Economic capacity is one of the two measures used by FERC to gauge the increase in concentration caused by the merger.¹¹⁷ As Joint Petitioners are fully aware, load is not considered in an economic capacity analysis.¹¹⁸ Even if Joint Petitioners’ load were considered, however, the incentive to

¹¹⁰ Hieronymus Rebuttal Testimony at 20-21.

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

¹¹² Kalt Surrebuttal Testimony at 17.

¹¹³ Tr. 384:4-14.

¹¹⁴ *Id.* at 384:9-10.

¹¹⁵ Kalt Surrebuttal Testimony at 18.

¹¹⁶ Kalt Direct Testimony, Exhibit JPK-8.

¹¹⁷ Hieronymus FERC Direct Testimony at 47.

¹¹⁸ Hieronymus Rebuttal Testimony at 21-22.

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

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

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

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

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

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

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

V. CONCLUSION.

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

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By 

December 20, 2005

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

RECEIVED
2005 DEC 20 PM 3:47
PA PUC
SECRETARY'S BUREAU

JOINT APPLICATION OF PECO
ENERGY COMPANY AND PUBLIC
SERVICE ELECTRIC AND GAS
COMPANY FOR APPROVAL OF THE
MERGER OF PUBLIC SERVICE
ENTERPRISE GROUP
INCORPORATED WITH AND INTO
EXELON CORPORATION

DOCKET NO. A-110550F0160

CERTIFICATE OF SERVICE

I hereby certify that, on this 20th day of December 2005, I served a copy of the foregoing Exceptions of the PPL Companies upon the parties listed below by electronic delivery and hand delivery or express mail:

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Date: December 20, 2005

A handwritten signature in black ink, appearing to read "Donald A. Kaplan", written over a horizontal line.

Donald A. Kaplan
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VIA UPS OVERNIGHT

December 20, 2005

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DEC 20 2005

James J. McNulty, Secretary
Pennsylvania Public Utility Commission
Keystone Building
Commonwealth of Pennsylvania
400 North Street, 2nd Floor
Harrisburg, PA 17120

PA PUBLIC UTILITY COMMISSION
SECRETARY'S BUREAU

RE: Joint Application of PECO Energy Company & Public Service
Electric Gas Company for Approval of Merger of Public Service
Enterprise Group Incorporated with and into Exelon Corporation
In Re: A-110550F0160

Dear Secretary McNulty:

Enclosed are the Exceptions of the City of Philadelphia in the above captioned
proceeding. Please file the original and ten (10) copies.

Please date stamp and return a copy to the City in the stamped, self-addressed
envelope.

Also enclosed is a disc containing the Exceptions.

Very truly yours,

Darlene Davis Heep

Darlene Davis Heep
Senior Attorney

DOCUMENT
FOLDER

DDH/mh

Enclosures

Cc: Honorable Marlane Chestnut, Administrative Law Judge
All parties (per Certificate of Service)

62

ORIGINAL

**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**

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: Docket No. A-110550F0160
DOCKETED
: DEC 27 2005

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DEC 20 2005

PA PUBLIC UTILITY COMMISSION
SECRETARY'S BUREAU

EXCEPTIONS OF THE CITY OF PHILADELPHIA

NOW COMES The City of Philadelphia (the "City") through its undersigned attorneys and files Exceptions as indicated below:

**DOCUMENT
FOLDER**

I. INTRODUCTION

On February 4, 2005, PECO Energy Company ("PECO") and Public Service Electric & Gas Company ("PSE&G") (jointly, "Applicants") filed with the Pennsylvania Public Utility Commission ("PUC" or "Commission") a Joint Application ("Application") for approval of the merger of PSE&G's parent, Public Service Enterprise Group, Inc. ("PSEG"), with and into PECO's parent, Exelon Corporation ("Exelon"), to form Exelon Electric & Gas ("EEG"). On March 4, 2005, The City of Philadelphia ("City") filed a Petition to Intervene in this proceeding. This proceeding was assigned to Administrative Law Judge ("ALJ") Marlane R. Chestnut.

During this proceeding, the parties submitted Direct, Rebuttal, and Surrebuttal Testimony, while also engaging in a collaborative process in an attempt to resolve this matter without litigation. On September 12, 2005, PECO submitted a Joint Petition for Settlement ("Joint Petition" or "Settlement") with the PUC; however, not all of the parties to this proceeding, including the City, joined the Settlement, and the City filed a Statement in Opposition to Approval of Merger Based Solely on Terms of Joint Petition for Settlement on

September 19, 2005 (“City Opp.”). As a result, evidentiary hearings were held in this proceeding, along with the submission of Main and Reply Briefs. The City filed both a Main Brief (“City M.B.”) and a Reply Brief (“City R.B.”). On November 30, 2005, ALJ Chestnut issued her Initial Decision (“I.D.”) in this proceeding.

The City files these Exceptions to the ALJ’s findings in the I.D. that (1) the market power analysis performed by the Federal Energy Regulatory Commission (“FERC”) provides an appropriate basis for analyzing the impact of the merger on Pennsylvania’s retail markets; (2) the merger, as modified by the Joint Petition, meets the requirements for approval under the Pennsylvania Public Utility Code; (3) the Joint Petition adequately resolves the Directed Questions raised by the PUC Commissioners in this proceeding; and (4) the Directed Question raised by the PUC Commissioners regarding PGW was adequately resolved.

The Competition Act requires an analysis of the merger’s affect on retail markets in Pennsylvania. Although several parties have raised significant concerns regarding the increased market power of the newly created EEG, the ALJ has not provided adequate review of this issue in the I.D. The ALJ’s reliance upon and unquestioning acceptance of the FERC wholesale market analysis is in error. Because she bases her approval on the FERC’s findings, which examine the impact on wholesale markets, the I.D. fails to scrutinize the impact of this merger on the retail markets, as the Public Utility Code requires. (Exception No. 1.)

This is particularly important in considering whether there will be any substantial benefit to *Pennsylvania* public interest as a result of the merger. Concentrated control of the retail market, whether directly or indirectly, cannot serve the public interest; it would in fact have a detrimental impact. Throughout this proceeding, the City has argued that the proposed merger does not meet the necessary requirements for approval under the Public Utility Code because this

merger, even as modified by the Settlement, does not advance the public interest. Rather, the merger merely maintains the status quo for ratepayers for a few years, while allowing the newly merged entity to reap significant benefits. Because any possible benefits that may occur under the Settlement are only short-term, the Joint Petition cannot be considered as in the public interest. (Exception No. 2.)

The ALJ's characterization of the proposal of the Commissioners to set aside virtually divested power for purposes of economic development as illegal and impractical is overly cautious and does not fully address the issues raised or ideas presented. By merely adopting the Applicants' analysis, the ALJ did not sufficiently explore the propositions. (Exception No. 3.)

Finally, the ALJ's I.D. does not adequately resolve the Directed Question raised by the PUC Commissioners regarding the possible combination of Philadelphia Gas Works ("PGW"), PECO Gas, and PSE&G Gas. Although she suggests in the I.D. that the Joint Petition adequately addresses this issue, further review indicates that the Settlement does not advance resolution of this issue in the timeframe necessary to ensure substantive benefit to the public. (Exception No. 4.)

For these reasons, the City submits that the PUC should reject the I.D. and instead (1) modify the Joint Petition to provide for conditions that will ensure that the proposed merger provides substantial benefits to the public or (2) reject the Joint Petition as proposed.

II. EXCEPTIONS

Exception No. 1: The ALJ Erred in Dismissing Concerns that the Proposed Merger Would Cause a Harmful and Impermissible Increase in Market Power, Contrary to Law and to the Public Interest.

The ALJ correctly notes that the Public Utility Code requires the PUC to examine whether the proposed transaction will result in anticompetitive or discriminatory conduct that would prevent *retail* customers from obtaining the benefits of properly functioning *retail* natural gas and electricity markets; conversely, the FERC has jurisdiction over whether the proposed merger would adversely impact competition in the wholesale market. I.D. at 43. While correctly expressing the differing scopes of review for the PUC and the FERC, however, the ALJ incorrectly finds that the proposed merger will not impact the Pennsylvania *retail* markets based upon the FERC's review of the impact of the merger on the *wholesale* markets. *Id.* at 46-49. Because the FERC did not review the impact of this merger on Pennsylvania's retail markets, and because the Commission has jurisdiction to review market power at least to the extent it would affect whether the merger would convey substantial public benefit, the ALJ analysis fails to meet the requirements of the Public Utility Code and must be rejected.

As indicated more fully in the City's Main and Reply Briefs, the Competition Act requires the Commission to investigate the effects of a merger on retail markets in Pennsylvania. *See* City M.B. at 21; *see also* City R.B. at 2. Because the FERC reviewed the impact of the merger on the wholesale markets, the PUC cannot rely on the FERC's findings in order to meet the requirements of the Public Utility Code. *Id.*

The ALJ notes that "the FERC has primary jurisdiction over the wholesale energy markets." I.D. at 44. In the I.D., she then reviews all of the evidence reviewed by the FERC regarding wholesale market power implications, including the testimony, analysis, and indices

used by the FERC in examining pre- and post-merger market concentrations. *Id.* at 44-46. For example, the ALJ focuses on the Applicants' analysis regarding the impact of the markets on PJM and PJM East transmission capacity, the calculation of market concentration regarding HHI statistics, and the resulting upstream and downstream concentrations in the markets. *Id.* at 45-47. In other words, the ALJ examines the evidence regarding the impact of the merger on the wholesale markets.

Based upon these findings, and without any independent analysis, the ALJ recommends that the "Commission come to the same conclusion as the FERC did concerning market power issues . . . [a]s the FERC's analysis and resolution of the relevant issues is clearly reasonable and thorough." *Id.* at 47. This analysis – suspect in any event because the FERC ruled without evidentiary hearings and without considering the compelling evidence of vertical market power presented by PGW witness Paul Carpenter – fails to address the proposed merger's likely impact on retail markets. *City R.B.* at 2. Under the Competition Act, the Commission must consider whether the proposed merger is likely to result "in anticompetitive or discriminatory conduct, including the unlawful exercise of market power, which will prevent *retail* electricity customers in this Commonwealth from obtaining the benefits of a properly functioning and workable competitive *retail* electricity market." 66 Pa. C.S. § 2811(e)(1); *see also* 66 Pa. C.S. § 2210(a)(1) (requiring the Commission to examine whether a proposed merger "will prevent *retail* gas customers from obtaining the benefits of a properly functioning and effectively competitive *retail* natural gas market) (emphasis supplied). And of course, the PUC may analyze all likely rate effects in determining whether the merger will substantially further the public interest.

Significant market power issues are present in this merger, and the Joint Petition provides no way of limiting this power. City M.B. at 18-21. While numerous parties have raised significant concerns regarding the market power implications that could arise from this merger, the Joint Petition fails to resolve, or even really address, these issues. City M.B. at 9-12. Under the Settlement, PECO must submit annual reports from 2007 to 2012 addressing wholesale market prices and price trends in PJM markets. If any party to the Settlement believes that PECO's affiliated generation company has unlawfully exercised market power in any PJM markets, the party may request that the PUC institute an investigation. City M.B. at 18. While the ALJ suggests that any concerns about mitigation efforts are "reasonably addressed" by this proposal, in actuality, these provisions fall short. Initially, the market reports neglect the retail markets, as required under the Competition Acts. In addition, the parties to the Settlement carry the burden of instituting an investigation regarding market power, and, even then, PECO is not required to undertake any prior measures to ensure that the merger does result in market power concentrations. *Id.*

Accordingly, reliance on the FERC's findings would be inappropriate and premature. The PUC may not shirk its responsibility under the Public Utility Code by relying on the FERC's wholesale market findings, whatever they may prove to be.¹ Instead, as the Public Utility Code requires, the PUC must examine the impact of this merger on the retail markets in Pennsylvania and on the public interest. In addition, the Joint Petition fails to provide the public any protection regarding these issues, as the provisions thereunder only address wholesale markets and provide nothing more than a "reporting requirement" for PECO, without instituting any

¹ The FERC had granted reconsideration on its own motion. Its final decision, apparently issued December 15, 2005, was unavailable to the ALJ for her Initial Decision, and was similarly unavailable in time to permit analysis for purposes of these Exceptions.

additional, preemptive measures. Because the ALJ does not account for these issues, the Commission must reject the I.D.

The City also adopts and incorporates by reference Exception No. 1 filed this day by the Philadelphia Gas Works (“PGW”) and all subsidiary arguments. The City made similar objections and arguments in its Main Brief at 4, 9-11, 18-21; in its Reply Brief at 3-5; and in its Opposition to Approval of the Joint Petition for Settlement at 1-2.

Exception No. 2: The ALJ Erred in Finding that the Merger, as Modified by the Joint Petition, Is in the Public Interest and that the Commission Should Approve It Without Modification.

In the I.D., the ALJ correctly notes that the Applicants in this proceeding bear the burden of proving, by 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.” I.D. at 10-11. Unfortunately, the ALJ finds the Joint Petition meets this requirement based, in part, on the fact that some of the parties to this proceeding were able to reach concessions regarding various issues. I.D. at 22. In other words, because the Settlement addresses a range of interests, the ALJ believes that the Merger under its terms must be in the public interest. *Id.* at 22-23. The public interest, however, is not served merely because a number of parties have agreed to compromise their positions in order to avoid litigation.

As set forth more fully in the City’s Main Brief, the PUC cannot approve a merger unless the merger would convey substantial public benefit overall. *See* City M.B. at 5-7. If the Applicants cannot prove this, then the Commission may impose conditions on the granting of an approval in order to ensure that the proposed merger is in the public interest. *Id.*

In this instance, the Application, as originally filed, only indicated that the transaction may not harm ratepayers. *Id.* at 7-8. While the Application addressed the benefits the merger should bring, including better economies of scale, lower costs, and greater revenue, the Application did not even include a proposal to decrease PECO's rates. *Id.* at 8. Instead, the Application suggested that the merger could only harm customers through the resulting market power concentrations. *Id.* at 9-12. As a result, the initial Application failed to provide any substantive benefits to the public, suggested possible harm to ratepayers, and failed to meet the necessary requirements of the Public Utility Code. *Id.* at 11-12.

The I.D. should state this clearly. Instead, the ALJ's I.D. focuses only upon whether the merger, as modified by the Joint Petition, is in the public interest. I.D. at 22-38. Moreover, the I.D.'s analysis fails to recognize that the modifications proposed by the Joint Petition do not render the merger beneficial to ratepayers overall. *See City M.B.* at 12-13. Because the merger initially presented no benefits whatsoever to ratepayers (and potentially could result in harm), the minor, short-term concessions brought about under the Settlement seem slightly more beneficial than the initial proposal. Further review, however, indicates that the terms of the Joint Petition do not provide the benefit required for approval under the Public Utility Code.

- a. *The ALJ Fails to Recognize that the Merger, Even under the Joint Petition, Would Expose the Public to Harm in PECO's Corporate Presence, Charitable Giving, and Staffing Levels.*

The Joint Petition would require PECO to approach the status quo for several years as to its corporate presence in Philadelphia, charitable giving, and staffing levels for field and executive forces. This is not "public benefit," especially since the merger would make the City and the Commonwealth a smaller portion of the EEG empire and would thereby make EEG more likely to harm them and their residents in the longer term. *See City M.B.* at 23-29.

According to the ALJ, because the Settlement “contains a number of terms that provide significant benefits to the City, the fact that the City thinks they are insufficient does not lead to the conclusion that the Settlement is not in the public interest.” I.D. at 28. To brush aside the City’s concerns regarding these issues because the Settlement may bring short-term *de minimis* guaranties fails to recognize that, with respect to these issues, the City is the bearer of the public interest. To advance the public interest adequately, the terms of any merger should require PECO to provide substantial and long-term benefits, for example by increasing its charitable giving to \$8 million for at least five years, maintaining its corporate headquarters in Philadelphia through 2014, and implementing concrete commitments regarding staffing levels irrespective of whether changes can be proven to be merger-related. *See* City M.B. at 25-28. Instead, the ALJ inappropriately recommends approval of the Joint Petition without any benefits above the status quo. *See* I.D. at 28-32.

For example, with respect to charitable giving, the Joint Petition provides that PECO will only continue its sponsorship at \$3 million per year for four years, which PECO claims is its current level of giving. City M.B., pp. 24-25. Not surprisingly, PECO’s charitable involvement is extremely important to the City and its residents and businesses, which the merger would make less important to EEG’s business than they are to PECO’s and Exelon’s. In light of the \$500 million in gross savings the Applicants will reap from the merger over the next four years, increasing PECO’s charitable giving above the status quo does not seem unreasonable. Rather, such a request only ensures that the merger will provide a substantial benefit, as the Public Utility Code requires. *See* City M.B. at 25-26. While the Commission may be unable to direct PECO to make a charitable contribution, the ALJ fails to recognize that the Commission can

deny the Application because it fails to provide substantial benefits to the public. I.D. at 30-31; City M.B. at 25-26.

With respect to corporate presence, the Joint Petition requires PECO to maintain its headquarters in Philadelphia through 2010,² even though the merger with PSE&G, a New Jersey based utility, creates a significant possibility that EEG would seek to achieve future synergies by moving the headquarters of Exelon's unregulated Pennsylvania businesses, and perhaps staff for certain PECO functions, to New Jersey after 2010. *See* City M.B. at 26. The ALJ incorrectly claims that requiring PECO to extend its corporate presence would constitute "micromanaging" the utility. She fails to recognize that Applicants have already agreed to a minor extension in the Joint Petition, and that the City's request is nothing more than an additional extension that would serve to provide substantial benefit to the public, as compared to the *de minimis* benefits that the Settlement might provide. I.D. at 28-30; City M.B. at 26.

Similarly, the Joint Petition provides that PECO will not make any reductions to its current field forces prior to January 1, 2011, and will not make any other reductions "as a result of the merger." City M.B. at 25. The ALJ incorrectly claims that this issue is only of concern to the City and is not congruent with the public interest generally. Indeed, this issue is of great importance not only to the City but also to its residents and businesses, and to PECO's ratepayers in general, as any reduction in PECO's field forces could affect the reliability of PECO's electricity service. I.D. at 31-32; City M.B. at 26-28.

The ALJ also suggests that one of the benefits of the merger is the reduction of staffing levels through the elimination of "unnecessary and duplicative positions." I.D. at 32. The Joint

² The PUC's approval of PECO's merger into Unicom, which formed Exelon in 2000, already requires PECO to maintain its headquarters in Philadelphia until at least 2008. *See* Docket No. A-00110550F0147.

Petition would provide PECO with an almost *carte blanche* ability to eliminate positions because, under the terms of the Settlement, PECO can modify its workforce size if this reduction is not demonstrably related to the merger. City M.B. at 26. Any party claiming an inappropriate reduction in staffing would have to prove that the reduction stemmed from the merger, contrary to PECO's claims. *Id.* Because many of PECO's employees live and/or work in the City and remit City wage tax, the City is extremely concerned that PECO may attempt to modify its workforce inappropriately; however, the Joint Petition creates a formidable task for the City to prove such inappropriate conduct. *Id.* Accordingly, the ALJ's analysis does not ensure that the Joint Petition is in the public interest.

While the ALJ proposes a holding that the Joint Petition provides adequate benefit to the public, the I.D. would not ensure that the merger would result in substantial benefit. Protecting the public interests raised by the City would not harm the other settling parties, and the City is the party in this proceeding best situated to define, uphold, and protect the public interest within the City limits. Because the Settlement does not adequately serve the public interest, the Commission must reject the ALJ's findings. Instead, absent an acceptable settlement, the RUC must either modify the Joint Petition to include the additional modifications the City has raised throughout this proceeding, to ensure this transaction provides a substantial benefit to the public, or must disapprove the merger.

b. The ALJ Fails to Recognize that the Joint Petition Sacrifices Long-Term Benefits for Short-Term Gain with Respect to Rate Protections.

The "rate protection" provisions of the Joint Petition would have a significant impact on all PECO customers, including the City, its businesses, and its residents. Unfortunately, the parties to the Settlement were willing to sacrifice any potential long-term benefits for short-term gain that will do little to offset the harm that ratepayers may later experience due to the merger.

Because the ALJ fails to recognize that this short-term gain does not meet the level of substantial public benefit when weighed against the overall detriments of the merger, she incorrectly finds that the Joint Petition adequately addresses these issues.

Under the Settlement, PECO would reduce its retail electric distribution rates by about \$1.26 per month for the average 700-kilowatt-hour-per-month customer for two years and then by about 63¢ a month for two more. *See* City Opp. at 3. While a rate decrease generally benefits customers, this decrease pales in comparison to the \$500 million in gross savings that the newly merged entity would achieve prior to 2010. *Id.*; City M.B. at 13-14. Similarly, PECO proposes to extend its transmission and distribution rate caps and to enhance the Customer Assistance Program and Matching Energy Assistance Fund through December 31, 2010, to coincide with the current generation rate cap. *Id.*; City Opp. at 3-4. Because the majority of the costs to achieve the merger would have been incurred prior to 2009, Applicants will enjoy the full benefits of the merger at the exact time that PECO ratepayers are subject to uncertain market prices for generation service, increases to transmission and distribution rates, and an end to almost all of the CAP enhancements.³ City M.B. at 13-14; City Opp. at 3-4.

The ALJ suggests that the Joint Petition provides adequate benefit because the Electricity Generation Customer Choice and Competition Act (“Competition Act”) does not provide for rate caps after a utility completes the recovery of its stranded costs. *I.D.* at 24. Because PECO’s transition period expires at the end of 2010, the ALJ determines that a further extension of the rate cap would not be appropriate. *Id.* She also suggests that “an indefinite moratorium on rate relief” could harm the financial health of PECO and compromise its ability to meet service obligations. *Id.* Such financial harm is highly unlikely given that PECO will have collected

³ An exception is the proposed 650-kW/month threshold, as the ALJ notes. *I.D.* at 35; *see* City M.B. at 13 (“most customer service initiatives will expire under the Joint Petition”).

100% of its stranded cost on its nuclear facilities by that time based on what turned out to be low market price forecasts from 1998, thus producing an overcollection of actual stranded costs compared to actual market prices. Meanwhile, PECO will have the ability in 2011 to sell its nuclear plant output into a PJM market based on a last-bid-in, locational-marginal-price market construct, thus permitting greater revenue recovery over “cost,” with natural gas prices frequently setting the market price.

While the Competition Act does not extend the rate caps beyond the transition period, neither does that Act prohibit a utility from capping its rates voluntarily. City M.B. at 14-15. Moreover, the City is not suggesting an “indefinite” extension of the rate cap, but rather, a prescribed extension for an additional period until customers have had an opportunity to transition to the competitive market. *Id.* Considering the significant benefits the Applicants and their shareholders will reap from the merger, there is no substantial evidence that requiring an additional extension of the rate caps could “seriously harm” PECO’s financial health, as the A.L.J. claims. I.D. at 24. Nor is there substantial evidence that the rate caps and CAP and MEAF enhancements (the latter discussed in the I.D. at 32-36) will exceed the net present value of the merger’s public detriments.

The ALJ’s proposed findings follow those of the signatories to the Settlement, which suggest that ratepayers should agree to minor concessions in order to obtain minimal short-term benefits with little regard to the long-term detriment that may stem from this merger. In other words, any rate protections provided in the Joint Petition would fail to protect customers post-2010, which is the exact period in which ratepayers will be most vulnerable. City M.B. at 16; City Opp. at 3-4. Conversely, the Applicants would begin reaping the biggest benefits from the merger post-2010. *Id.* Thus, although the ALJ believes that the Joint Petition provides

substantial benefits, the I.D. fails to weigh these benefits with the future impact of the merger, which suggests that the net benefit from this merger is non-existent. To avoid shortsighted judgment, the Commission should not approve the merger without requiring PECO to implement rate and other protections that truly protect customers from the harm the merger may cause post-2010.

c. The ALJ Fails to Recognize that the Other Commitments of the Joint Petition Do Not Outweigh the Potential Benefits to the Public Within PECO's Service Territory.

The ALJ overestimates the value of PECO's promises and fails to recognize the significant detriments that the merger may well cause.

For example, the Joint Petition would provide a modest tightening of reliability standards, under which PECO could *lower* its reliability within the City; and would commit PECO to the status quo in making reliability and safety a part of its executive compensation criteria for those positions not outsourced. City Opp. at 3; City M.B. at 16-18.

In addition, the direct environmental and economic-development benefits to PECO's service territory could be minimal, in that only \$500,000 (less than 5%) of the total of \$8 million pledged to the Pennsylvania Economic Development Authority for energy-related economic development, none of the \$12 million pledged to PEDA for environmental projects, and none of the one-time \$7.2 million pledged to the Sustainable Development Fund, would need to go to the service territory. City Opp. at 4; City M.B. at 15. While these commitments may be beneficial, they need not directly benefit PECO's service territory or customers, which could otherwise see further rate reductions or more direct benefits from these contributions. *Id.* The ALJ tacitly concedes that these provisions may not "provide[] a substantial affirmative benefit to PECO's

customers.” I.D. at 36. Logically, the Commission must ignore these provisions as drafted as support for any proposition that the merger would serve the public interest.⁴

Contrary to the ALJ’s findings, the Joint Petition fails to provide substantial benefits to customers overall, as required for approval under the Public Utility Code. Rather, the Settlement is the result of concessions by various parties, some with a rather narrow view of the public interest, that provide modest short-term benefits in return for long-term financial gain by the Applicants at the public’s expense. Because the Application, as originally filed and as the Joint Petition would modify them, provides no substantial public benefit when analyzed in the long term, the Commission must reject the ALJ’s findings.

Exception No. 3: The ALJ Erred in Finding that the Joint Petition Adequately Answers Directed Questions 1 Through 4.

In the I.D., the ALJ finds that the Commissioners’ proposals concerning possible set-asides of virtually divested power for purposes of economic development, *see* I.D. at 49-50, would be illegal and impractical. I.D. at 49-53. To the contrary, a program of the scope and nature detailed by the City’s witness Kent Miller in response to these questions would be both lawful and practical, and would provide far more public benefit within PECO’s service territory than would the related terms of the Settlement. *See* City M.B. at 15-16, City Opp. at 4, Phila-1-S at 2-6.

The ALJ apparently adopts the Applicants’ objections to the Commissioners’ proposals almost verbatim. I.D. at 50-52. The City addresses them seriatim.

a. While “comparable programs in other states have been implemented on a state-wide basis and funded by customers or the state,” I.D. at 50, the question here is whether the

⁴ The City also discusses economic development in connection with the following Exception, concerning the first four Directed Questions.

Applicants' novel "virtual divestiture" can serve a public purpose. A set-aside for use within PECO's service territory would not have the effect of subsidizing others outside of that territory (unlike the Settlement provisions), and could serve as a laboratory for testing whether the Commission should establish a state-wide program, and could also be proper regardless due to EEG's great size and market power.

b. In light of EEG's assets to be "virtually divested" and PJM's pricing structure, the Commission could fix an appropriate price significantly lower than "market" – and thus suitable for economic-development purposes – while still compensating EEG at far above its cost. In other words, the proposal makes economic sense. The Joint Applicants and their affiliates could choose to fight this; they could also choose not to merge.

c. Constitutional concerns fade because this would be a significant piece of the significant net public benefit the law requires, and because the requirement would not need to use out-of-state power. Use of power to subsidize companies for a time that agree to locate and provide jobs within PECO's service territory, or to remain there, would not violate public policy any more than PECO's current tariff policies which provide the same thing – except that it would be the public and not PECO weighing the public benefits. Indeed, both the Joint Applicants and the ALJ concede that most businesses would prefer "a more direct subsidy" to reduced rates. I.D. at 51-52.

d. Competitors' expressed concerns about an "artificial limit to market availability" are not well-taken, due to the short-term nature of subsidies and the modest scope of the program. The Joint Applicants could agree to the proposal, or the Commission could withhold approval of the merger. The Commission could ensure fairness in the "selection of winners and losers," ensuring a successful program like those in New York State and New York City.

e. There is no reason EEG must fund the program out of “the total pool of merger savings.” But even if it did so, this would be no different from the Joint Settlement – except that all benefits would go to, and be magnified within, the PECO service territory.

f. The same is true of OSBA’s professed concern for “a misallocation of merger benefits across PECO’s rate classes.”

Exception No. 4: The ALJ Erred in Finding that the Joint Petition Adequately Resolves the Directed Question Raised by the PUC Commissioners regarding PGW.

The two Commissioners also asked whether the combination of the PSE&G gas division with PECO’s gas division and PGW would provide critical mass for a viable, profitable, shareholder-owned public utility.⁵ I.D. at 53. The ALJ suggests that the Joint Petition adequately resolves this issue, when the Settlement actually fails to address this complex issue in a timely manner.

As indicated in the City’s Main Brief, substantial benefits could be reaped by the combination of PGW with some variation of the newly merged entity’s natural gas operations; however, the Joint Petition merely suggests that an investigation regarding the feasibility of this combination may begin after the consummation of the merger. City M.B. at 22. As a result, the Joint Petition does not ensure that such fact-finding will occur, must less ensure that this investigation occur expediently. *Id.*

The ALJ notes that such consolidation would constitute a significant and complicated transaction that would “entail months of due diligence, extensive negotiations, and a lengthy regulatory approval process.” I.D. at 54. Despite this recognition, the ALJ finds that such investigation should not occur until after the merger has been consummated. *Id.* If the issues

⁵ This question assumed a revenue stream from off-system sales from a Liquefied Natural Gas facility and a separate resolution of PGW’s billion-dollar debt. I.D. at 53.

and investigation are as significant and complicated as she suggests, then it is in the public interest to begin this investigation as soon as possible. City M.B. at 22-23.

The public could reap substantial economic benefits and financial advantages from such a consolidation, thereby providing significant public interest benefits. If, however, the due-diligence related to this consolidation is delayed indefinitely, the benefits from such consolidation may never materialize. *Id.* at 23. Moreover, the City is only recommending that the parties undertake the preliminary investigation stage, with any consolidation occurring only after adequate due diligence. Thus, if for some reason the merger is not consummated, none of the parties will be harmed, as any action would not have occurred beyond the preliminary stage. *Id.*

Because of the public benefits that could stem from this combination, along with significant time that will be needed to perform the requisite due diligence, the Commission must ensure that any investigations begin upon conclusion of this proceeding, thereby allowing for an expedited track for these issues. If, however, the preliminary stage of this proceeding does not begin until after consummation of the merger, as recommended by the ALJ, any potential benefits will be substantially delayed. In light of the fact that this merger is providing little, if any benefit, to PECO's ratepayers, further delay with respect to this issue is unnecessary and unwarranted. The Commission should reject the I.D. for this additional reason.

The City also adopts and incorporates by reference Exception No. 3 filed this day by the Philadelphia Gas Works ("PGW") and all subsidiary arguments. The City made similar objections and arguments in its Main Brief at 22-23; in its Reply Brief at 5-6; and in its Opposition to Approval of the Joint Petition for Settlement at 2.

III. CONCLUSION

Throughout the course of this proceeding, the City has indicated that the Applicants have not met their burden of proving that the merger, even with the conditions proposed by the Joint Petition, would bring substantial benefits to the public. Rather, any proposed benefits would be *de minimis*, temporary in nature, if not vague and illusory in many instances. Although the Joint Petition fails to require PECO to improve its services above the status quo, the I.D. finds that the inadequate concessions made by the parties in this proceeding to reach the Settlement should be the basis for approving the merger. Further review, however, indicates that the Joint Petition does not provide any substantial benefits overall, as required for approval under the Public Utility Code.

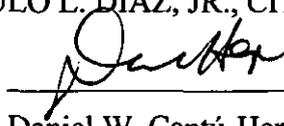
In order to ensure that the public substantively benefits from this merger, the PUC must modify the Joint Petition to provide for significant protections against market power, along with such items as substantial rate protections and long-term public benefits with respect to charitable contributions and corporate presence, as the City has advocated. Similarly, the PUC must perform the requisite review of the impact on retail markets, rather than relying on FERC's wholesale analysis, in determining whether this merger will detrimentally impact Pennsylvania markets. Finally, ratepayers are receiving limited benefits in this proceeding, while the Applicants reap significant monetary rewards while at the same time imposing risk of market volatility and price increases from exercise of market power. For that reason, the PUC should move forward expeditiously in undertaking an investigation of the potential combination of PGW with PECO's and PSE&G's current natural gas divisions, as the investigation may provide the only substantive public benefit stemming from the merger. Because the ALJ fails to recognize these issues, her recommendations in the I.D. must be rejected. Rather, the PUC

should adopt the City's proposed modifications, as set forth more fully herein and in the City's Main and Reply Briefs.

WHEREFORE, The City of Philadelphia respectfully requests that the Pennsylvania Public Utility Commission either: (1) apply the aforementioned conditions to the Joint Petition for Settlement submitted in this proceeding; or (2) reject the Joint Petition absent the agreement of all parties regarding the specific conditions and deadlines that must be imposed in order to ensure substantive benefits for the public as a result of this merger.

Respectfully submitted,

ROMULO L. DIAZ, JR., CITY SOLICITOR

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Dated: December 20, 2005

CERTIFICATE OF SERVICE

I hereby certify that I am this day serving a true copy of the City's Exceptions to Administrative Law Judge's Initial Decision upon the participants listed below in accordance with the requirements of Section 1.54 (relating to service by a participant), via e-mail and via first-class mail, except as otherwise indicated.

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Docket No. A-110550F0160

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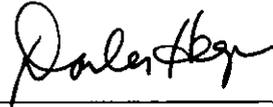
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Darlene Davis Heep

Dated this 20th day of December, 2005 in Philadelphia, Pennsylvania.

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(1913 - 1998)

December 20, 2005

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

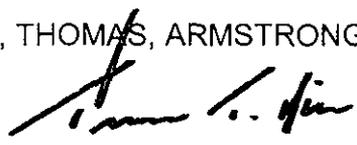
Dear Secretary McNulty:

Enclosed for filing on behalf of Philadelphia Gas Works are an original and nine (9) copies of its Exceptions to the Initial Decision of Administrative Law Judge Chestnut in the above matter. Copies of the Exceptions are being served upon the persons and in the manner set forth on the Certificate of Service attached to the Exceptions.

Very truly yours,

THOMAS, THOMAS, ARMSTRONG & NIESEN

By



Thomas T. Niesen

Encl.

- cc: Certificate of Service
- Office of Special Assistants (w/encl.)
- Steven P. Hershey, Esquire (w/encl.)
- Denise Adamucci, Esquire (w/encl.)

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Before the
PENNSYLVANIA PUBLIC UTILITY COMMISSION

ORIGINAL

Administrative Law Judge
Marlane R. Chestnut, Presiding

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

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EXCEPTIONS OF PHILADELPHIA GAS WORKS
TO THE INITIAL DECISION
OF ADMINISTRATIVE LAW JUDGE CHESTNUT

AND NOW, comes Philadelphia Gas Works ("PGW"), by its attorneys, and files the following Exceptions to the Initial Decision of Administrative Law Judge Marlane R. Chestnut, dated November 22, 2005, and transmitted to the parties by Secretarial Letter, dated November 30, 2005.

I. BACKGROUND

This proceeding concerns the Joint Application of PECO Energy Company ("PECO") and Public Service Electric & Gas Company ("PSE&G") seeking the approval of the Public Utility Commission ("Commission") for the merger of Public Service Enterprise Group, Inc. ("PSEG"), PSE&G's parent company, into Exelon Corporation ("Exelon"), PECO's parent company. The proposed merger is the largest utility merger ever proposed in the United States. The merged entity will serve over seven million electric customers and two million gas customers.

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PGW actively participated in the proceeding. PGW pays PECO more than \$2 million a year for electric service. Most PGW heating customers are, moreover, PECO electric customers. An exercise of market power by the merged entity that increases the price of electricity will make it more difficult for PGW and those of PGW's customers who are on limited budgets to pay their PGW gas bills. An exercise of market power by the merged entity that increases the price and/or the volatility of the price of natural gas in the wholesale market will cause severe injury to the public interest and will also make it more difficult for competitive suppliers to gain a foothold in Philadelphia where there are, currently, no natural gas suppliers in operation.

PGW presented the testimony of Dr. Paul R. Carpenter and Craig E. White. It opposed a Joint Petition for Settlement of the proceeding emphasizing its failure to provide any mitigation of the market power problem and filed Main and Reply Briefs addressing the issue of market power and Directed Questions Nos. 2 and 5 and in opposition to the proposed settlement. Concerning market power, PGW explained how the merged entity will create market power and have the ability to affect the level and volatility of the price of gas and the incentive to increase gas and electric prices contrary to the public interest.

In an Initial Decision dated November 22, 2005, Judge Chestnut concludes that the merger, as modified and conditioned by the Joint Petition for Settlement, is in the public interest and will not result in impermissible market power.¹ While noting that the concerns raised by parties not joining in the settlement are valid and well-presented, the

¹ Applicants' own analysis shows that, absent mitigation, the proposed merger will not pass the market power screen test. The mitigation plan proposed by Applicants involves the divestiture of 6,600 MW of generation. See Initial Decision at 40. Applicants' mitigation plan does not adequately address the market power which will result from the proposed merger as explained in these Exceptions.

Initial Decision concludes that those concerns do not represent a sufficient basis for disapproval or conditional approval of the proposed merger.

PGW submits these Exceptions to the Initial Decision. The Joint Application and the Joint Petition for Settlement, modifying the terms of the merger, should be denied. The Joint Application could be approved if the merger were further modified to provide for the divestiture of those assets that create the market power problem - PECO Gas and PSE&G's gas distribution company² - to remedy the impermissible market power that will result from the merger. In *Re DQE, Inc.*, 186 PUR 4th 39, 61 (1998), the Commission recognized that asset divestiture is often utilized as an effective means of addressing market power concerns and that the Commission has the authority to direct such a remedy.

² The divestiture of the PSE&G distribution company assets would include the gas assets held and managed by PSEG ER&T, an unregulated affiliate of PSE&G.

II. EXCEPTIONS

EXCEPTION NO. 1-

PGW excepts to the analysis and conclusions concerning market power expressed in Section VI of the Initial Decision, Conclusions of Law 11, 12, 13 and 14 and Ordering Paragraphs 1 through 6. The proposed merger is likely to result in the unlawful exercise of market power contrary to the public interest and in violation of the Electric and Natural Gas Competition Acts.

A. Introduction

A vertical merger is one that involves entities that have positions in two product markets where one product (e.g. natural gas) is an important input to the production of the second product (e.g. electricity). Applicants proposed merger is a vertical merger because Exelon and PSEG own and control significant gas and electric assets and natural gas is an important input to the production of electricity. The proposed merger would create a merged entity that has a substantial position in both the gas and electricity markets in the PJM East region. The principal risk presented by this vertical merger is that the merged entity would have the ability to use its market power in the natural gas (input) market to harm competition and raise prices in the electric (output) market. PGW St. No. 1 at 8. Because it could profit from such activity, the merged entity would also have the incentive to do so. PGW St. No. 1 at 24-29.

PGW witness Carpenter evaluated the proposed merger and testified that it raises serious vertical market power concerns. Dr. Carpenter frequently performs market power analyses for merger evaluations and in antitrust lawsuits. He testified before the FERC and the California Public Utilities Commission on the merger of Enova and Pacific Enterprises regarding vertical market power issues and before those same

bodies on the exercise of market power in western natural gas markets during the California Energy Crisis of 2000-2001.³ PGW St. No. 1 at 2-3 and Appendix A.

The Initial Decision concludes that FERC's analysis and resolution of the market power issue is reasonable and thorough and that the Commission should afford FERC's Merger Order issued July 1, 2005, in *Exelon Corp.*, 112 FERC ¶61,011, considerable weight.⁴ It recommends that the Commission come to the same conclusion as FERC and accept the proposed merger with the mitigation measures proposed by the Applicants. In respect to the testimony of PGW witness Carpenter, the Initial Decision states that, while FERC did not expressly consider Dr. Carpenter's testimony, FERC thoroughly considered and discussed the vertical market power issue. Initial Decision at 38-49.⁵

As set forth below, no weight should be given the FERC Merger Order and the Initial Decision should be rejected. The FERC Decision relied on in the Initial Decision

³ Dr. Carpenter holds a Ph.D. in applied economics from the Massachusetts Institute of Technology. He was a post-doctoral fellow at the MIT Center for Energy Policy Research. His areas of expertise, in which he is nationally known, include the fields of energy economics, regulation, pricing policy, and antitrust. PGW St. No. 1, Appendix A.

⁴ In an Order Granting Rehearing For Further Consideration, issued August 29, 2005, FERC granted rehearing of the Order issued July 1, 2005. At its December 15, 2005, session, FERC voted to affirm its Order issued July 1, 2005, but, as of the preparation of these Exceptions, FERC has not issued its written decision adopted December 15.

⁵ In the Introduction portion of the Market Power discussion at page 41, the Initial Decision comments upon the wholesale and retail markets and states that the focus of testimony has been whether the merged entity will be able to exert market power in the wholesale markets to "indirectly" affect retail markets. The import of the characterization of the relationship between wholesale and retail markets as "indirect" is not clear but the relationship between the markets is "direct." Applicants' witness Hieronymus testified about the relationship between wholesale and retail markets at page 14 of PECO Exhibit WHH-1. There, under the heading "that there will be no competitive harm in wholesale markets is also important from a retail perspective," Dr. Hieronymus stated that "[c]ompetitive retail markets *rely on* procurement of power from a competitive wholesale market, and, thus it is important from an ultimate customer perspective that the merger not increase market power in wholesale markets." Given this testimony, there is no basis to suggest that the relationship between competitive wholesale and competitive retail markets is in some way "indirect." A merger that harms the competitive wholesale market harms the competitive retail market.

was not final at the time of the Initial Decision and has since been the subject of a FERC Decision affirming the result, but, lacking a written decision from FERC, the reasoning or derivation of the decision of December 15, 2005, is not known. The FERC proceeding will be the subject of further litigation and/or appeal. The FERC ruling relied on in the Initial Decision provides absolutely no guidance and no comfort to this Commission that the legal issues central to **this** Commission's legal analysis have been addressed in any significant manner.

Furthermore, the legal principles for application by this Commission in this matter under the Public Utility Code, the Electric and Natural Gas Competition Acts and applicable precedent are different than those mandated for FERC, whether or not FERC applied its standards.

The FERC record, moreover, was dramatically different than the record before this Commission. For example, on the central issue of market power, FERC did not have for review any of the testimony that this Commission has from Dr. Carpenter. FERC relied heavily on testimony of Dr. Hieronymus without being aware that, upon Dr. Carpenter's criticism of that testimony in filings before this Commission, Dr. Hieronymus agreed before this Commission that the testimony was wrong. This Commission, in contrast to FERC, has the advantage of a developed record which demonstrates that the proposed merger will result in market power requiring mitigation beyond that proposed by Applicants.

B. The Initial Decision Inappropriately Relies on the Results of the FERC Merger Proceeding

1. The FERC Merger Proceeding May Be the Subject of Further Litigation Or Appeal

The Initial Decision's reliance on the FERC Merger Order, which, in effect, applies principles of *res judicata* or collateral estoppel without expressly stating so, is inappropriate. The Merger Order cited in the Initial Decision is not yet final. FERC's as yet unpublished decision of December 15, 2005, is, until January 14, 2006, subject to further requests for rehearing.⁶ Even if no rehearing requests are filed and the Order becomes final, it is still subject to a petition for review by an appropriate federal circuit court.⁷ The results of the FERC proceeding should not be afforded weight by this Commission.

Further challenge to the FERC proceeding would be wholly justified. The Merger Order *assumes* FERC has authority to impose post-merger obligations, but the assertion of that authority is both novel and inconsistent with FERC's own published regulations⁸ which state as follows:

We do not intend to rely on post-merger review or on new remedies imposed after a merger is approved. We must find that a merger is consistent with the public interest *before* we approve a merger.⁹

This Commission should not base its opinion on a FERC Order which, in addition to not being final, is also based on the imposition of novel post-merger obligations that are not

⁶ 16 U.S.C. §825/(a).

⁷ 16 U.S.C. §825/(b).

⁸ The only instance in the Merger Order in which FERC claims to have such authority is without citation at page 142 of the Order.

⁹ *Inquiry Concerning the Commission's Merger Policy Under the Federal Power Act: Policy Statement*, Order No. 592, 61 Fed. Reg. 68,595 (1996) (emphasis added).

consistent with FERC's own Policy Statement, are subject to further administrative and judicial challenge and may, ultimately, not be part of FERC's final decision. FERC abdicated responsibility on the issue. This Commission should not do the same, but should take immediate steps to protect the public interest and mitigate market power.

2. **Applicable Pennsylvania Legal Standards Differ From Those Applied by FERC and This Commission Should Not Authorize This Merger Since the Requirements of Pennsylvania Law Have Not Been Met**

The FERC proceeding is essentially irrelevant in any event. Regardless of what occurred at FERC, Applicants still must meet the requirements of Pennsylvania law, including the Public Utility Code and the Competition Acts. The public interest, moreover, requires that this Commission undertake its own independent analysis of the benefits and detriments of the proposed merger, the market power issue and the substantial evidence of record before it. An exercise of vertical market power would deny Pennsylvania customers the benefits of retail competition in both gas and electricity markets and is impermissible under the Electric and Natural Gas Competition Acts. For all of those reasons and because of the risk of the consequences of exercise of market power, the merger is contrary to the public interest. FERC gave less than full and adequate attention to the vertical market power issue - the very issue that may be of most concern to Pennsylvania. FERC did not address Pennsylvania statutory requirements and did not speak to the standards articulated in *City of York v. Pa. P.U.C.*, 449 Pa. 136, 295 A.2d 825 (1972), and other applicable precedent. FERC's analysis in no way satisfies the requirements of Pennsylvania law and nothing in Pennsylvania law provides that approval of the merger by FERC by necessity indicates that Pennsylvania law has been satisfied and, thus, that this Commission should approve the merger. See Section F, *infra*.

3. FERC Failed To Consider the Testimony of PGW Witness Carpenter and Conducted No Market Power Analysis

It would be a mistake for the Commission to believe that FERC thoroughly considered and discussed the vertical market power issue as suggested in the Initial Decision. FERC simply did not have a fully developed record on which to base its decision on vertical market power.¹⁰ In fact, FERC had only a paper record that was completely untested by discovery, which was not allowed, or by cross examination, since there were no hearings.

In contrast, the record before this Commission was fully developed and the parties had the full benefit of discovery. In fact, the record before this Commission provides substantial persuasive evidence that Applicants have failed to meet their burden of demonstrating that the merger is in the public interest. It includes: (1) the original vertical market power analysis of the Applicants by their witness Hieronymus (which was also submitted by Applicants at FERC), (2) the vertical market power analysis of PGW by its witness Carpenter, (3) Applicants' revised vertical analysis by witness Hieronymus, in which Applicants acknowledge making errors in and make corrections to the vertical market power analysis they submitted at FERC (PECO St. No. 3-R at 57-58), (4) the testimony of an additional witness, Dr. John Morris (PECO St. No. 11-R), offered by Applicants to attempt to bolster their claims that impermissible market

¹⁰ Dr. Carpenter's testimony was not considered at FERC. Applicants themselves allow as much, stating: "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." Initial Decision at 46 and footnote 17; Applicants' Initial Brief at 19. Direct Energy submitted an affidavit at FERC by Dr. George Briden which addressed vertical market power. This affidavit was considered by FERC. However, Dr. Briden's testimony was significantly different from Dr. Carpenter's. See PGW Statement 1-SR, page 5, fn. 5. Dr. Briden's affidavit is not part of the record in this proceeding.

power will not occur as a result of the proposed merger,¹¹ and (5) the surrebuttal testimony of PGW witness Carpenter (PGW St. No. 1-SR). Of this testimony, only the first, the original vertical market power analysis of the Applicants, which they later abandoned after acknowledging that it contained errors, was considered by the FERC in rendering its decision on vertical market power.

The several rounds of testimony on vertical market power issues in this proceeding added to the FERC record in a meaningful way. First, testimony in this proceeding showed that the Applicants' vertical market power analysis considered by the FERC contained errors, as the Applicants acknowledge. Applicants abandoned their flawed FERC analysis in this proceeding. The acknowledgment of errors is very important because it demonstrates that FERC not only did not consider the Carpenter testimony, but that the record which was the basis for the FERC decision was fraught with mistakes committed by the Applicants' witness on market power. Second, Applicants **could not** replace their FERC analysis with a single, compelling analysis that showed that the merger would not create vertical market power. Instead, the Applicants

¹¹ Counsel for the Applicants explained that Dr. Morris had greater expertise than Dr. Hieronymus, the Applicants' witness before FERC, on natural gas issues (Tr. 504-505):

MR. NIESEN [Counsel for PGW]: If Your Honor pleases, this portion of Dr. Carpenter's testimony addresses something presented by Dr. Hieronymus, not Dr. Morris. *It would seem to me that if a rebuttal or rejoinder were appropriate, it would have come from Dr. Hieronymus, not Dr. Morris on this point.*

MR. ESTES [Counsel for the Applicants]: Your Honor, I don't know that Mr. Niesen gets to decide who my witnesses are on certain issues. If Dr. Morris has the expertise to provide a response to this, I don't know why he should be barred.

JUDGE CHESTNUT: I have to say, it's a little unusual, since this question could have been directed – I mean, Dr. Hieronymus could have addressed this yesterday. Is there some reason he didn't?

MR. ESTES: Your Honor, Dr. Morris is more familiar with these natural gas definition issues than Dr. Hieronymus. The main point of Dr. Hieronymus' testimony was to perform these market concentration calculations.

provided several different, shifting analyses in an unsuccessful attempt to show that the merger would not create vertical market power.

A Herfindahl-Hirshman Index (“HHI”) calculation is used to evaluate market concentration.¹² In contrast to the FERC record, Applicants produced three HHI analyses in this proceeding, each with results different from the one before – a different, moving target at each stage of the proceeding as the flaws in their earlier analyses were revealed. Applicants’ witness Hieronymus’ first analysis produced an HHI of 1,572, which, at a minimum, confirms the existence of a moderately concentrated market and is just 228 points less than the 1,800 threshold level for a highly concentrated market. Subsequently, Dr. Hieronymus admitted to making errors in his initial analysis (See PECO St. No. 3-R at 57-58) and produced a new HHI calculation of 1,292, which again confirms the existence of a moderately concentrated market. Finally, Applicants’ witness Morris produced a third analysis with a dramatically different HHI result of 897.

In effect, Applicants improperly defined and re-defined the gas market during the course of the proceeding dramatically changing their HHI results in an attempt to demonstrate that they do not have market power.

¹² In reviewing market power issues, the Commission applies the analytical process delineated in the 1992 Department of Justice and Federal Trade Commission Horizontal Merger Guidelines (“Merger Guidelines”) and the FERC Merger Policy Statement Under the Federal Power Act, which incorporated the Merger Guidelines into the FERC merger analysis. Appendix A of the Policy Statement addresses the potential market power implications of electric mergers by providing a methodology which is based primarily on a series of screens defined by FERC. These screens utilize concentration statistics based on the Herfindahl-Hirshman Index (“HHI”). Initial Decision at 39.

An HHI below 1,000 is considered unconcentrated and will have no adverse competitive effect. An HHI between 1,000 and 1,800 is considered moderately concentrated and if the HHI increases 100 or more points from the pre-merger level, there may be competitive concerns depending on other competitive factors. An HHI above 1,800 is considered highly concentrated, and the merger guidelines provide that mergers in this range producing an increase in the HHI of more than 50 points raise significant competitive concern and further presumes that mergers producing an increase of more than 100 points are “likely to create or enhance market power or facilitates its exercise.” Initial Decision at 39.

- Dr. Hieronymus initially proposed a geographic market of PJM East, made up of New Jersey, Delaware, and counties in the eastern portions of Pennsylvania and Maryland. PGW St. No. 1 at 16.
- Dr. Hieronymus dramatically changed the size of his market (from 5,934 Mmcf/d to 6,831 Mmcf/d) and his measures of suppliers' capacity in his revised analysis after acknowledging errors that he made. PECO Exhibit WHH-1, Exhibit J-16 and PECO St. No. 3-R at 59.¹³
- Dr. Morris produced an analysis that was very different from that presented by Dr. Hieronymus and included capacity on three pipelines, Maritimes & Northeast, Portland Natural Gas Transmission, and Iroquois Gas Transmission, which do not physically serve PJM East. PGW St. No. 1-SR at 19.¹⁴
- At hearing, Dr. Morris presented a still different and new market definition that changed the boundary of Dr. Hieronymus' PJM East market, redrawing the boundary to exclude northern New Jersey north of Linden, where the Applicants hold capacity and make gas sales. Tr. 508.¹⁵

4. **Conclusion - The FERC Merger Order Is Not Entitled to Any Weight and This Commission Must Conduct Its Own Review of the Evidence**

In short, FERC did *not* develop a record and it did *not* thoroughly consider and discuss the vertical market power issue. Rather than deferring to FERC, the Commission, having conducted its own independent review of the evidence, should conclude as discussed in the following sections that the proposed merger will result in impermissible market power and is not in the public interest. Indeed, PGW respectfully submits that the failure of the Commission to conduct its own independent review of the evidence in this proceeding and its failure to make findings and reasons explaining its

¹³ These changes overstate the size of the relevant geographic market and the amount of pipeline capacity available to serve it during peak periods. See Section D, *infra*.

¹⁴ Like the Hieronymus' analyses, these changes inappropriately include downstream capacity and overstate the size of the relevant geographic market and the amount of pipeline capacity available to serve it during peak periods. See Section D, *infra*.

¹⁵ This analysis inappropriately excludes PSEG's Transco Capacity with New York deliverability from the market power analysis. See Section D, *infra*.

decision would result in the Commission failing to exercise its jurisdictional authority and render any decision in this important matter legally insufficient. See 2 Pa. C.S. §507; *Barasch v. Pa. P.U.C.*, 507 Pa. 496, 491 A.2d 94 (1985); 66 Pa. C.S. §703(e).

C. The Proposed Merger Raises Significant Vertical Market Power Concerns

1. The Post-Merger Market for Delivered Natural Gas in PJM East Will Be Highly Concentrated

PGW witness Carpenter presented an HHI analysis of the delivered natural gas market in PJM East created by the proposed merger. As shown in Table 1 to PGW Statement No. 1, the HHI in the delivered gas market, at 1,942, will exceed 1,800 if PSEG and Exelon merge. Applying the criteria recognized by the Commission in *DQE, Inc., supra*, the post-merger gas market, thus, will be highly concentrated. Additionally, the proposed merger increases the HHI by over 470. If the post-merger HHI exceeds 1,800 and the change (increase) in the HHI exceeds 100, "it is presumed that the merger is likely to create or enhance market power." PGW St. No. 1 at 15-17¹⁶; *Also see* Initial Decision at 39.

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

The merged entity will control 2.51 Bcf/day of delivery capability into the natural gas market. PGW St. No. 1 at 22; Tr. 468. When demand conditions are such that pipeline transportation capacity in the region becomes heavily utilized, the merged entity, operating in this highly concentrated market, will have a pivotal supplier role in the gas market and its decisions concerning the use, or lack of use, of the gas assets

¹⁶ Dr. Carpenter's conclusion differs from that presented by Applicants' witness Hieronymus. Dr. Carpenter used Dr. Hieronymus' analysis as a starting point, but then made several corrections to what are clear errors in his analysis. Some of the corrections increase the post-merger HHI while others decrease it. The corrections are identified and addressed at pages 17 through 21 of PGW Statement No. 1.

it controls will affect the level and volatility of the price of gas. PGW St. No. 1 at 22; Tr. 480-481.

The merged entity, operating in this highly concentrated market, will also have the ability to increase the volatility of the price of gas through the discretionary use of selected storage injection and withdrawal strategies. Decisions to accelerate or decelerate withdrawals during the winter in lieu of using the merged entity's pipeline transportation capacity to meet retail requirements or make off-system sales could cause rapid movements in prices (both upward and downward). PGW St. No. 1 at 23.

3. The Merged Entity Will Have the Incentive to Increase Gas Prices Within PJM In Order to Increase Prices and Its Profits from Its Electric Baseload Capacity

How could market power in the upstream market for natural gas affect the price of electricity? The answer lies in the fact that there is a direct relationship between the price of natural gas and the price of electricity. Gas was on the margin during almost 40% of all hours in 2004 in PJM East, and during 60% of peak hours. Applicants did not dispute this. When gas is on the margin in PJM East, an increase in the PJM East gas price increases the price for PJM East electricity See PGW St. No. 1-S at 3.

Exelon and PSEG have generating capacity in PJM of 26,164 MW and 13,963 MW, respectively, and the proposed merger will produce an entity with combined generating capacity in PJM of 40,127 MW. Giving full effect to the actual and virtual

divestiture¹⁷ of generating assets proposed by Applicants¹⁸ would still leave the merged entity with 33,527 MW of generating capacity in PJM.¹⁹ PGW St. No. 1 at 24-25.

With market power to affect the price of gas, the merged entity will be able to increase the price for PJM electricity. With 33,527 MW of generating capacity in PJM, the merged entity will have a strong incentive to increase gas prices and benefit from higher electric prices and increased profits on its baseload electric capacity. PGW St. No. 1 at 24-25.

4. **Approval of the Merger Without Providing a Vertical Market Power Remedy Would Result in Harm to the Public and Retail Electric and Natural Gas Markets**

The harm to the public and retail electric and natural gas markets as a result of the vertical market power of the merged entity would manifest itself in several ways. The merged entity would have the ability and incentive to increase both the level and the volatility of gas prices in the mid-Atlantic region. This would harm retail gas customers to the extent that they are served using gas purchased in mid-Atlantic gas markets. It will also harm retail gas customers by making it more difficult for competitive gas suppliers to gain a foothold. Retail electricity customers would be harmed because increased gas prices would cause electricity prices to increase. PECO's electricity customers are protected from electricity price increases by a rate cap, but only until 2010.

¹⁷ When Exelon proposed this virtual divestiture, it implicitly recognized both the existence of a market power problem and that divestiture is the appropriate method for resolving the problem. Initial Decision at 40. Some parties argue that virtual divestiture is not really divestiture.

¹⁸ Nuclear plants, which are at the heart of providing Exelon with the incentive to exercise market power, are to be divested only by "virtual" divestiture. Initial Decision at 40.

¹⁹ Calculated as 40,127 MW minus 4,000 MW of actual divestiture and 2,600 MW of "virtual" divestiture.

As stated earlier, PGW pays PECO more than \$2 million a year for electric service. Most PGW heating customers are, moreover, PECO electric customers. An exercise of market power by the merged entity that increases the price of electricity will make it more difficult for PGW and those of PGW's customers who are on limited budgets to pay their electric bills as well as PGW gas bills. An exercise of market power by the merged entity that increases the price and/or the volatility of the price of natural gas in the wholesale market will cause severe injury to the public interest and will also make it more difficult for competitive suppliers to gain a foothold in Philadelphia where there are, currently, no natural gas suppliers in operation. See PGW St. No. 1 at 6-7.

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

There are two classes of remedies available to eliminate the vertical market risk resulting from the proposed merger: 1) remedies that eliminate the *incentive* to exercise vertical market power, and 2) remedies that eliminate the *ability* to exercise that power. The second of these two alternatives is preferable as explained below. PGW St. No. 1 at 29-30. See *DQE*, 186 PUR 4th at 60-61.

Both structural and conduct remedies are available to eliminate the ability to exercise vertical market power. Structural remedies involve the divestiture of natural gas assets that are the source of the market power. Conduct remedies include regulatory rules and codes of conduct that help prevent the exercise of market power. Structural remedies are preferred because conduct remedies are difficult and costly to enforce by the regulators. PGW St. No. 1 at 30; See *DQE*, 186 PUR 4th at 61.²⁰

²⁰ In addition, if a conduct remedy is not effectively enforced, how would the consuming business that ceased operations or the family that spent too much on energy and not on medicine be compensated?

The cleanest, easiest and most effective remedy for the vertical market power problem in this proceeding is to require, as a condition for approval of the merger, the divestiture of PECO Gas and PSE&G's gas distribution company (including the gas assets held and managed by PSEG ER&T). Divestiture would, by definition, eliminate the vertical problem.²¹ PGW St. No. 1 at 30-31.

Divestiture of natural gas assets is not an extreme remedy in this case. Indeed, divestiture of natural gas assets is no more extreme than, and is as necessary as, the divestiture of the 6,600 MW of generating capacity that Applicants have already proposed to address the substantial market power that Applicants themselves acknowledge will occur as a result of this large merger. In *DQE*, moreover, this Commission recognized that asset divestiture is often utilized as an effective means of addressing market power concerns and that the Commission has the authority to direct such a remedy, explaining as follows (186 PUR 4th at 61 (footnotes omitted)):

Although we are not directing divestiture as a strategy in this case, it is important to note that remedy is within our authority under the Act. ... Indeed, section 2811(e)(2) specifically provides the Commission with broad authority to fashion 'terms and conditions' it finds necessary to preserve a competitive retail electric market. As divestiture of assets has long been accepted by the courts and enforcement agencies as an effective means to address market power concerns in merger cases, this Commission may utilize this remedy (and other structural remedies as well) whenever it deems appropriate pursuant to its authority under section 2811 of the Electric Competition Act.

In contrast to structural remedies, conduct restriction remedies are generally considered inferior to the protection of competition that would result from the imposition of a structural remedy such as membership in an approved, functioning ISO. Mark W. Frankena & Bruce M. Owen, *Electric Utility Mergers Principles of Antitrust Analysis* 141 (1994). The

²¹ A second, more targeted remedy is also one that would require greater regulatory supervision going forward. This remedy would require that the gas assets (upstream transportation contracts and storage rights) held by PECO and PSEG be placed in the hands of third parties that are independent of the merged entity and subject to oversight by Pennsylvania and New Jersey regulators, respectively. See Section E, *infra*, and PGW St. No. 1 at 31.

creation of new competition through structural remedies is likely to be better for electric customers than the creation of additional oversight requirements. Regulatory conditions that require continuing oversight by a regulatory body to ensure compliance generally are less effective in preventing the exercise of market power and more costly to enforce.

6. Summary of Vertical Market Power Analysis and Concerns

The Initial Decision presents no substantive review of the record, findings or conclusions concerning vertical market power proposing, instead, that the Commission “give considerable weight” to a non-final FERC Merger Order. “Giving weight” to the FERC decision fails to provide the legally mandated findings and conclusions based on the record in this proceeding. The Initial Decision is, thus, legally insufficient. See 2 Pa. C.S. §507; *Barasch v. Pa. P.U.C.*, 507 Pa. 496, 491 A.2d 94 (1985); and 66 Pa. C.S. §703(e).

The Commission should rely on the evidence of record in this proceeding regarding the vertical market power analysis and concerns presented by PGW witness Carpenter. That analysis is discussed at some length above. PGW submits that the following bullet point summary of Dr. Carpenter’s direct testimony, PGW Statement No. 1, as the appropriate and proper vertical market power findings in this matter:

- The proposed merger of Exelon and PSEG raises significant vertical market power concerns. The merged entity would possess market power in the downstream electricity market represented by PJM East, and it would possess market power in the upstream market for delivered natural gas in the same geographic area. The degree of market power in the upstream gas market, as measured by the level and change in the HHI statistic, is sufficient to establish a presumption that the merger is “likely to create or enhance market power.”
- Applicants’ vertical market power analysis contains several errors. When corrected, Applicants’ own analysis establishes that the merger fails the tests for lack of vertical market power. Conservatively, the HHI in the PJM East delivered gas market rises from 1,469 to 1,942 with the merger – a change of over 470 points.

- The merged entity will have the ability and incentive to raise the level and volatility of natural gas prices, and thus electricity prices, in PJM East. Its ability to raise the price of natural gas derives from the merged entity's control of substantial gas transportation rights, and its discretion and flexibility to draw on those rights depending on demand conditions in the market during particular days. The merged entity would control 2.51 billion cubic feet (Bcf) per day of delivery capability into the market, over 1.9 Bcf per day of which is held currently by PSE&G's unregulated affiliate PSEG ER&T. When demand conditions are such that pipeline transportation capacity in the region becomes heavily utilized, the merged entity will potentially have a pivotal supplier role in the gas market.
- The incentive of the merged entity to raise the price of gas derives from its substantial baseload power generation capacity that will remain in its possession after the proposed divestitures. Since natural gas fired generation is "on the margin" during more than 50 percent of the peak hours in PJM East, an increase in the price of gas during those hours would directly translate into the market price of electricity to the benefit of the merged entity's baseload generation.
- Existing regulations are not sufficient to protect against the potential for the exercise of market power by the merged entity, particularly since such a large proportion of its upstream holdings will be in the possession of an unregulated affiliate. There is no equivalent to the PJM Market Monitoring Unit for the gas markets relied on for power generation in PJM.
- The vertical market power concerns raised by this merger are best remedied by eliminating the source of the market power in natural gas. This could be accomplished cleanly by requiring the divestiture of the regulated gas operations of PECO and PSE&G (including the contracts held by PSEG ER&T).

D. Testimony of Applicants' Witnesses Is Incorrect and/or Irrelevant

Rebuttal to Dr. Carpenter's vertical market power analysis and HHI calculation was presented by Applicants' witnesses Hieronymus and Morris. Dr. Carpenter responded to the Hieronymus and Morris testimonies in PGW Statement No. 1-SR. Since the Initial Decision is based on acceptance of the FERC Merger Order, it presents *no substantive discussion of either Applicants' rebuttal testimony or PGW's surrebuttal*

response.²² For the benefit of the Commission's understanding of the discussion, a summary of Dr. Carpenter's surrebuttal points follows (PGW St. No. 1-SR at 3-5):

- In rebuttal, Dr. Hieronymus presents an entirely new gas market concentration analysis that corrects some of the errors in his original analysis but perpetuates the fundamental problem with his methodology – a geographic market that is too broad to correctly reflect competitive alternatives to the Applicants' natural gas capacity during peak periods in PJM East.
- Instead of performing his own analysis to justify this expanded geographic market, Dr. Hieronymus relies on the testimony of Dr. Morris for his conclusion that “the value of gas flowing through PJM East and its value downstream rarely diverge by more than a trivial amount.” Dr. Carpenter demonstrates that no such conclusion can be reached from Dr. Morris' work.
- A more detailed and expanded analysis of prices than was performed by Dr. Morris indicates that there is nothing “trivial” about the frequency and magnitude of the price separation between the PJM East and New York/New England natural gas markets during peak demand periods. Thus, pipeline capacity serving the New York/New England region should not be included in the same geographic market as the capacity serving PJM East for purposes of a gas market concentration analysis.
- Dr. Morris claims that additional factors eliminate the ability of the merged entity to exercise market power in the PJM East gas market, including: the use of interruptible transportation (“IT”) capacity as a substitute for firm capacity, the fact that the utilities hedge their gas positions, that the merged entity could not create or benefit from increased price volatility, the entry of new LNG facilities on the East Coast, and pervasive regulatory oversight of PSEG ER&T by the New Jersey Board of Public Utilities (“New Jersey BPU”). Dr. Carpenter demonstrates that:
 - Dr. Morris' claim that IT is an economic substitute for firm transportation during peak periods is incorrect.
 - Whether the utilities hedge their gas position is irrelevant to whether they have the discretion to use their gas assets to create volatility and profit from that volatility. The evidence demonstrates that the merged entity will have substantial discretion in the use

²² As set forth above, PGW submits that the lack of substantive analysis, findings and conclusions renders the Initial Decision legally insufficient. See 2 Pa. C.S. §507; *Barasch v. Pa. P.U.C.*, 507 Pa. 496, 491 A.2d 94 (1985); and 66 Pa. C.S. §703(e).

of its transportation and storage assets to move prices during peak periods while simultaneously serving their peak loads.

- [T]he more likely scenario [to the entry of new LNG facilities on the East Coast] is the construction of additional LNG capacity on the Gulf Coast, leading to further potential congestion on the pipelines serving PJM East.
- The New Jersey BPU's regulatory authority over PSEG ER&T is not as all-pervasive as implied by Dr. Morris.
- Dr. Hieronymus did not respond in any way to Dr. Carpenter's proposed remedies. Dr. Morris's response was simply to assert without support that a divestiture remedy "has no nexus to the alleged problem." He ignores completely the second, more targeted, remedy, but which would require greater regulatory oversight.

An expanded response to the testimony of Applicants' witnesses is presented at pages 21 through 35 of PGW's Main Brief and pages 9 through 19 of PGW's Reply Brief and, pursuant to 52 Pa. Code §5.533(c), incorporated herein by reference. Several specific arguments are addressed hereinafter for the Commission's consideration in regard to the vertical market power issue.²³

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

In response to Dr. Carpenter, Applicants' witness Hieronymus rechecked his data, accepted some of Dr. Carpenter's corrections²⁴ and made two material changes

²³ Recognizing the precariousness of their HHI analyses, Applicants also argued to Judge Chestnut that there will be no market power problem regardless of the HHI calculations. They presented four assertions in this regard at pages 43 through 46 of their Initial Brief. The assertions are not addressed in the Initial Decision. None is, however, supported by the evidence of record. PGW addressed the assertions at pages 14 through 17 of its Reply Brief and PGW respectfully incorporates those pages of its Reply Brief herein by reference pursuant to 52 Pa. Code §5.533(c).

²⁴ Specifically, Dr. Hieronymus added three contracts held by PECO and PSEG with capacity of approximately 117 MMcf/d that have delivery rights in PJM East that he improperly excluded in his initial concentration analysis. He also added a number of contracts that he had improperly excluded in his initial concentration analysis. He excluded a contract held by PSEG totaling approximately 187 MMcf/d that has *receipt* rights solely within PJM East. PGW St. No. 1-SR at 6-7.

to his analysis: (1) he increased the total size of his PJM East gas market by including 885 MMcf/d of capacity on Transco's Leidy Line,²⁵ and (2) he changed his allocation of pipeline capacity to explicitly include holders of firm transportation into PJM East **and** markets downstream of PJM East, namely Eastern New York. PGW St. No. 1-SR at 6-8.

The end result of Dr. Hieronymus' rebuttal analysis is a 15% increase in the PJM East Gas Market from 5,934 MMcf/d to 6,831 MMcf/d and a 7% reduction in the measure of the Exelon/PSEG capacity from 2,115 MMcf/d to 1,974 MMcf/d. With these revisions, his HHI calculation decreases from 1,572 in his original analysis to 1,292, which, being less than 1,800, is then claimed to support Applicants' position that the proposed merger will not raise market power concerns. PGW St. No. 1-SR at 9, Table 1.

Dr. Hieronymus' revised HHI calculation is understated. The analysis that produces it improperly overstates the size of the relevant geographic market during peak periods and the amount of pipeline capacity that is available to serve the market during those periods. The essential error is the inclusion of interstate capacity with delivery rights downstream of PJM East into New England and New York in the PJM East market. This capacity will not be available during peak periods to deliver to PJM East and, thus, should not have been included in the analysis. PGW St. No. 1-SR at 10; Tr. 486.

Applicants, however, support the inclusion of New York and New England transportation capacity in the analysis by looking at prices in the three regions. While

²⁵ Dr. Hieronymus' revised analysis increased the size of the PJM East market by a total of 897 Mmcf/d. The remaining 12 Mmcf/d is the result of his use of more recent EIA pipeline capacity data. PGW St. No. 1-SR at 7, footnote 7.

Applicants acknowledge that natural gas prices between PJM East, New England and New York separate at times during peak periods, they claim that the separation is sporadic, non-sustainable, short-lived and, thus, not important. In effect, as claimed by Applicants, PJM East, New York and New England are all part of one big market.

If one goes below the superficial data, as Dr. Carpenter did in response to Applicants, it is, nevertheless, clear that there is a large separation in prices during winter peak periods and, thus, PJM East, New York and New England are not one market. During 2003 to 2005, the New York price exceeded 105% of the PJM East price on 23% of winter days (or approximately 1/4 of the winter period), and the New England price exceeded the PJM East price on 24% of winter days (again, approximately 1/4 of the winter period). Prior to the 2003 – 2005 period, this test, which is referred to in the record as the 5% test, also fails for the New York and PJM East markets during some summer periods, particularly the summer of 2002. PGW St. No. 1-SR at 15.

These price differences were significant on absolute terms. PGW St. No. 1-SR at 15. During the 23% of winter days when the New York price exceeded 105% of the PJM East price, the New York price exceeded the PJM East price by \$3.00/MMBtu on average. During the 24% of winter days when the New England price exceeded 105% of the PJM East price, the New England price exceeded the PJM East price by \$2.20/MMBtu on average. PGW St. No. 1-SR at 15.

These separations in prices demonstrate that downstream capacity into New England and New York should not be included in the HHI calculation and that Dr. Hieronymus' revised HHI analysis, at 1,292, is understated. They also reveal a serious vertical market problem as a result of the proposed merger. Indeed, the days when

prices separate represent a significant portion of the winter when natural gas prices are typically their highest. PECO St. No. 11-R, Figure 2, at 19. Even if the merged entity only had market power during the periods when prices separate, that market power will exist during a significant portion of the winter season when gas prices in PJM East are highest.

In sum, while Applicants argue that there is no reason to believe that price separations would permit sustainable price increases in PJM without drawing a supply response from New York and New England, the price data demonstrates just the opposite. During the winter period, prices separate on a significant and sustainable basis. Even according to Applicants' witness Morris the price differences occur "about 30 percent" of the time in the winter. Tr. 502. So, Applicants' own testimony suggests that Exelon/PSEG could exercise market power and cause price increases during 30% of the winter, when prices are already at their highest. Again, the price separations are significant and sustainable and they do not support Dr. Hieronymus' revised HHI analysis. Proper pricing analysis demonstrates that a serious vertical market problem will exist as a result of the proposed merger. The Initial Decision fails to address these issues, makes no findings or conclusions in regard to them and, thus, provides no useful guidance for the Commission.

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

Having submitted an original and revised measure of gas market concentration through their witness Hieronymus, Applicants submitted yet a third measure of PJM East gas market concentration through their witness Morris. While different still from the Hieronymus analysis, the Morris analysis, which includes an HHI calculation of 897,

fails for the same reason - it includes downstream capacity that will not be available in PJM East during peak demand periods. PGW St. No. 1-SR at 19.

Dr. Morris includes capacity on three pipelines, Maritimes & Northeast, Portland Natural Gas Transmission, and Iroquois Gas Transmission, which do not even physically serve PJM East. These pipelines physically serve only the New York and New England markets²⁶ and, thus, are inappropriately included in the market analysis. Even Dr. Hieronymus does not include capacity on these pipelines in his PJM East market concentration analysis. Dr. Morris' analysis only compounds the error made by Dr. Hieronymus, resulting in a severely understated HHI calculation. PGW St. No. 1-SR at 19.

3. In Order to Properly Analyze This Merger, PSEG's Transco Capacity with New York Deliverability Should Be Included in the Market Power Analysis

In further support of a reduced HHI calculation, Applicants propose, as an alternative to expanding the market to include capacity into New England and New York, to shrink the size of the merged entity's share of the PJM East market. They do this by proposing that 794 MMcf/d of PSEG's Transco capacity with delivery points in the New York market be excluded from the PJM East market calculation. They, in effect, assume that this capacity does not exist in the PJM East market.

PSEG's Transco capacity is appropriately included in the analysis for two reasons. First, PSEG's Transco capacity represents almost half (794 MMcf/d out of 1,663 MMcf/d) of PSEG's total interstate capacity into PJM East. The PSEG Transco capacity is used, in significant part, to meet PSE&G's basic gas service requirements

²⁶ PECO Cross Examination Exhibit 3 which purports to depict the pipelines passing through PJM does not include even one of the additional pipelines included by Dr. Morris in his market concentration analysis.

("BGSS") in PJM East during winter months. Capacity required for BGSS requirements is not available to sell gas into New York and is appropriately included in the analysis. PGW St. No. 1-SR at 17.

Second, Dr. Carpenter reviewed sales data and demonstrated that PSEG's sales into New York on peak days are never even close to 794 MMcf/d. He also showed that PSEG uses its Transco capacity to sell in PJM East, in New Jersey. Thus, it is unreasonable for Applicants to suggest that the 794 Mmcf/d of PSEG Transco capacity should be excluded from PJM East, and entirely appropriate to include this capacity in an HHI and vertical market power analysis. See PGW St. No. 1-SR at 17-19 (Proprietary and Public Versions).

E. The Additional Bases Cited By the Initial Decision Do Not Support A Conclusion of Lack Of Market Power

Having recommended that the Commission afford the FERC Merger Order considerable weight, the Initial Decision offers several supplemental thoughts in support of its conclusion. Initial Decision at 47-49.

The Initial Decision notes, first, that, because of the rate caps contained in the settlement, any market changes would not affect electric rates until after 2010. Initial Decision at 47-48. This recommended reliance on rate caps is contrary to Commission precedent. In *DQE*, 186 PUR 4th at 61, this Commission refused to accept a rate cap as a mitigation measure explaining that a rate cap is a conduct restriction remedy and that a rate cap, as a mitigation proposal, is "clearly inadequate" to deal with substantial market power:

" ... the Applicants' offer of a rate cap is an example of a conduct restriction remedy designed to prevent the merged firm from extracting monopoly prices after the merger. As found in the Recommended Decision, rate caps do not remove the market power problem nor do they ensure competitive rates. See, e.g., R.D. at 176. Rate caps are almost

always inevitably set above the competitive market price, so that a merged entity can still extract above-market prices for its product by charging customers the rate cap prices and not be in violation of this regulatory condition. See, e.g., OTS Statement No. 4, at 19-20; OCA Statement No. 1, at 29-30; APSEUG Main Brief at 30. This mitigation proposal, therefore, is clearly inadequate to deal with the substantial market power found to exist in this case. We adopt the recommendation of the ALJs which rejected the use of the rate cap as a mitigation strategy.

A rate cap is no more an appropriate market power remedy here than it was in DQE. A rate cap of short duration is, furthermore, no answer to the long term market power concerns raised by the proposed merger. PECO's rate cap expires in 2010, less than five years from conclusion of this proceeding, while the proposed merged entity will be with us long after the cap's expiration.

The Initial Decision also concludes that any concerns regarding natural gas issues are addressed by Applicants' commitment not to combine their natural gas procurement functions without Commission approval. Initial Decision at 49. This "commitment," which was proposed by Applicants for the first time in their Main Brief, leaves control of the natural gas assets in the hands of the merger partners and does nothing to address market power concerns. It ignores and leaves unaddressed Applicants' intended combination of Exelon's significant electricity trading operation, Power Team, with the significant gas and electricity trading operations of PSEG ER&T. See PGW St. No. 1 at 14.

The "commitment" is, moreover, not even a concession on the part of the Applicants. Applicants' witness Morris testified that the Applicants would already have to seek approval of this Commission if they were to combine their gas operations. Tr. 512. *It also does nothing to remedy the Applicants' vertical market power. The merged entity's vertical market power is not based on an assumption that Applicants combined*

their gas procurement functions. The proposed merger creates vertical market power even if PECO and PSE&G's gas procurement functions are not combined. The Applicants' commitment, even if true, is meaningless.

Even if Applicants' gas procurement operations are kept separate, they would still each have an incentive to exercise market power in a way that benefits Exelon/PSEG. By trying to separate in a non-binding manner this issue related to the merger from the approval of the merger itself, Applicants not only seek to have their cake and eat it too, but they ask the Commission and all the parties to dedicate substantial resources to re-litigate these same issues at a later time.

Finally, the Initial Decision suggests that the annual 1307(f) proceedings of PECO will protect the public from the merged entity's market power. This Commission will, however, have no information about the gas market activities of PSE&G or PSEG ER&T, PSE&G's unregulated affiliate, available to it when it conducts its annual 1307(f) review of PECO. This Commission, thus, will not be in a position to use PECO's annual 1307(f) proceedings to monitor storage or other gas asset manipulation by the merged entity.

In addition, market manipulation is very difficult for regulators like the Commission to detect after the fact unless the regulators are collecting the right data, are carefully monitoring the entity's actions on a continual basis, and are able to distinguish between price movements caused by actions of the entity and price movements that are the result of the complexities of market forces. PGW St. No. 1 at 23. In short, the market could be manipulated without regulators ever being aware of it. In addition, as addressed in the quote above from *DQE*, at 60-61, oversight by a

regulatory body is generally less effective in preventing the exercise of market power and more costly to enforce than structural remedies such as divestiture.

Reliance on regulatory proceedings, such as the annual 1307(f) proceeding, might be appropriate if it were coupled with placement of the gas assets (upstream transportation contracts and storage rights) held by PECO and PSEG in the hands of *third parties* that are independent of the merged entity. The combination of the assets in the hands of *third parties* and the oversight of regulators would ensure that the ability to exercise market power is mitigated and separated from the incentive to exercise that power. This alternative remedy would require greater regulatory supervision going forward, and ultimately prove less effective than divestiture. PGW St. No. 1 at 31.

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

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

Statutory language (66 Pa. C.S. §1103) and long standing precedent (*City of York v. Pa. P.U.C.*, 449 Pa. 136, 295 A.2d 825 (1972)), require Applicants to demonstrate that the merger will promote the public interest in a substantial way. When the public interest is considered, it is contemplated that the benefits and detriments must be measured as they impact on all affected parties. *Middletown Township v. Pa.*

P.U.C., 85 Pa. Commonwealth Ct. 191, 482 A.2d 674 (1984). Here, the evidence of record demonstrates substantial detriment to the public as a result of concentration of market power in the natural gas and electric markets. This significant detriment outweighs any possible benefit from the merger or from the merger as modified by the proposed settlement. See Exception No. 2, *infra*.

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

The merger clearly concentrates market power to a level that requires the application of mitigating terms and conditions. Applicants acknowledge as much when they propose unprecedented levels of actual and virtual divestiture of electric generation. However, these mitigating terms and conditions are insufficient and do not address vertical market power concerns, in particular market power in the gas market. The testimony of PGW witness Carpenter demonstrates that the merged entity will have vertical market power and the ability and incentive to exercise it. In an attempt to disprove Dr. Carpenter’s conclusions, Applicants present not one, not two, but three analyses of the natural gas market and a “five percent” pricing rule, none of which should be given any weight.

The FERC Merger Order cited in the Initial Decision is not yet final. More importantly, it is not based on a developed record and it is not entitled to weight by this Commission. Regardless of what occurs at FERC, the Applicants must meet the requirements of Pennsylvania law, including the Public Utility Code and the Competition Acts. An exercise of vertical market power would deny Pennsylvania customers the benefits of retail competition in both gas and electricity markets. The result of an exercise of such market power would also make it impossible to find, as a matter of law, that the merger provides substantial, positive benefit to the public. *City of York v. Pa. P.U.C.*, *supra*. Such a result is also impermissible under the Competition Acts and contrary to the public interest. To assure compliance with the Acts and the public interest, the Commission should require divestiture of PECO Gas and PSE&G's gas operations as a condition precedent to the merger. PGW's Proposed Findings of Fact and Conclusions of Law presented at pages 44 through 54 of PGW's Main Brief are incorporated herein by reference pursuant to 52 Pa. Code §5.533(c).

PGW submits that its Exception No.1 should be granted.

2. **EXCEPTION NO. 2-** PGW excepts to the analysis and conclusions concerning the Joint Petition for Settlement expressed in Sections IV and V of the Initial Decision, Conclusions of Law 11, 12, 13 and 14 and Ordering Paragraphs 1 through 6. The Joint Petition for Settlement does not adequately protect the public and the Commission should not approve it.

The Initial Decision concludes that the proposed merger as described in the Merger Agreement and modified by the Settlement is in the public interest and should be approved by the Commission without further modification. It concludes also that the proposed merger will affirmatively promote the service, accommodation, convenience, or safety of the public in a substantial way, and is not likely to result in anticompetitive

or discriminatory conduct, including the unlawful exercise of market power, which would prevent retail electricity or gas customers in Pennsylvania from obtaining the benefits of properly-functioning and workable electricity and natural gas markets. Initial Decision at 20-21.

The analysis presented in support of the recommended acceptance of the Joint *Petition for Settlement* focuses entirely on the benefits, mostly shallow and short term in nature, provided to parties as a result of the Settlement without any analysis of the potential long term detriments that will occur and, thus, without any attempt to balance the one against the other. Thus, a merger of two already large corporate entities is recommended for approval in reliance upon arguments that the “greater scale, scope and diversification” of the even larger merged entity “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.” Initial Decision at 21.

Such internal benefits to the merging companies have no relationship whatever to the standard imposed in *City of York v. Pa. P.U.C.*, *supra*, which requires an examination and demonstration of the benefits to the public, not to the merging companies. One assumes that the Applicants would not propose a merger unless it provided benefits to the merging companies and their shareholders; the issue, however, is the impact on the public.

The focus on purported benefits of the various settlement contributions and terms without any consideration of the potential detriments occurring as a result of the proposed merger is inconsistent with applicable precedent. The Commission is required to measure the benefits **and** the detriments of the proposed merger. *Middletown*

Township v. Pa. P.U.C., supra. If this requirement is to mean anything, then the Commission must expand its analysis of the proposed merger and consider the potential detriments resulting from it, including the vertical market power concerns presented in PGW Exception No. 1.

Nominal rate reductions, contributions to various organizations and reporting of wholesale prices, are, in any event, not substantial, affirmative public benefits sufficient to support the proposed merger. Concerning rate reductions for example, the Settlement offers the typical residential customer a rate reduction of just \$1.26 per month for two years, and just \$0.63 per month for an additional two years. These rate reductions are inconsequential and of no real benefit to the public, especially when weighed against the risks to the public from an exercise of market power. PGW St. No. 1-S at 6-7. Such rate reductions will have no substantial impact on the ability of struggling Philadelphia customers to better afford their monthly living expenses.

The pricing report to be provided by Applicants pursuant to the Settlement involves electricity prices, not natural gas prices. This pricing report does not give the Commission any information it does not already have access to on the PJM website. PGW St. No. 1-S at 4. More importantly, it does not give the Commission access to any additional information that would be useful in determining whether Exelon's affiliates have been exercising market power in the PJM East electricity market. PGW St. No. 1-S at 4-5.

The following bullet point summary addresses how the Joint Petition for Settlement fails to adequately protect the public and why the Commission should not approve the Settlement. PGW Statement No. 1-S at 3-7. PGW submits these points as the appropriate and proper conclusions concerning the proposed Settlement:

- The Joint Settlement Neither Mitigates the Merged Entity's Market Power in the PJM East Natural Gas Market Nor Protects Customers from the Exercise of Market Power by the Merged Entity in the PJM East Gas Market.
 - The Joint Settlement contains no term or provision designed to protect the electricity market from potential market power abuses in the **natural gas** market.²⁷ There is a direct linkage between the price of natural gas and the price of electricity during many hours of the year. It is not possible to ensure that the wholesale and retail electricity markets are competitive without ensuring that the natural gas market is also competitive.
 - The provisions of Section F of the Joint Settlement concerning Affiliate Risk and Cross-Subsidization are very limited and do not give the Commission the ability to monitor the gas market activities of the merged entity's unregulated gas market affiliates. The Settlement, moreover, does not *require* the Applicants to maintain separate gas procurement operations for PECO and PSE&G.
- Section I - Competitive Electric Markets - of the Joint Settlement Provides No Additional Protection to Customers from the Exercise of Market Power by the Merged Entity in the PJM East Electricity Markets.²⁸
 - The electricity price reporting requirement created in Section I does not give the Commission any information it does not already have access to on the PJM website. More importantly, it does not give the Commission access to any additional information that would be useful in determining whether Exelon's affiliates were exercising market power in the PJM East electricity market.
 - The "other information necessary to assess price trends in the PJM markets" to be included in the Section I report is so vague as to be meaningless. The Commission currently has access to an annual report on PJM electricity markets prepared by the PJM Market Monitor that is more comprehensive than the report required of PECO in the Joint Settlement.

²⁷ Section I of the Joint Settlement concerns the electric market, not the natural gas market.

²⁸ For example, the Joint Settlement requires PECO to file an annual report with this Commission in 2007 – 2012 "addressing wholesale market prices and price trends in the Pennsylvania-New Jersey-Maryland Interconnection ("PJM") markets." The report is to contain "information regarding price differentials between PJM East and other PJM regions and other information necessary to assess price and price trends in the PJM markets." All of the information referred to in this section involves the prices for electricity as opposed to natural gas. PGW St. No. 1-S at 4.

- Even if the information for the report were better specified, it is extremely difficult to detect the exercise of market power after the fact by simply looking at price differential data, because it is very difficult to distinguish between high price levels and differentials that are the result of an exercise of market power and those that *are the result of naturally tight supply and demand conditions in particular locations. See DQE, supra.*
- The ability of a party to ask the Commission to initiate an investigation is already available to a party and the threshold level or type of information necessary to initiate the request is unclear. Again, if a merger creates a risk that market power could be exercised, it is best to mitigate it through structural remedies prior to approving the merger rather than to rely on the possibility of after-the-fact investigation to deter its exercise. *See DQE, supra.*
- There Are Significant Risks from Not Addressing the Merged Entity's Gas and Electricity Market Power
 - The Settlement offers the typical residential customer a rate reduction of \$1.26 per month for two years, and \$0.63 per month for an additional two years. The risks to customers from an exercise of market power are potentially much greater than the rate reductions offered by the Settlement. These risks are in the form of higher price levels for natural gas and electricity than would otherwise be the case, and greater price volatility which increases costs for gas and electricity ratepayers in ways that are difficult to quantify in advance but potentially significant.
 - The Settlement benefits are short-term in duration. The merged entity itself will likely be around for a very long time. Because it is very difficult to undo a merger once it has been completed, the Commission should not approve the merger unless there is adequate mitigation to resolve the vertical market power problem it presents.

PGW submits that its Exception No. 2 should be granted. The Joint Settlement does not adequately protect the public and provides no remedy for the vertical market power that will occur as a result of the merger.

3. EXCEPTION NO. 3-

PGW excepts to the analysis and conclusions concerning Directed Question 5 expressed in Section VII.B. of the Initial Decision. The proper response to Directed Question 5 is a due diligence type study of a possible combination of PGW with PECO Gas Division including consideration of an authority type structure to house the combined entity.

Directed Question 5 asked the parties to address whether the combination of the PSE&G gas division with the PECO gas division and PGW would provide critical mass for a viable, profitable, shareholder owned public utility, assuming a revenue stream from off system sales from an LNG facility, and separate resolution of the problem of a billion dollar debt. PGW addressed Directed Question 5 in testimony of Dr. Carpenter and Craig E. White, PGW's Acting Chief Operating Officer.

Utilizing a preliminary analysis of publicly available information concerning PECO revenue, cash flow and debt, Mr. White testified that a combination of PGW with the PECO Gas Division could result in a viable, profitable gas utility and that there is sufficient data supporting the concept to warrant a more detailed due diligence type study.²⁹ While the term "profitable" in the Question implies investor ownership, one other alternative to house the combined entity would be a not for profit entity such as an authority structure. PGW St. No. 2 at 3-5.³⁰

The Initial Decision accepts Section J of the Joint Settlement as the answer to Directed Question 5. Section J provides that the Commission "may" initiate a separate

²⁹ An analysis of PSE&G data was not done for the several reasons explained by Mr. White at pages 2 and 3 of PGW Statement No. 2. Assuming that market power issues could be resolved, PGW would have no objection to including three gas systems in a combined entity and would review any information that might indicate that the concerns articulated at pages 2 and 3 of PGW Statement No. 2 can be overcome. PGW St. No. 2 at 2-3.

³⁰ Mr. White's testimony should not be misinterpreted. It is not intended to serve as the final and dispositive answer to Directed Question 5. It is intended to provide some evidence that a combination of PGW and PECO Gas is worth further study if full information is available to inform the study. See PGW St. No. 2 at 5.

fact-finding investigation following consummation of the merger to examine issues related to a potential consolidation of the operations of PGW with and into the natural gas distribution business of the new Exelon Electric & Gas Corporation.

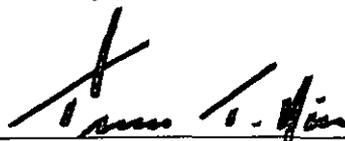
PGW does not support Section J of the Settlement as the answer to Directed Question 5, nor does it support the idea of a separate fact-finding investigation following consummation of the merger. In contrast to a fact-finding investigation that the Commission “may” initiate, existing publicly available data warrant a full due diligence type study of the combination concept. Regardless of the outcome of Applicants’ Joint Petition for Settlement, the Commission should order such a study as the response to Directed Question 5.

PGW submits that its Exception No. 3 should be granted.

III. CONCLUSION

The Exceptions of PGW should be granted as set forth above. The proposed merger, even as supplemented by the terms and conditions of the Joint Petition for Settlement, would not promote the public interest. Instead, the proposed merger would produce substantial detriments, including substantial market power for the merged entity in both the electric and gas markets, that far outweigh any benefit that might result. The Joint Application of PECO Energy Company and Public Service Electric and Gas Company at Docket No. A-110550F0160 and the Joint Petition for Settlement at that same docket should be denied unless the merger is modified to provide for the divestiture of PECO Gas and PSE&G's gas distribution company (including the gas assets held and managed by PSEG ER&T).

Respectfully submitted,

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DATE: December 20, 2005

PGW Exceptions.wpd

Before The
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Administrative Law Judge
Marlane R. Chestnut, Presiding

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

CERTIFICATE OF SERVICE

I hereby certify that I have this 20th day of December, 2005, served a true and correct copy of the Exceptions of Philadelphia Gas Works to the Initial Decision of Administrative Law Judge Chestnut, upon the persons and in the manner set forth below:

BY EMAIL AND OVERNIGHT DELIVERY

Honorable Marlane R. Chestnut
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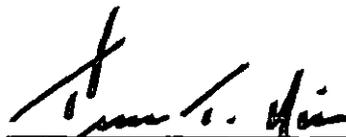
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2005 DEC 21 AM 10:34

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December 20, 2005

James J. McNulty, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
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VIA HAND DELIVERY

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

Dear Secretary McNulty:

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

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

DOCUMENT
FOLDER

Very truly yours,

McNEES WALLACE & NURICK LLC

By *Charis Mincavage*
Charis Mincavage

Counsel to Philadelphia Area Industrial
Energy Users Group

CM/lhe
Enclosures

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

DOCKETED
DEC 21 2005

ORIGINAL

CERTIFICATE OF SERVICE

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

VIA E-MAIL AND FIRST-CLASS MAIL

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Certificate of Service

Docket No. A-110550F0160

Page 2

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Certificate of Service

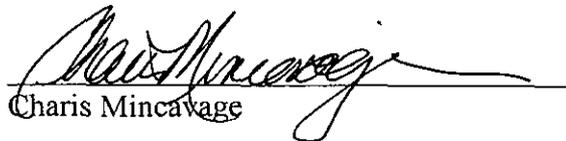
Docket No. A-110550F0160

Page 3

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Charis Mincavage

Dated this 20th day of December, 2005 in Harrisburg, Pennsylvania.

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2005 DEC 21 AM 10:34
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Consumer Advocate

December 20, 2005

James J. McNulty, Secretary
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DOCUMENT
FOLDER

DOCKETED
DEC 21 2005

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 be advised that the Office of Consumer Advocate ("OCA") will not be filing Exceptions to the Initial Decision, in the above-captioned proceeding. If any party does file Exceptions, however, the OCA reserves the right to file Reply Exceptions.

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

Sincerely,

James A. Mullins
James A. Mullins
Assistant Consumer Advocate

Enclosure
cc: Parties of record,
Honorable Marlane R. Chestnut
86918.DOC

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31
2005 DEC 20 PM 4:30
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SECRETARY'S BUREAU

CERTIFICATE OF SERVICE

ORIGINAL

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

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

Dated this 20th day of December 2005.

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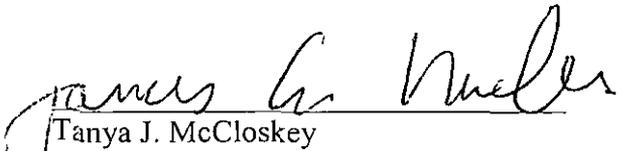
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COMMONWEALTH OF PENNSYLVANIA
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IN REPLY PLEASE
REFER TO OUR FILE

December 20, 2005

James J. McNulty, Secretary
Pennsylvania Public Utility Commission
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ORIGINAL

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

DOCUMENT
FOLDER

Dear Secretary McNulty:

Please be advised that the Office of Trial Staff (OTS) will not be filing
Exceptions in the above-referenced case.

Copies are being served on all active parties of record.

Sincerely,

Kenneth L. Mickens
Senior Prosecutor
Office of Trial Staff

DOCKETED
DEC 21 2005

Enclosure

c: Parties of Record

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2005 DEC 20 PM 4:31
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ORIGINAL

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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

CERTIFICATE OF SERVICE

I hereby certify that I am serving the foregoing **Letter** of the Office of
Trial Staff, dated December 20, 2005, either personally, by first class mail, electronic
mail, express mail and/or by fax upon the persons listed below:

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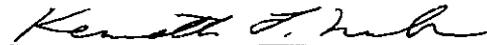
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Kenneth L. Mickens
Senior Prosecutor

Robert V. Eckenrod
Prosecutor

Dated: December 20, 2005
Docket No. A-110550F0160



ORIGINAL

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December 20, 2005

HAND DELIVERED

James J. McNulty, Secretary
Pennsylvania Public Utility Commission
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DOCUMENT
FOLDER

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

Dear Secretary McNulty:

Please be advised that the Office of Small Business Advocate will not be filing Exceptions to the Recommended Decision of Judge Chestnut issued on November 30, 2005, in the above-captioned proceeding. As evidenced by the enclosed certificate of service, all parties have been served as indicated.

If you have any questions, please contact me.

Sincerely,

Sharon E. Webb
Assistant Small Business Advocate

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DEC 21 2005

Enclosures

cc: Cheryl Walker Davis
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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

ORIGINAL

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

CERTIFICATE OF SERVICE

I certify that I am serving a copy of the foregoing document , on behalf of the Office of Small Business Advocate, by e-mail and first class mail (unless otherwise indicated) upon the persons addressed below:

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PA PUBLIC UTILITY COMMISSION
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December 29, 2005

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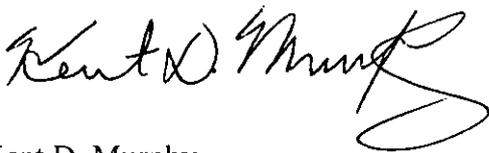
RE: Joint Application of PECO Energy Company and Public Service Electric & Gas Company for Approval of the Merger of Public Service Enterprise Group, Inc., with and into Exelon Corporation; Docket No. A-110550F0160

Dear Secretary McNulty:

Please find enclosed an original and nine (9) copies of PECO Energy Company's Reply Exceptions for filing in the above referenced matter.

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

Very truly yours,



Kent D. Murphy

KDM/yaw

Enc.

cc: Certificate of Service

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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Joint Application Of SBC Communications, Inc. and AT&T Corp.,
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I. INTRODUCTION

On November 30, 2005, Administrative Law Judge Marlane R. Chestnut (ALJ) issued her Initial Decision in this matter, concluding that the merger of Public Service Enterprise Group, Incorporated (PSEG) with and into Exelon Corporation (Exelon) (“Merger”) was in the public interest and should be approved. More specifically, Judge Chestnut found that the Joint Applicants - - PECO Energy Company (PECO) and Public Service Electric and Gas Company (PSE&G) - - had established, by a preponderance of substantial evidence, that the Merger, as conditioned by the terms of the Joint Petition for Settlement submitted on September 12, 2005 (Joint Petition or Settlement),¹ would (1) affirmatively promote the service, accommodation, convenience or safety of the public in a substantial way, (2) not result in any anti-competitive or discriminatory conduct, including the unlawful exercise of market power, which would prevent retail electric or natural gas customers from obtaining the benefits of properly functioning and workable competitive retail energy markets, and (3) not adversely affect the employees of PECO’s Gas Division or any authorized collective bargaining agent representing those employees (Initial Decision at 56-57).

Exceptions to the Initial Decision have been filed by the PPL Companies (PPL), the City of Philadelphia (City) and the Philadelphia Gas Works (PGW). Each of these parties, to varying degrees, contests the ALJ’s analysis of market concentration issues and contends that the generation mitigation plan previously approved by the Federal Energy Regulatory Commission (FERC) is insufficient to curb the potential exercise of market power.² In addition, repeating arguments advanced before the ALJ, the City asserts that the Joint Applicants have failed to

¹ The Joint Petition, which was executed by most of the active parties to the proceeding, is attached as Appendix A to the Initial Decision.

² Notably, the FirstEnergy Companies, which expressed similar market power concerns before the ALJ, have not taken an exception to the Initial Decision.

satisfy the “affirmative public benefit” test enunciated in the *York* case,³ essentially because the Settlement does not give the City all the concessions it was hoping to extract. Finally, the City and PGW criticize the ALJ’s resolution of the “Directed Questions” posed by Vice Chairman Cawley and Commissioner Shane.

As set forth in the Joint Applicants’ Initial and Reply Briefs, filed on October 14, 2005 and October 21, 2005, respectively, and as summarized below, the opposing parties’ objections to the Initial Decision are wholly without merit. With regard to market power concerns, the record in this proceeding confirms that, upon execution of the FERC-approved mitigation plan, Exelon (or EEG as it will be known following the Merger) will lack both the ability and the incentive to increase electric or natural gas prices. Furthermore, there is absolutely no evidence that suggests the Merger will have an adverse effect on the continued development of competitive retail energy markets in Pennsylvania.

The City’s complaint that the benefits of the Settlement are insufficient and/or short-lived should also be dismissed. As the Commission has made clear on numerous occasions, most recently in the *SBC/AT&T* case,⁴ *York* does not require merging parties to demonstrate that all aspects of their operations will be enhanced or that the benefits of their proposed transaction will be realized indefinitely. Moreover, and as Judge Chestnut observed (Initial Decision at 23), the City’s effort to equate its self-interest with the public interest misses the point:

Although the City of Philadelphia criticized the parties for compromising their litigation positions (Philadelphia Main Brief at 3, 12-13), the resulting settlement is the product of compromises made by all parties (especially the joint applicants) to reach a comprehensive framework designed to produce the substantial benefits to PECO, its customers and the public generally as

³ *York v. Pa. P.U.C.*, 449 Pa. 136, 295 A.2d 825 (1972).

⁴ *Joint Application of SBC Communications, Inc. and AT&T Corp.*, Docket No. A-31163F0006 *et seq.* (October 6, 2005)(SBC).

required by the City of York standard. It is the Commission's policy to encourage settlements (52 Pa. Code §5.231) and compromise is part of such negotiation. The signatory parties were able to resolve many difficult issues to arrive at a comprehensive plan that satisfies a diverse array of interests and which provides substantial affirmative benefits.

Lastly, there is no basis for criticizing the ALJ's treatment of the Directed Questions. As Judge Chestnut properly determined, the Joint Petition's proposed \$8.0 million funding of the Pennsylvania Energy Development Authority (PEDA) will spur economic development initiatives in a more direct and expeditious manner than the cumbersome, and arguably unlawful, "set-aside" of virtually divested generation as proposed by the City. In addition, the Settlement provides an appropriate vehicle for exploring the possible combination of the gas operations of PECO, PSE&G and PGW should the Commission so choose.

For these and the other reasons set forth herein, the Exceptions to the Initial Decision should be rejected and the September 12, 2005 Joint Petition for Settlement approved without modification.

II. ARGUMENT

A. The Initial Decision Applied The Correct Legal Standards To The Market Power Issues

1. Burden of Proof (City Exception 1; PPL Exception 1)

The Commission's focus in reviewing the Merger for market power concerns is the impact of the Merger on *competitive retail markets*. See 66 Pa. C.S. §§ 2811(e)(1), 2210(a)(1). In order to address this standard, the Joint Applicants submitted testimony that the Merger would not have any direct impact on retail markets in Pennsylvania given that: (1) the Joint Applicants are located in different states, (2) Exelon does not engage in retail marketing in PJM East, and (3) PSEG does not engage in retail marketing at all (PECO Exh. WHH-1 at Exh. J-1, pp. 19-22). No party submitted any evidence whatsoever contradicting the factual support for this testimony,

nor did any witness assert that the Merger would have any direct impacts on competitive retail markets. As a result, the Initial Decision correctly found that it is unlikely the Merger will directly impact the competitiveness of retail markets (Initial Decision at 41).

PPL cites to language found at page 41 of the Initial Decision that “no party asserted or presented evidence that the proposed merger is likely to directly increase the joint applicants’ market power in any competitive retail market in Pennsylvania.” According to PPL, this statement suggests that the Initial Decision improperly placed the burden of proof on the intervenors (PPL Exceptions at 13-15). In a related argument, the City argues that the Joint Applicants failed to present any evidence regarding the Merger’s impact on retail competition, and that the Initial Decision failed to address this deficiency (City Exceptions at 4-7).

These arguments are entirely without merit. As noted above, the Joint Applicants *did* submit evidence regarding the direct impact of the Merger on retail competition, and the Initial Decision cited to this evidence in reaching its conclusion (Initial Decision at 41). In the sentence quoted by PPL, the ALJ did nothing more than observe that the Joint Applicants’ evidence was uncontroverted. Observing the complete failure by any party to even attempt to controvert the evidentiary showing made by the Joint Applicants does not equate to a misassignment of the burden of proof. Instead, it represents the weighing of evidence submitted on a particular issue required in order to determine whether the Joint Applicants satisfied their burden of proof through a preponderance of the evidence. *See Se-Ling Hosiery v. Margulies*, 70 A.2d 854 (1950)(preponderance of the evidence means that one party has submitted evidence that is more convincing than evidence presented by the other party).

Moreover, the evidence presented by the Joint Applicants was more than enough to satisfy their burden of proof. The Joint Applicants presented the exact same type of evidence

relied upon by the Commonwealth Court to find that the GPU Energy – FirstEnergy merger would not adversely impact retail electric competition. *See ARIPPA v. Public Utility Commission*, 792 A.2d 636, 658 (2002)(citing to evidence showing that GPU Energy was not in the retail market before the merger to support conclusion that merger would not affect competitive retail markets).⁵

2. Relevance of the FERC Decision (PPL Exception 2; PGW Exception 1)

a. This Commission Has Adopted FERC’s Approach to Analyzing Wholesale Market Power Issues

The *only* contested market power issues in this proceeding involve *wholesale* market power issues, which are relevant only to the extent that the exercise of wholesale market power has an indirect impact on the competitive retail markets that this Commission has been directed by the General Assembly to review. As the Initial Decision correctly found, FERC has exclusive jurisdiction over wholesale electric and natural gas markets, and FERC considered the impact of the Merger on these wholesale markets in its order authorizing the Merger (Initial Decision at 43-44 (citing *Exelon Corp.*, 112 FERC ¶ 61,011 at P 10 (2005)). FERC reaffirmed this decision on rehearing subsequent to the issuance of the Initial Decision, rejecting many of the same arguments presented in this proceeding by PPL and PGW. *See Exelon Corp.*, 113 FERC ¶ 61,299 (2005).⁶

⁵ To the extent that PPL also is arguing that the Joint Applicants were not made to carry the burden of proof on the issue of *wholesale* market power, that too is simply incorrect. The Joint Applicants submitted significant amounts of testimony supported by a detailed and highly sophisticated analysis of the impact of the Merger on competition in wholesale markets. This evidence clearly satisfies the burden placed on the Joint Applicants with respect to this issue.

⁶ For the Commission’s convenience, the Joint Applicants are attaching a copy of the Rehearing Order as Appendix A.

In determining how to analyze the claims regarding the impact of the Merger on wholesale markets, the Initial Decision relies primarily on the Commission's decision regarding the since-aborted proposed merger between Duquesne and Allegheny Power. *DQE, Inc.*, 186 PUR4th 39 (Pa. PUC 1998) (Initial Decision at 39). In that decision, the Commission held that it would adopt the use of the wholesale market power analysis employed by FERC under Appendix A of its Merger Policy Statement. 186 PUR4th at 58-60. This is the same type of "Analysis A" analysis that the Joint Applicants presented in this proceeding through the testimony of Dr. Hieronymus. (See Exhibits WHH-1 and WHH-1a).

Moreover, although not relied upon by the ALJ, the Commonwealth Court's *ARIPPA* decision discussed above also addresses the question of how FERC's wholesale market power findings should be treated in merger proceedings before the Commission. In addressing 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. 792 A.2d at 658.

Based on this precedent, the ALJ appropriately relied upon FERC's Order addressing wholesale market power issues in considering the identical wholesale market power issues that were raised in this proceeding. To do otherwise, as the ALJ noted, would be to ignore the considerable expertise that FERC has developed in evaluating those wholesale market power issues, as well as the fact that FERC has exclusive jurisdiction over wholesale markets.

It would be especially inappropriate to second-guess FERC here, given that the arguments raised are essentially that the wholesale market power analyses performed by the Joint Applicants do not conform to FERC's merger regulations and merger precedent. The parties raising these arguments in essence are asking the Commission to hold that it better is able than FERC to conduct FERC's own review of the impact of the Merger on wholesale markets.

(Initial Decision at 44).

b. The Attacks on FERC's Order Are Without Merit

PPL and PGW argue that the FERC decision should not be given any weight whatsoever by this Commission. Their assertions that FERC did not consider the specific arguments that they raised in this proceeding are discussed in detail in Section II B below. Their more general attacks on the FERC decision also are without merit.

FERC's Order is Final. Contrary to PGW's and PPL's assertions (PGW Exceptions at 7-8; PPL Exceptions at 17), the FERC Order is final. While the FERC Order was subject to requests for rehearing at the time the Initial Decision was issued, as noted above, FERC has since issued an Order on Rehearing (the "Rehearing Order") rejecting the various attacks that were made on the FERC Order, including many of the same arguments that PGW and PPL make here. *Exelon Corp.*, 113 FERC ¶ 61,299 (2005).

The Commission Has Adopted FERC's Approach to Analyzing Wholesale Market Power. PGW and PPL both argue that this Commission must apply different statutory standards than were applied in the FERC Order (PGW Exceptions at 8; PPL Exceptions at 16-17). While this statement is correct in the abstract, it does not undercut the conclusions reached in the Initial Decision regarding the relevance of FERC's decision on wholesale market power issues.

As noted above, the Commission has adopted the exact same approach used by FERC to evaluate the impact of the Merger on wholesale markets, *see DQE, Inc.*, 186 PUR4th at 58-60, and the Pennsylvania Commonwealth Court has similarly deferred to FERC on this point. *ARIPPA*, 792 A.2d at 658. Given that this Commission and FERC apply the very same standards and analysis to the wholesale market power issues, it was not erroneous for the ALJ to use FERC's Merger Order as a starting point for her wholesale market power analysis.

The FERC Order Does Not Depend on Post-Merger Review. PGW argues that the FERC Order is flawed because it depends on post-merger review of the proposed divestiture, rather than an up-front public interest determination before the Merger is consummated. According to PGW, this reliance on post-merger review is inconsistent with FERC's Merger Policy Statement (PGW Exceptions at 7-8).

FERC dealt with this argument at length in its Rehearing Order. *See Exelon Corp.*, 113 FERC ¶ 61, 299 at PP 34-50. As FERC explained, it found that the Merger would have no adverse impact on wholesale competition, based on the Joint Applicants' commitment to divest 6,600 MW of generation with specified cost and market location characteristics. While it is true that FERC also required a post-merger compliance filing, that filing was not needed for FERC to determine that the Merger is consistent with the public interest, but instead allows FERC to determine that the Joint Applicants in fact lived up to their pre-merger commitments. Requiring such a post-merger compliance filing is perfectly consistent with FERC's past practice in a number of mergers. *Id.* at PP 37-40.

PPL's similar contention that *this* Commission somehow is required under the Initial Decision to engage in post-merger review of the Joint Applicants' divestiture and in an ongoing monitoring of the Joint Applicants' virtual divestiture (PPL Exceptions at 19-24), is equally without merit. No matter how the post-merger actions that *FERC* will be required to take are characterized, the Initial Decision does not contemplate that *this Commission* would be involved in *any* post-merger review. The *only* post-merger conditions recommended by the Initial Decision are that the Joint Applicants be obligated to make a post-merger compliance filing *at FERC*, and that the Joint Applicants agree to implement any additional mitigation required *by FERC* (Initial Decision at 48).

B. The Initial Decision's Holding On Each Market Power Issue Is Fully Supported By The Record

1. Relevant Geographic Market (PPL Exception 4)

PPL claims that PJM Classic should have been analyzed as a separate geographic market, a claim that FERC specifically rejected, as the Initial Decision notes (Initial Decision at 45 (citing *Exelon*, 112 FERC ¶ 61,011 at PP 68,123)). FERC re-emphasized in the Rehearing Order that it had fully considered the arguments raised by PPL regarding PJM Classic and found them to be without merit. *Exelon*, 113 FERC ¶ 61,299 at P 10.

PPL argues that the FERC decision somehow is flawed because it relies on a misreading of the PJM MMU Report. According to PPL, FERC relied entirely on the conclusion that the PJM MMU did not analyze PJM Classic as a separate market, when in fact the PJM MMU report never considered the question of whether PJM Classic is a separate market but instead “focused its analysis entirely on interfaces and constraints” (PPL Exceptions at 29).

PPL mischaracterizes FERC's analysis on this issue. Although the FERC Order cites to the PJM MMU report, this was not FERC's basis for rejecting PPL's argument. FERC also considered PPL's arguments regarding alleged transmission constraints that it asserts require treating PJM Classic as a separate market. FERC rejected these arguments, finding that “no one has shown that there are frequent binding transmission constraints that isolate PJM-Classic from the rest of PJM Pre-2004.” *Exelon*, 112 FERC ¶ 61,011 at PP 68,123. Thus, PPL is simply wrong when it argues that FERC did not consider its arguments.

Furthermore, the record demonstrates that it would not be appropriate to consider PJM Classic as a separate market.⁷ In essence, PPL is arguing that the Allegheny Power system

⁷ This record evidence is discussed in detail in the Joint Applicants' Initial Brief at pages 24-28, and in their Reply Brief at pages 25-28.

should not be considered to be in the same geographic market with the other PJM systems that make up the traditional PJM parties, which PPL calls “PJM Classic” (Initial Decision at 42 n. 13). PPL’s support for this argument is focused entirely on price differences between the Allegheny Power and Pepco pricing zones, and ignores that price differences between Allegheny Power and the other PJM Classic zones are considerably lower (*see* Exhibit WHH-3 at 3). There certainly is no basis from the record evidence regarding price differences to exclude Allegheny Power from a geographic market that includes FE Penelec, PPL and Pepco.⁸

Similarly, the evidence that PPL references to support its argument that there is congestion between Allegheny Power and the PJM Classic systems is *not* congestion on the Western Interface that separates the Allegheny Power system from the PJM Classic systems. Instead, the congestion is limited to the Beddington-Black Oak line, which transfers power from Allegheny Power to Pepco, but which does not affect the Western Interface, as PPL conceded (*see* PPL Statement No. 1 at 17). PPL’s argument thus does not contradict the record evidence showing the PJM Classic is not a separate geographic market.

2. Allocation of Import Capacity (PPL Exception 5)

PPL also attacked the method used by Dr. Hieronymus to allocate import capacity, arguing that instead of a pro rata approach, Dr. Hieronymus should have allocated import capacity based on FTR ownership. Again, as the Initial Decision found, FERC approved Dr. Hieronymus’ approach over the same PPL assertions regarding FTRs (Initial Decision at 45 (citing *Exelon*, 112 FERC ¶ 61,011 at PP 112, 129)). In the Rehearing Order, FERC reaffirmed

⁸ Moreover, page 3 of Exh. 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 Allegheny Power 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 Allegheny Power and Pepco to place Allegheny Power in a different geographic market from Pepco.

that Dr. Hieronymus' pro rata allocation approach was appropriate. *Exelon*, 113 FERC ¶ 61,299 at P 24.

Again, the record in this proceeding fully supports the decision to reject PPL's approach.⁹ As PPL concedes, FTRs do not confer firm transmission rights – they are financial instruments unrelated to the generation or transmission of energy (*see* PPL Statement No. 1-SR at 13; *see also* PECO Statement No. 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 Statement No. 3-R at 21). As Dr. Hieronymus testified, “[o]wnership of FTRs provides 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 Statement No. 3-R at 21). As a result, there simply is no basis for allocating imports into PJM East based on FTR ownership. Such an allocation would bear no relationship to reality.

PPL also argues that FTR ownership gives the Joint Applicants an incentive to raise electric prices in PJM East in order to increase the value of their FTRs (PPL Exceptions at 35). Even if this were correct, that is a completely different issue from the allocation of import capacity, and does not justify deviating from the FERC-approved pro rata allocation methodology employed by Dr. Hieronymus. Moreover, as was explained at the hearing, FTRs and load obligations create equal and opposite incentives for market participants to attempt to change market prices. While an increase in PJM electric prices relative to the rest of PJM would increase FTR values, it also would increase by the exact same amount the Joint Applicants' cost of serving their own PJM East loads (Tr. at 384). PPL's analysis, however, did not take load obligations into account at all (Tr. at 385). PPL's analysis thus not only fails to reflect how

⁹ The record evidence regarding this issue is discussed in more detail at pages 28-32 of the Joint Applicants' Initial Brief and pages 29-33 of the Joint Applicants' Reply Brief.

import allocation works in PJM, but it also fails to provide any useful information about the impact of FTRs on the Joint Applicants' incentives to increase prices in PJM East.

3. The Efficacy of Virtual Divestiture (PPL Exception 3)

Another issue in the FERC proceeding was the adequacy of the Joint Applicants' virtual divestiture proposal as a market power mitigation tool. Notwithstanding that FERC had dealt exhaustively with this subject, a number of parties rehashed in this proceeding the same arguments that FERC already rejected. As the Initial Decision found, no one raised any reason to reconsider FERC's holding on this issue (Initial Decision at 45 (citing *Exelon*, 112 FERC ¶ 61,011 at PP 134-40)). Furthermore, the same arguments again were rejected in FERC's Rehearing Order. *Exelon*, 113 FERC ¶ 61,229 at PP 51-57.

FERC's conclusion is fully supported by the record here.¹⁰ The Joint Applicants are obligated to make the energy sold in the virtual divestiture auctions available on a firm basis twenty-four hours a day, seven days a week. Thus, the energy has to be produced regardless of maintenance decisions with respect to any particular unit, which means that the amount of virtually-divested energy cannot be withheld from the market even if the Joint Applicants were to attempt to keep a nuclear unit off-line longer than necessary (PECO Statement No. 3-R at 36). In addition, 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. (*Id.*) As FERC found in its Rehearing Order, PPL's arguments "make little economic sense." *Exelon*, 113 FERC ¶ 61,299 at P 56.

PPL argues, however, 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 three-year virtual divestiture auctions. (PPL Exceptions at 25). This argument suffers from a number of defects.

¹⁰ The record evidence on this issue is discussed in more detail at pages 33-36 of the Joint Applicants' Initial Brief and page 34 of the Joint Applicants' Reply Brief.

- As Dr. Hieronymus testified, the Joint Applicants will have divested 4,000 MW of fossil generation, and their mitigation package as a whole has been found to mitigate market power resulting from the merger. As a result, the entire predicate for PPL's theory is unfounded (PECO Statement No. 3-R at 38).
- Raising prices in the near-term markets, even if it were possible, would not 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 PPL do not have a significant impact on prices in the long-term markets.
- 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 (*see* PECO Statement No. 3-R at 38; *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. No protestor has raised compelling evidence that there are significant entry barriers in the PJM markets.")).
- Finally, the withholding conduct posited by PPL most likely would be detected by the PJM Market Monitor Unit ("PJM MMU") (*See* PECO Statement No. 9-R). Moreover, under the recently enacted Energy Policy Act of 2005, FERC now has the ability to impose civil and criminal penalties of up to \$1 million/day. *See* Energy Policy Act of 2005, §§ 1283-84.

4. Reduction in Required Virtual Divestiture (PPL Exception 6)

As noted in the Initial Decision, FERC rejected PPL's argument, raised again here (PPL Exceptions at 26-27), that the Joint Applicants' virtual divestiture obligation should not be reduced as nuclear units are retired (Initial Decision at 45-46 (citing *Exelon*, 112 FERC ¶ 61,011 at P 143)). FERC reaffirmed this decision on rehearing. *Exelon*, 113 FERC ¶ 61,299 at P 64. This decision, too, is supported by the record.¹¹ As the Joint Applicants explained in their FERC application, no nuclear facility may be retired unless the Joint Applicants first put the plant up for bid and do not receive any bids higher than the alternate use value of the facility. This means

¹¹ The record evidence on this issue is discussed in more detail at pages 34-35 of the Joint Applicants' Reply Brief.

that the plant would be retired regardless of ownership, and cannot be artificially withheld from the market (see PECO Exh. WHH-1a, Exh. J-17 at 40 (“exactly the same effect would have occurred if Applicants had divested the unit outright and the new owner had retired it.”)).

In addition, as Dr. Hieronymus explained, the primary market concern resulting from the ownership of nuclear facilities is not that these units will be withheld from the market, but that they will give the Joint Applicants the incentive to use other units to attempt to increase market prices. Retiring a nuclear unit eliminates this incentive just as surely as selling the unit to a third party – in either event the Joint Applicants will not be able to sell power from the unit and reap the benefits of the increased market prices (PECO Exh. WHH-1a, Exh. J-17 at 40).

5. Identification of Specific Units (PPL Exception 3)

As noted in the Initial Decision, the argument that the Joint Applicants must more specifically identify the units they intend to divest was considered and rejected by FERC (Initial Decision at 46 (citing *Exelon*, 112 FERC ¶ 61,011 at PP 141-42)). PPL, however, argues that it was inappropriate for FERC to have approved the Merger without knowing the specific units being divested. According to PPL, until that information is known, the mitigation proposal is too ill-defined and cannot be evaluated (PPL Exceptions at 18-24).

This argument again is inconsistent with the record evidence.¹² The Joint Applicants have provided the Commission with a specific list of mitigation-eligible units (PECO Exh. WHH-1 at Exhs. J-3, J-12). They also provided the Commission with a chart that specifies: (1) the market in which divested generation units must be located; (2) the cost characteristics of the divested generation; and (3) the amount of divested capacity that must fit into each cost characteristic and each location (PECO Exh. WHH-1a, Exh. J-17 at 47). This chart provides

¹² The record evidence regarding this issue is discussed in more detail at pages 36-37 of the Joint Applicants' Reply Brief.

significantly more detail regarding the required divestiture than PPL suggests. Indeed, as FERC explained in its Rehearing Order, the Joint Applicants provided all of the information regarding units to be divested that is required to determine that market power will be mitigated.

[U]nder the Commission's Appendix A analysis, we need to know the general location (*i.e.*, control area or sub-region of an regional transmission organization (RTO)) and cost characteristics of the generators being divested – *not the actual units* -- in order to calculate the post-merger-and-divestiture Herfindahl-Hirschman Indexes (HHI) to determine market concentration. *Applicants provided that information.*

Exelon, 113 FERC ¶ 61,299 at P 45 (emphasis added).

6. Referral of Findings (PPL Exception 7)

The Commission should reject PPL's final suggestion that it refer its findings regarding the impact of the Merger on competition to several agencies, including the Attorney General of Pennsylvania and the United States Department of Justice (PPL Exceptions at 38-39). As was noted in the Initial Decision, such action would be appropriate only if the Commission were to find that the Merger is likely to have an adverse impact on competition. Because the record does not support such a finding, there simply is nothing to refer (Initial Decision at 48).

7. Natural Gas Issues (PGW Exceptions 1 and 2)

PGW submitted the testimony of Dr. Carpenter to FERC only a few days before FERC issued its order, and thus that testimony was not addressed by name in FERC's order. However, FERC made clear in its Rehearing Order that it had in fact considered the arguments advanced in Dr. Carpenter's testimony in performing its analysis of the natural gas vertical competition issues:

After reviewing Philadelphia Gas' June 27, 2005 filing, the Commission determined that *it did not provide new information that would have assisted the Commission in its decision-making process.* Therefore, the Commission properly declined to accept the late-filed comments. However, we note that Philadelphia Gas'

arguments *actually duplicated arguments raised* by FirstEnergy, NJ Ratepayer Advocate and Pennsylvania Office of the Consumer Advocate, among others, *and those arguments were addressed*.

Exelon, 113 FERC ¶ 61,299 at P 33 (emphasis added). Thus, PGW is wrong when it argues that FERC failed to consider Dr. Carpenter's testimony and arguments when it found that no natural gas-related vertical market power issues were raised by the Merger (PGW Exceptions at 9-12).

The primary issue that was contested at the hearing in this proceeding was whether the relevant natural gas market was unconcentrated or moderately concentrated (*i.e.* with an HHI less than 1,800), as the Joint Applicants contended, or highly concentrated (*i.e.* with an HHI above 1,800), as Dr. Carpenter contended. Under FERC's merger analysis, vertical market power issues relating to natural gas are present only when there is a highly concentrated market with an HHI over 1,800. *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). As the Initial Decision found, FERC concluded that the natural gas market was not highly concentrated, and thus that no natural gas vertical market power issues are raised by the Merger (Initial Decision at 46-47 (citing *Exelon*, 112 FERC ¶ 61,011 at PP 182-85, 187-91, 193-96, 200, 202)).

a. The Initial Decision is Supported by Uncontested Price Data

Again, the record in this proceeding supports the conclusion made by FERC.¹³ 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 in his calculation all

¹³ The record evidence regarding the natural gas issues is discussed in more detail at pages 37-48 of the Joint Applicants' Initial Brief and pages 41-48 of the Joint Applicants' Reply Brief.

transportation capacity that runs through PJM East and which is deliverable in PJM East under the terms of FERC's regulations and the underlying transportation contracts, even if the primary delivery points are in New York or New England (PECO Statement No. 3-R at 57-59). Dr. Morris, who also testified for the Joint Applicants, includes all transportation capacity deliverable in PJM East, New York and New England (PECO Statement No. 11-R at 23-24). Dr. Carpenter, however, achieves his higher market concentration levels by excluding from his PJM East calculation all transportation contracts for delivery in PJM East into pipelines serving New York or New England and, *with one glaringly inconsistent exception*, contracts that have primary delivery points in New York or New England even if that capacity also is deliverable in PJM East (Tr. 485-87).

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 whether there is price separation (PECO Statement No. 11-R at 17-18; PGW Statement No. 1-SR at 12-13).¹⁴ 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 (*see* PECO Statement No. 11-R at 16-18; Tr. at 487-88). Dr. Carpenter asserts, however, that because prices separate at times during peak periods, the three regions should be considered as separate geographic markets during peak periods (PGW Statement No. 1-SR at 16).

Under the relevant Department of Justice guidelines, in order for price separation to require the establishment of separate geographic markets, that price separation must be

¹⁴ Dr. Morris used a threshold of a 5% difference in prices to define price separation, which is based on the Department of Justice/FTC *Horizontal Merger Guidelines*. (PECO Statement No. 11-R at 17). Although Dr. Carpenter at one point objects to the use of this standard (PGW Statement No. 1-SR at 11-12), Dr. Carpenter never proposes a different standard, and in fact goes on to apply the 5% standard to his own analysis. (*See, e.g.* PGW Statement No. 1-SR at 14-15).

sustainable (*see* PECO Statement No. 11-R at 17-18). The uncontested record evidence shows, however, that the price separations between PJM East, New York and New England occur only on a sporadic, non-sustainable basis. This record evidence includes the following:

- 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 Statement No. 11-R at 18-21).
- Calculations based on detailed pricing information showing 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 year (Tr. at 501).
- The price data used in the analysis 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. The record evidence shows that even a 1% increase in prices in PJM East will trigger some transactions in New York and New England on 99% of all days, and a 5% increase will trigger transactions 100% of the days (PECO Statement No. 11-R at 31-34).

The only conclusion that can be drawn from this uncontested data is that price separations between PJM East, New York and New England are sporadic and short-lived and are not significant. As a result, Dr. Carpenter’s geographic market is too narrowly drawn.

b. PGW’s Inconsistent Market Definition

The uncontested record evidence also demonstrates that, even with his overly narrow (and invalid) market definition, Dr. Carpenter can show a market power problem only by applying that definition in an inconsistent and biased manner. 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 reviewing actual PSEG sales data (Tr. at 509), and thus under Dr. Carpenter’s market definition, this capacity is part of the New York market instead of the PJM East market. As a result, if Dr. Carpenter’s argument that capacity deliverable to the New York and New England markets 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 from the PJM East market HHI calculation (*Id.* at 509-10).

The impact of excluding the PSEG 794 MMcf/d north of Linden capacity from Dr. Carpenter's narrowly-defined PJM East market is significant. This capacity represents almost 20% 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. This again is a moderately concentrated market well below the 1,800 threshold for defining a highly concentrated market (PECO Statement No. 3-R at 52). 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. Indeed, this is exactly what FERC found with respect to the similar argument presented to FERC by Direct Energy. *See Exelon*, 112 FERC ¶ 61,011 at PP 193, 200.

PGW argues that a significant amount of PSEG's New York Transco capacity is needed to serve PSEG's BGSS requirements in PJM East and therefore should be treated as PJM East capacity rather than New York capacity (PGW Exceptions at 25-26). This argument ignores, however, that the BGSS requirements north of Linden are part of the New York market, as explained above. PGW's argument also ignores that the BGSS obligations are *retail* obligations. PGW's market power allegation is that the Joint Applicants will withhold capacity from the *wholesale market* that is *not needed to serve retail obligations* (*see* PGW Statement No. 1 at 22). PSEG's Transco capacity deliverable to the New York market is used to make *wholesale* sales in the New York market on the peak days when prices in the New York market are more than 105% of prices in PJM East. Dr. Carpenter, PGW's own witness, testified that this is the case:

PSEG makes spot sales on the PSE&G system off Transco on many (39 of 67) of the days when New York prices significantly

exceed PJM East prices. PSEG receives prices for these sales that significantly exceed the PJM East gas price. *Thus, PJM East capacity does not offer an alternative to PSEG's sales on the PSE&G system on these days.*

(PGW Statement No. 1-SR at 18 (emphasis added)). It is precisely because “PJM East capacity does not offer an alternative to PSEG’s sales on these days” that the capacity used to make those New York market sales should not be considered part of the PJM East market on those days.

PGW also notes that the amount of PSEG's wholesale sales in New York during periods of price separation are not close to PSEG's 794 MMCF/d of Transco capacity. PGW argues that it therefore is not reasonable to exclude the full 794 MMcf/d of PSEG’s New York capacity from the PJM East market concentration calculation (PGW Exceptions at 26).

This argument again ignores that PGW’s market power argument is that the Joint Applicants could withhold capacity from the *wholesale* market that is not used to serve retail loads. At the hearing, PGW did not identify *any* wholesale sales made by PSEG from its New York capacity into the PJM East market. Indeed, Dr. Morris testified that his review of the sales data shows that “virtually all the sales” are “past the Linden constraint point” (Tr. at 509).¹⁵ Given that the sales data do not indicate that PSEG uses any of its New York capacity to make wholesale sales into the PJM East market, there is no basis for including any of that capacity in Dr. Carpenter’s narrowly-drawn PJM East wholesale market.

c. PGW's Extreme Remedy

Finally, the record demonstrates that the market power problem alleged by PGW, even if credited, has absolutely nothing to do with PGW's proposed remedy, which is the divestiture of

¹⁵ PGW also argues that the PSEG Transco sales are being made in New Jersey (PGW Exceptions at 26). However, because these sales are being made north of Linden in the New York market at New York market prices, they should be considered part of the New York market even if deliveries are in New Jersey.

the Joint Applicants' natural gas distribution operations (PGW Exceptions at 16-18). This proposed remedy is too broad – like killing the dog to get at the fleas (Tr. at 510). As Dr. Carpenter conceded, it is Joint Applicants' interstate natural gas pipeline transportation 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 this problem (PECO Statement No. 11-R at 51; Tr. at 510), and would cause PECO, PSE&G and their electric and gas customers substantial economic harm (\$410 million annually) from the complex task of unwinding the synergies presently benefiting them from being part of the same enterprise (PECO Statement No. 13-DQ at 4-9).

As the ALJ found, to the extent that the Commission has any concerns regarding natural gas issues, that concern is addressed by the fact that Joint Applicants will not be combining the natural gas procurement functions of PECO and PSEG, and thus cannot act in the concerted manner alleged by PGW (Initial Decision at 49). Furthermore, Joint Applicants have committed not to combine their natural gas procurement functions in the future without the Commission's approval (Initial Decision at 49). This commitment fully mitigates any possible natural gas market power concern that could otherwise obtain as a result of the Merger.

C. Affirmative Public Benefits (City Exception 2; PGW Exception 2)

The City contends that Joint Applicants failed to demonstrate that the Merger, even as supplemented by the September 12, 2005 Settlement, will affirmatively benefit the public in a substantial way. The City therefore proposes a host of additional conditions be imposed, including (1) a largely undefined extension of PECO's rate caps "until customers have had an opportunity to transition to the competitive market;"¹⁶ (2) a substantial increase in PECO's

¹⁶ By January 1, 2011, when the rate caps would be lifted under the Joint Petition, customers will have had **twelve years** to "transition to the competitive market."

charitable giving; (3) a requirement that PECO maintain its corporate headquarters in Philadelphia through 2014; and (4) further commitments regarding mandatory staffing levels (City Exceptions at 7-14). PGW also asserts that the claimed benefits of the Merger are insufficient but does nothing to develop that argument, other than to restate concerns over the “potential detriments” of Joint Applicants’ alleged market power (PGW Exceptions at 31-35).

The City proclaims itself the “bearer of the public interest” with respect to issues of purported concern to it (City Exceptions at 9). Joint Applicants do not question the City’s interest in this proceeding. But, as explained in detail in Joint Applicants’ Reply Brief (at 4-5), the City seriously misconstrues relevant Commission and appellate court precedent by assuming that *York’s* affirmative benefit test requires the Commission to find, or mandate, that a proposed merger provide individualized benefits to each allegedly affected party. Thus, in *Middletown Township v. Pa. P.U.C.*, 482 A.2d 674, 682 (Pa. Cmwlth. 1984), the Commonwealth Court, in addressing the standards for Commission approval of an acquisition, held:

Further, when the “public interest” is considered, it is contemplated that the benefits and detriments of the acquisition be measured as they impact on *all affected parties*, and not merely on one particular group or geographic subdivision as might have occurred in this case. (Emphasis in original.)

Similarly, this Commission has held that, once it is determined that a merger will, overall, produce substantial, affirmative public benefits, there is no basis for attaching conditions to its approval in order to assure specific benefits to particular parties. *See Joint Application of Pennsylvania-American Water Company And Thames Water Aqua Holdings* (Initial Decision of Administrative Law Judge Wayne L. Weismandel), 2002 Pa. PUC LEXIS 32 (2002), affirmed 221 P.U.R. 4th 487 (2002) (As joint applicants established that the merger overall produced affirmative benefits, conditions proposed by opposing parties addressed to their particular interests were rejected.) *See also SBC, supra. fn.4* (Order at 27) and Jt. App. Initial Brief at 8-9.

The City also seeks to downplay the import of the Settlement by suggesting that the Joint Petition “merely maintains the status quo for ratepayers for a few years” (City Exceptions at 3) and asserting that certain conditions are “temporary in nature,” “vague” or “illusory” (*Id.* at 19). Nothing, of course, could be further from the truth. To the contrary, the benefits of the Settlement are real and tangible - - \$120 million of rate relief; rate stability for an additional four years; an enforceable Quality of Service Plan with specific performance metrics; a significant expansion of universal service coverage; and substantial funding of environmental, energy efficiency and economic development initiatives, among other commitments. Indeed, and as previously noted (Jt. App. Reply Brief at 8-9), the concessions to which the Joint Applicants have agreed guarantee aggregate benefits far in excess of those the Commission has deemed sufficient to warrant its approval of other utility mergers.

D. The “Directed Questions” (City Exceptions 3-4; PGW Exception 3)

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

The City is the only party that favors a “set-aside” of virtually divested generation and, even at that, its support is apparently contingent on such generation being “set-aside” for the City’s benefit. As explained in the Joint Applicants’ Initial (at 48-49) and Reply (at 13-14) Briefs, there are serious legal and other obstacles to implementing a set-aside program, obstacles which the City fails to meaningfully address in its Exceptions. Moreover, and as Judge Chestnut recognized, the rate relief and rate stability provided by the Settlement, coupled with the contributions PECO has agreed to make to PEDDA, will produce economic development benefits that “are substantial, will be available sooner, will be shared by more customers and will be allocated more fairly than the benefits from any set-aside” (Initial Decision at 52).

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

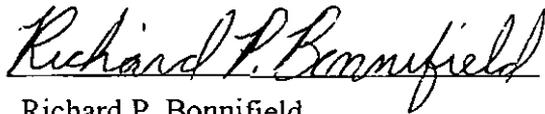
In response to Directed Question No. 5, the settling parties have proposed that the viability of combining the gas operations of PECO, PSE&G and PGW into a “profitable, shareholder owned public utility” be taken up in a separate, fact-finding investigation to commence upon consummation of the Merger. Quoting favorably from the OCA’s Main Brief, the ALJ agreed with this recommendation, noting that such a process “would allow consideration of this issue to continue in a forum where the myriad of issues can be thoroughly explored, where all affected parties can fully participate, and where a reasoned decision can be reached on the issues” (Initial Decision at 54).

The City and PGW have taken exception to the ALJ’s determination, questioning the scope and timing of any further investigation (City Exceptions at 17-18; PGW Exceptions at 36-37). The Joint Applicants have nothing to add to the ALJ’s thoughtful analysis of this issue, other than to note that (1) Exelon has no intention of spinning off its gas operations and, consequently, pursuit of the opposing parties’ “state authority” model would be a waste of time, and (2) only in the post-Merger environment will it be possible to assemble all of the data needed to fully evaluate the pros and cons of consolidating PGW with EEG’s combined gas operations.

III. CONCLUSION

WHEREFORE, for the reasons set forth above and in their Initial and Reply Briefs, PECO Energy Company and Public Service Electric and Gas Company request that the Commission reject the Exceptions submitted herein and adopt, without modification, the Administrative Law Judge's Initial Decision, approving the Joint Petition For Settlement, filed September 12, 2005.

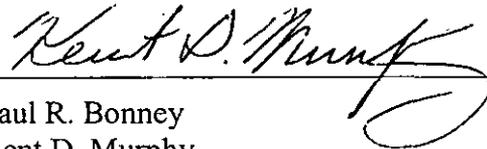
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Date: December 30, 2005

113 FERC ¶ 61,299
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Joseph T. Kelliher, Chairman;
Nora Mead Brownell, and Suedeem G. Kelly.

Exelon Corporation
Public Service Enterprise Group, Inc.

Docket Nos. EC05-43-000
EC05-43-001

ORDER DENYING REHEARING, ACCEPTING COMPLIANCE FILING AND
GRANTING CLARIFICATION

(Issued December 21, 2005)

1. Numerous entities¹ filed requests for rehearing of the Commission's Merger Order² authorizing the merger of Exelon Corporation (Exelon) and Public Service

¹ American Public Power Association (APPA), National Rural Electric Cooperative Association (NRECA), Public Citizen's Energy Program (Public Citizen), together with Action Alliance of Senior Citizens of Greater Philadelphia, Citizen Power, Energy Justice Network, Illinois Public Interest Research Group (IPIRG), New Jersey Citizen Action (NJ Citizen Action), New Jersey Public Interest Research Group (NJPIRG), Pennsylvania Public Interest Research Group (PennPIRG), Philadelphia Association of Community Organizations for Reform Now, Service Employees International Union, SEIU New Jersey State Council, Tenant Action Group, Three Mile Island Alert and Utility Workers Union of America Local 601, Hoosier Energy Rural Electric Cooperative, Inc. (Hoosier Energy), Pennsylvania Office of Consumer Advocate (PaOCA), New Jersey Board of Public Utilities (NJBPU), New Jersey Division of the Ratepayer Advocate (NJ Ratepayer Advocate), Philadelphia Gas Works together with the City of Philadelphia (Philadelphia Gas), PPL Companies (PPL), and the Illinois Attorney General on behalf of the People of the State of Illinois (Illinois). Public Citizen's Energy Program with Citizen Power, Energy Justice Network, IPIRG, NJ Citizen Action, NJPIRG, PennPIRG and Three Mile Island Alert are collectively referred to throughout this order as "Public Citizen." As discussed below, the remainder of the entities joining in Public Citizen's request for rehearing did not intervene in the original proceeding, and we will not allow them to intervene at this late date and request rehearing as parties.

² *Exelon Corporation and Public Service Enterprise Corporation, Inc.*, 112 FERC ¶ 61,011 (2005) (Merger Order.)

Enterprise Corporation, Inc. (PSEG) (collectively, Applicants) under section 203 of the Federal Power Act (FPA).³ In this order, we deny the requests for rehearing.

Background

2. Applicants requested Commission approval of a transaction that includes Exelon's acquisition of PSEG and the resulting indirect acquisition of Exelon's and PSEG's jurisdictional facilities and the internal restructuring and consolidation of Exelon's and PSEG's subsidiaries establishment of a new corporate structure for the new entity, Exelon Electric & Gas Corporation (EE&G). The Commission determined that proposed transaction, which included mitigation of harm to the competitive market through substantial divestiture of generation and several compliance filings with the Commission, is consistent with the public interest, as required by section 203 of the FPA.⁴

3. Several parties filed timely requests for rehearing. Applicants filed an answer, and NJBPU filed an answer to Applicants' answer. Philadelphia Gas filed a motion to strike Applicants' answer to the requests for rehearing.

Discussion

A. Procedural Matters

4. When late intervention is sought after the issuance of a dispositive order, the prejudice to other parties and burden upon the Commission of granting the late intervention may be substantial. Thus, movants bear a higher burden to demonstrate good cause for granting such late intervention.⁵ Action Alliance of Senior Citizens of Greater Philadelphia, Philadelphia Association of Community Organizations for Reform Now, Service Employees International Union, SEIU New Jersey State Council, Tenant

³ 16 U.S.C. § 824(b) (2000). The Energy Policy Act of 2005 (EPAct 2005) repeals the Public Utility Holding Company Act of 1935 (PUHCA 1935) and enacts the Public Utility Holding Company Act of 2005 (PUHCA 2005). EPAct 2005 §§ 261 *et seq.*, Pub. L. No. 109-58, 199 Stat. 594 (2005). We analyzed this transaction under section 203 as it appears pre-EPAct 2005, since the amended section 203 does not become effective until February 8, 2006. Additionally, this transaction was filed before EPAct 2005 was enacted. EPAct 2005 §§ 1289(c) Pub. L. No. 109-58, 199 Stat. 594 (2005).

⁴ *Id.*

⁵ See, e.g., *Midwest Independent Transmission System Operator, Inc.*, 102 FERC ¶ 61,250 at P 7 (2003).

Action Group and the Utility Workers Union of America Local 601 have not met this higher burden.

5. Pursuant to Rule 713(d) and Rule 213(a)(2) of the Commission's Rules of Practice and Procedure,⁶ answers to requests for rehearing are not permitted. Therefore, the Commission will reject Applicants' answer to the requests for rehearing. Since we reject Applicants' answer, we find Philadelphia Gas' motion to strike Applicants' answer moot.

6. On August 1, 2005, pursuant to the Merger Order, Applicants submitted a compliance filing outlining the independent administration of the baseload energy auction, including the hiring of an auction manager and an independent auction monitor.⁷ Notice of the August 1, 2005 compliance filing was published in the *Federal Register*, with comments due on or before December 8, 2005. The City of Philadelphia filed a timely protest to the compliance filing. We will accept Applicants' compliance filing, as discussed below.

B. Did the Commission Fail to Address Protestors' in the Merger Order?

1. Requests for Rehearing

7. Several parties argue that the Commission failed to address comments made in response to Applicants' proposal. NJBPU states that the Commission ignored the report of the PJM Interconnection, LLC (PJM) Market Monitoring Unit (PJM MMU) evaluating the merger's effect on the PJM-administered markets. NJBPU argues that the PJM MMU has access to historical market information and additional information relating to the specific PJM region which makes the PJM MMU analysis superior to the Applicants' Appendix A analysis and the "only *bona fide* assessment" of the merger's effects on the PJM markets.⁸

8. Additionally, NJBPU states that the Commission failed to recognize that the PJM MMU recommended more precise mitigation than that proposed by Applicants. NJBPU also argues that the Commission failed to address arguments that Applicants' Appendix A analysis was based on questionable assumptions and thus understated Applicants' market power and the mitigation necessary to ameliorate that market power. Some of these errors are assuming a low share of transmission import capacity and

⁶ 18 C.F.R. § 385.713(d) and § 385.213(a)(2) (2005).

⁷ August 1, 2005 Compliance Filing, Docket No. EC05-43-000.

⁸ NJBPU Request for Rehearing at 23.

ignoring the effect of retirement of facilities and the possibility of withholding or other strategic bidding.

9. PPL argues that the Commission failed to address its comment that Applicants improperly analyzed the Northern New Jersey and PJM Classic markets, including evaluating appropriate mitigation in the Northern New Jersey market and the amount of import capability applicants have in the PJM Classic market. PPL also states that the Commission never responded to the issue of increased cost-capping under PJM's three pivotal supplier rule.

2. Commission Determination

10. It is simply not correct that the Commission failed to address these issues. The Commission addressed the analysis of the PJM MMU specifically in PP 103-109 of the Merger Order and throughout the Commission's discussion section. The Merger Order also addresses the issues of properly analyzing the Northern New Jersey and PJM Classic markets in evaluating Applicants' market power.⁹ PPL argues that the Commission did not address increased cost-capping under PJM's three-pivotal-supplier rule. We did not directly address the three-pivotal-supplier rule because we made a finding, based on Applicants' Appendix A analysis, that competition in the relevant capacity markets would not be adversely affected by the merger.¹⁰ We do not use the three-pivotal-supplier rule in our analysis of a merger's effect on competition. Rather, it is a test used by the PJM Market Monitor to determine when bid caps should be put into place.

11. While the Commission disagrees that we failed to address these issues in the Merger Order, we will once again explain the basis for many of the decisions in the Merger Order below.

C. Should the Commission Have Established an Evidentiary Hearing to Evaluate Issues of Material Fact?

1. Requests for Rehearing

12. Several parties argue that the Commission should have established an evidentiary hearing to evaluate numerous disputed issues of material fact, such as inconsistencies and concerns about Applicants' Appendix A analysis and the proposed divestiture.¹¹

⁹ Merger Order at PP 122-23.

¹⁰ *Id.* at P 167.

¹¹ Hoosier Energy at 3.

13. For example, Public Citizen states that Applicants' analysis and economic expert witness were not subject to cross-examination and discovery.¹²

14. PaOCA and Illinois argue that the Commission's failure to establish an evidentiary hearing denied parties a meaningful opportunity to be heard and to develop a complete record.¹³ PaOCA identifies several issues that, it argues, require a opportunity for discovery, cross-examination and full analysis through an evidentiary hearing. Denial of such an opportunity, PaOCA argues, would violate the parties' due process rights.¹⁴

15. NJ Ratepayer Advocate argues that the Commission erred in failing to establish an evidentiary hearing to evaluate numerous issues of material fact, including Applicants' ability to engage in strategic bidding and the effect Applicants' gas operations will have on competition.¹⁵ NJ Ratepayer Advocate also identifies several other issues that should have been analyzed through an evidentiary hearing and argues that the Commission's failure to order the hearing was arbitrary and capricious and was not reasoned decision-making.¹⁶

16. PPL argues that the Commission's failure to order an evidentiary hearing to address the issues of material fact was not "a consideration of the relevant factors."¹⁷ PPL states that the Commission ignored expert testimony, exhibits and analysis that demonstrated that material issues of fact existed.¹⁸ This failure to establish a hearing terminated the parties' ability to explore these issues through discovery and cross-examination, according to PPL.¹⁹

¹² Public Citizen at 12.

¹³ PaOCA at 5-6.

¹⁴ *Id.* at 9.

¹⁵ NJ Ratepayer Advocate at 5 & 9.

¹⁶ *Id.* at 16.

¹⁷ PPL at 8.

¹⁸ *Id.* at 9.

¹⁹ *Id.* at 12.

2. Commission Determination

17. The Commission has broad discretion regarding when to set matters for hearing.²⁰ If the Commission can resolve disputed issues based on the written record, then the Commission is not required to establish an evidentiary hearing to address disputed issues of fact.²¹ No party has shown why the voluminous written record²² in this case was inadequate.

D. Did the Commission Fail to Evaluate Market Power in the Natural Gas Market?

1. Requests for Rehearing

18. NJPBU and Philadelphia Gas argue that the Commission did not consider all the evidence in finding that the merger would not have anticompetitive effects on the natural gas market. They state that the Commission ignored the analysis of Dr. Paul Carpenter, which indicated that the merger will affect natural gas prices in the PJM East market due to Applicants' control of upstream gas capacity and storage.²³ Dr. Carpenter's analysis concluded that Applicants will have significant market power in the relevant natural gas market. The HHI screen failures are not remedied by the mitigation because the mitigation only attempts to remedy the horizontal concentration in the electricity market, not the vertical concentration in the natural gas market.²⁴

19. NJ Ratepayer Advocate argues that the Commission erred in failing to evaluate the natural gas markets because there is a potential for horizontal market power in natural gas transportation and storage rights. This market power could lead to gas price manipulation even in the absence of a high level of concentration in the market.

²⁰ *ISO New England, Inc.*, 111 FERC ¶ 61,096 (2005).

²¹ *Moreau v. FERC*, 982 F.2d 556 at 568 (D.C. Cir. 1993).

²² The record in this case exceeds 2,000 pages.

²³ NJPBU at 41.

²⁴ Philadelphia Gas at 20.

2. Commission Determination

20. With respect to the vertical competitive impacts of a merger, the Commission examines three issues: (1) foreclosure/raising rivals costs; (2) competitive coordination; and (3) regulatory evasion.²⁵ The Commission has held that in order for a merger to have an adverse impact on competition by increasing the merged firm's ability or incentive to engage in foreclosure or raise rivals' costs, both the upstream and downstream markets must be highly concentrated.²⁶

21. NJBPU, Philadelphia Gas, and NJ Ratepayer Advocate either misunderstand the Commission's standard for consistency with the public interest, or propose a new standard. As explained in the Revised Filing Requirements, we examine the effect of a merger on the upstream natural gas market, but *only* in conjunction with the downstream wholesale electric energy market. And *only* if both of these markets are concentrated do we have concerns.²⁷

22. The FPA does not grant the Commission authority to examine the horizontal impact of a merger on natural gas markets alone, which is what the parties ask. The Commission did indeed examine concentration in the natural gas market, in conjunction with concentration in the wholesale energy market, and determined that the merger did not raise an issue with respect to foreclosure.

²⁵ *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 at 31,904 (2000) (Revised Filing Requirements).

²⁶ *Id.* at 31,911. See also *Dominion Resources, Inc. and Consolidated Natural Gas Company*, 89 FERC ¶ 61,162 (1999).

²⁷ The Natural Gas Act does not grant the Commission authority to examine the effect of a merger on the horizontal natural gas market. The Natural Gas Act states that "[n]o natural-gas company or person which will be a natural-gas company upon completion of any proposed construction or extension shall... acquire or operate any such facilities or extensions thereof, unless there is in force with respect to such natural-gas company a certificate of public convenience and necessity issued by the Commission authorizing such acts or operation." 15 U.S.C. § 717f (c)(1)(a) (2001).

E. Did the Commission Err in Accepting Applicants' Proposal to Allocate Transmission Transfer Capacity on a Pro Rata Basis?

1. Requests for Rehearing

23. Hoosier Energy argues that the Commission erred in accepting Applicants' allocation in their study of scarce transmission transfer capability on a *pro rata* basis. It argues that this method of allocation creates a bias towards lower HHI estimates in the market analysis by maximizing the hypothetical participation of all potential competitors, regardless of price.²⁸ Hoosier Energy argues that the Commission ignored the argument that a least cost access method should be used to enable low cost suppliers to secure firm transmission rights, thus possibly precluding more expensive suppliers from access to the market.²⁹

2. Commission Determination

24. We will deny Hoosier Energy's request for rehearing. As we stated in the Merger Order, we are not persuaded 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,³⁰ and believe it reasonably models suppliers' ability to compete in a given destination market. Moreover, Hoosier's argument that the use of the *pro rata* allocation creates a bias towards lower HHI estimates by maximizing the hypothetical participation of all potential competitors, regardless of price, ignores a key feature of the DPT: only sellers with costs within 5 percent of the market price are assumed to be competing for the scarce transmission capability. All sellers with a profit opportunity would be competing to sell into the destination market. The *pro rata* allocation method recognizes that and gives appropriate weight to the potential sellers based on relative size.³¹

²⁸ Hoosier Energy at 10.

²⁹ *Id.*

³⁰ Order No. 654 at 31,894; *Commonwealth Edison*, 91 FERC ¶ 61,036 (2000); *CP&L Holdings*, 92 FERC ¶ 61,023 (2000).

³¹ For example, for simplicity, assume that there are two potential sellers competing for 1,000 MWs of scarce transmission capability, with 1,500 MWs and 500 MWs of economic capacity, respectively. The *pro rata* allocation method would assign 750 MWs and 250 MWs to the two suppliers, respectively.

F. Should the Commission Have Evaluated Applicants' Ability to Engage in Strategic Bidding?

1. Requests for Rehearing

25. NJ Ratepayer Advocate argues that the Commission should have required Applicants to conduct a further analysis of their ability to engage in strategic bidding. Due to the nature of the Basic Generation Service auctions and the large market share Applicants will have in New Jersey, NJ Ratepayer Advocate states that Applicants could engage in strategic bidding in the Basic Generation Service auctions and exercise market power. However, the Commission determined that Applicants would not be able to exercise market power and engage in strategic bidding based on the analysis of the HHI screen and the Commission's Market Behavior Rules.³²

2. Commission Determination

26. We deny rehearing. Strategic bidding is a form of economic withholding, which is a way of exercising market power.³³ In the Merger Order, we gave two reasons why the Applicants' Appendix A analysis did address the merger's effect on Applicants' incentive or ability to engage in strategic bidding. First, the DOJ Merger Guidelines recognize that the HHI conveys information about the likelihood of the unilateral exercise of market power.³⁴ Second, in order to address the screen failures in various season/load conditions, Applicants 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. Using widely accepted measures of a merger's effects on competition and the market power of the merged firm, Applicants showed that the proposed divestiture would mitigate any increase in the merged firm's market power and thus its ability to harm competition through strategic bidding.

G. Did the Commission Employ a Flawed Competitive Analysis?

1. Requests for Rehearing

27. PPL argues that the Commission should have required Applicants to address the

³² NJ Ratepayer Advocate at 6.

³³ Market Behavior Rules, 105 FERC ¶ 61,218 (2003), *order on reh'g*, 107 FERC ¶ 61,175 (2004) Rule 2.E prohibits "bidding the output of or misrepresenting the operational capabilities of generation facilities in a manner which raises market prices by withholding available capacity from the market."

³⁴ Section 2.0 of the DOJ Merger Guidelines.

concerns PPL raised as to whether Applicants' chosen price levels accurately reflected market prices; instead the Commission accepted Applicants' vague response that "choosing market prices... is as much an art as it is a science."³⁵ PPL asserts that the accuracy of Applicants' DPT should have been set for hearing.³⁶

2. Commission Determination

28. We deny PPL's request for rehearing. Applicants supported their DPT by: (1) providing tests of the sensitivity of their results to changes in the critical parameters in the model; (2) answering protestors' specific questions regarding assumed input prices and wholesale energy market prices; (3) providing an analysis by PSEG's witness, Mr. Rodney Frame, that confirmed Dr. Hieronymus' results.³⁷ In addition, as we stated in the Merger Order, the PJM MMU Study largely confirmed the accuracy of Applicants' results, finding similar pre-merger and post-merger concentration levels. PPL has not explained why this was not adequate.

H. Did the Commission Ignore Evidence of Applicants' Power Marketing in Analysis?

1. Requests for Rehearing

29. Public Citizen argues that the Commission should have discussed the failure of Applicants' market concentration analysis to address Applicants' power marketing activities.³⁸

³⁵ PPL at 33-34.

³⁶ *Id.* at 35.

³⁷ As explained in P 125 of the Merger Order, Dr. Hieronymus; 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. In addition, 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, and the consistency of Dr. Hieronymus; results across various assumed market prices shows that the results of the analysis are robust.

³⁸ Public Citizen at 16.

2. Commission Determination

30. We deny Public Citizen's request for rehearing. The Appendix A analysis focused on capacity *controlled* by all potential sellers in the relevant market. Without control of capacity, whether through ownership of physical assets or through power purchase agreements, sellers cannot harm competition in wholesale energy markets. If Applicants (or any other potential suppliers) gain control of generation capacity through power marketing activities, the Appendix A analysis does consider power marketing activity, but simply the presence of a large power marketing operation does not, in itself, confer any additional market power on the merged firm or on any other seller.

I. Did the Commission Improperly Fail to Consider Supplemental Evidence?

1. Requests for Rehearing

31. Philadelphia Gas argues that the Commission ignored evidence it submitted pointing out errors in Applicants' analysis that affected the evaluation of the proposed merger's effect on the delivered gas market in PJM East.³⁹

2. Commission Determination

32. Comments and protests to the proposed merger were due on or before April 11, 2005. In response to the numerous comments and protests filed in response to Applicants' proposed merger, on May 10, 2005 Applicants made a supplemental filing that amended their proposed analysis and mitigation. The Commission then provided all parties with an additional opportunity to respond to the supplemental filing with comments due on or before May 27, 2005. Several parties, including Philadelphia Gas, filed additional comments in response to Applicants' amended filing and many of the additional comments included lengthy responses to the Applicants' amended market power analysis. However, one month after the comment date had already passed, Philadelphia Gas filed additional comments disputing Applicants' amended market power analysis.

33. The Commission did not accept Philadelphia Gas' additional comments due to the lateness of its filing. The Commission has discretion whether to accept a late-filed answer. After reviewing Philadelphia Gas' June 27, 2005 filing, the Commission determined that it did not provide new information that would have assisted the Commission in its decision-making process. Therefore, the Commission properly declined to accept the late-filed comments. However, we note that Philadelphia Gas' arguments actually duplicated arguments raised by FirstEnergy, NJ Ratepayer Advocate

³⁹ Philadelphia Gas at 19-20.

and Pennsylvania Office of the Consumer Advocate, among others, and those arguments were addressed.

J. Did the Commission Improperly Approve the Merger Based in Part Upon Compliance Filings and Future Actions?

1. Requests for Rehearing

34. Hoosier Energy, PaOCA and Illinois state that the Commission failed to meet the section 203 standard by approving the merger based on its “understanding” that further mitigation may be required in the future if the proposed mitigation proves insufficient.⁴⁰

35. NJBPU argues that the Commission violated section 203 by finding that the proposed merger is consistent with the public interest after determining that the proposed mitigation and divestiture may not adequately mitigate the merger’s harm to competition.⁴¹ NJBPU states that the Commission requirement of compliance filings to demonstrate that the mitigation actually does mitigate the harm to competition after the merger has already been consummated does not satisfy the public interest standard in section 203.⁴² This would be an after-the-fact determination that the merger is consistent with the public interest and is contrary to the requirement that we find that the merger is consistent with the public interest before approving it.⁴³

36. Based on the Commission’s finding that additional mitigation may be required if the mitigation conditions accepted in the Merger Order are not adequate to remedy the harm to competition, Philadelphia Gas argues that the Commission has failed to make the statutorily required finding that the merger is consistent with the public interest.⁴⁴ Philadelphia Gas contends that the Commission seeks to “hedge its bets” in approving the merger by stating its right to impose additional future mitigation.⁴⁵ Philadelphia Gas claims that, by asserting its right to impose future mitigation, the Commission is

⁴⁰ Hoosier Energy at 4.

⁴¹ NJBPU at 10.

⁴² *Id.* at 15.

⁴³ *Id.* at 16-17.

⁴⁴ Philadelphia Gas at 5.

⁴⁵ *Id.* at 7.

admitting that the merger is not in the public interest, even though the Merger Order found that the merger does satisfy the public interest standard under section 203.⁴⁶ Finally, Philadelphia Gas states that it is not clear whether the Commission has the authority to impose additional mitigation and divestiture obligations.⁴⁷

2. Commission Determination

37. Section 203(a) states that if the Commission determines that a proposed merger is consistent with the public interest, then the Commission shall approve the proposed transaction.⁴⁸ Section 203(b) clarifies that the Commission may approve a proposed merger upon a finding that it is consistent with the public interest and "... upon such terms and conditions as it finds necessary or appropriate to secure the maintenance of adequate service and the coordination in the public interest of facilities subject to the jurisdiction of the Commission."⁴⁹ Thus, while the Commission must find that proposed mergers are consistent with the public interest before they can be approved, the Commission can do this by imposing conditions and requiring supplemental filings to demonstrate both that the additional conditions have been met and that the accepted mitigation is actually ensuring that markets are not harmed.

38. The Commission determined in the Merger Order that the proposed merger of Exelon and PSEG is consistent with the public interest. However, due to the size of the proposed merger, the Commission decided to exercise its section 203(b) powers and order compliance filings to ensure that the mitigation plan proceeds as expected to ensure that market power does not increase. The Commission retains its right under section 203(b) to order future mitigation, if necessary, to ensure that the proposed merger and mitigation remain consistent with the public interest.

39. The Commission has ordered additional filings in previous mergers to ensure that the mitigation will alleviate market power concerns resulting from the merger. In approving the merger of American Electric Power Company, Inc. and Central and

⁴⁶ *Id.* at 8.

⁴⁷ *Id.* at 7.

⁴⁸ 16 U.S.C. § 824b(a) (2001).

⁴⁹ 16 U.S.C. § 824b(b) (2001).

SouthWest Corporation, for instance, the Commission permitted the companies to divest different generation upon a compliance filing with the Commission.⁵⁰

40. Here, the Commission is requiring that Applicants provide compliance filings with an updated Appendix A analysis upon completion of the divestiture to ensure that the Applicants are fulfilling their mitigation obligations and to permit the Commission to monitor the market in the wake of the merger. The compliance filings are just one method the Commission uses to be doubly sure that market power concerns are resolved.

K. Should the Commission Have Required Applicants to Specify the Units to be Divested?

1. Requests for Rehearing

41. Hoosier Energy states that the Commission did not engage in reasoned decision-making because the Merger Order did not require Applicants to specify the exact units they plan to divest. The Commission violated its own Merger Policy Statement⁵¹ and regulations, Hoosier Energy argues, by approving the merger without knowing which specific units Applicants plan to divest. Hoosier Energy also states that the Commission did not explain why it did not follow the Merger Policy Statement or section 33.3 of the Commission's regulations.⁵²

42. NJ Ratepayer Advocate argues that the Commission's approval of the merger without requiring Applicants to specifically identify the units they will divest raises issues of Applicants market power and the effectiveness of the proposed mitigation plan.⁵³

⁵⁰ *American Electric Power Company, Inc., Central and SouthWest Corporation*, 100 FERC ¶ 61,316 at P 20 (2002).

⁵¹ *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).

⁵² Hoosier Energy at 6.

⁵³ NJ Ratepayer Advocate at 14.

43. Philadelphia Gas argues that the Commission's failure to comply with the Merger Policy Statement and require Applicants to specify exactly which facilities it will divest violated the FPA and the Administrative Procedure Act⁵⁴ and was arbitrary, capricious, an abuse of discretion and a denial of due process.⁵⁵

44. PPL argues that the Commission's failure to require Applicants to specify which units will be required for divestiture increases the post-merger market uncertainty. In addition to ignoring the Commission's Merger Policy Statement, this failure to require specificity also violates practices of other antitrust enforcement agencies such as the Department of Justice.⁵⁶ PPL further argues that not requiring Applicants to specify the units available for divestiture makes it more difficult for the Commission to determine if the mitigation will actually remedy the merger-related harm in the Northern New Jersey market.⁵⁷

2. Commission Determination

45. We will reject arguments that we should have required Applicants to specify the exact units to be divested prior to approval. As we stated in the Merger Order, under the Commission's Appendix A analysis, we need to know the general location (*i.e.*, control area or sub-region of an regional transmission organization (RTO)) and cost characteristics of the generators being divested -- not the actual units -- in order to calculate the post-merger-and-divestiture Herfindahl-Hirschman Indexes (HHI) to determine market concentration.⁵⁸ Applicants provided that information and performed the Delivered Price Test (DPT), which calculates the economic capacity of all sellers in the market based on the running costs of the potential suppliers in the market and the transmission available to those sellers that could export energy into the market. Generators in the relevant geographic market are assumed to be able to supply all of their economic capacity in the market, while those outside the market are assigned a *pro rata* share of the available import capacity. The mitigation addresses the screen failures that occurred in the PJM-East, PJM Pre-2004, and Northern PSEG markets. Therefore, in order to calculate the effectiveness of the mitigation, we need to know the running costs

⁵⁴ 5 U.S.C. § 551 *et seq.* (2005).

⁵⁵ Philadelphia Gas at 16-17.

⁵⁶ PPL at 30.

⁵⁷ *Id.* at 31.

⁵⁸ Merger Order at P. 142.

of the plants to be divested that are in PJM-East, Pre-2004 PJM, or Northern PSEG. We address the mitigation for the three specific markets below.

46. For PJM-East, the market with the most significant screen failures without mitigation, Applicants committed to divest 5,500 megawatts (MWs) of generating capacity: 2,400 MWs of nuclear capacity, 550 MWs of coal-fired capacity, 1,550 MWs of mid-merit capacity, and 1,000 MWs of peaking capacity. Because of the differences in running costs of the four types of capacity, the amount of effective mitigation ranges by season/load levels from 2,400 MWs in the winter and shoulder off-peak periods (when only the nuclear capacity is economic, and therefore is considered mitigation) to 5,500 MWs in the summer extreme peak period, when all of the capacity is economic. As a result of the mitigation, the markets are moderately concentrated for all season/load levels and the change in market concentration does not exceed 100 HHI (the Commission's threshold for moderately concentrated markets) in any of the season/load levels. Therefore, as we stated in the Merger Order, Applicants have shown that the proposed mitigation adequately addresses any merger-related harm to competition in the PJM-East energy market.

47. For the larger PJM Pre-2004 market, which includes PJM-East, in addition to the 5,500 MWs in PJM-East, Applicants committed to divest 1,100 MWs of generating capacity, consisting of 200 MWs of nuclear capacity, 150 MWs of coal-fired capacity, 550 MWs of mid-merit capacity, and 200 MWs of peaking capacity. Because of the differences between running costs of the four types of capacity, the amount of mitigation ranges by season/load levels from 2,600 MWs in the winter and shoulder off-peak periods (when only the nuclear capacity is economic, and therefore is considered mitigation) to 6,600 MWs in the summer extreme peak period, when all of the capacity is economic. As a result of the mitigation, the markets are either unconcentrated or moderately concentrated for season/load levels and the change in market concentration does not exceed 100 HHI in any of the season/load levels. Therefore, as we stated in the Merger Order, Applicants have shown that the proposed mitigation adequately addresses any merger-related harm to competition in the PJM Pre-2004 energy market.

48. For the smaller Northern PSEG market, Applicants committed to divest 200 MWs of generating capacity, consisting of 100 MWs of coal-fired capacity and 100 MWs of mid-merit capacity. As a result of the mitigation, the markets are either unconcentrated or moderately concentrated for all season/load levels and the change in market concentration does not exceed 100 HHI in any of the season/load levels. Therefore, as we stated in the Merger Order, Applicants have shown that the proposed mitigation adequately addresses any merger-related harm to competition in the Northern PSEG energy market. We note that in the Merger Order, we misstated Applicants' commitment as being a 100 MW divestiture rather than the 200 MWs to which they committed. We

clarify that we are relying on Applicants' 200 MW mitigation commitment in finding that the proposed mitigation adequately addresses any merger-related harm to competition in the Northern PSEG energy market.

49. Applicants' divestiture commitment also addresses merger-related harm to competition in the PJM-East capacity market. As with the PJM-East energy markets discussed above, by committing to divest 5,500 MWs of capacity located within PJM-East, applicants have demonstrated that the proposed mitigation addresses any merger-related harm to competition in the relevant market.⁵⁹

50. Finally, the rehearing requests ignore the fact that, as an additional measure of protection, Applicants are required to submit a revised Appendix A analysis upon completion of the divestiture. That analysis will show, given the exact units sold and the identities of the buyers, whether the divestiture adequately mitigates the merger-related harm to competition. If the divestiture does not sufficiently reduce market concentration, we will require additional mitigation. Moreover, the interim mitigation, which adequately addresses the merger-related harm to competition, will remain in place until Applicants have made an affirmative showing that the divestiture mitigates the harm to competition the merger otherwise would cause. Therefore, any merger-related harm to competition will be mitigated from the date of the merger consummation to the time when sufficient permanent structural mitigation is in place.

L. Did the Commission Err in Accepting Applicants' Proposal for Virtual Divestiture?

1. Requests for Rehearing

51. Hoosier Energy challenges the Commission's approval of Applicants' proposal to treat their long-term energy sales as "virtual divestiture." Specifically, it argues that the Commission ignores Applicants' ability to maintain control over this "virtually divested" capacity through scheduling outages for maintenance and refueling.⁶⁰ Hoosier Energy also argues that Applicants will be able to raise short-term energy market prices, which would, in turn, result in higher prices for long-term energy sales from the virtual divestiture.⁶¹

⁵⁹ Dr. Hieronymus's analysis of the PJM-East capacity market shows that 5,325 MWs of capacity needs to be divested in order to restore market concentration to within the Commission's screening threshold of the pre-merger concentration. Exhibit J-21.

⁶⁰ Hoosier Energy at 8.

⁶¹ *Id.* at 9.

52. PaOCA, Illinois, NJ Ratepayer Advocate and PPL argue that the Commission's approval of the virtual divestiture plan is not consistent with the Merger Policy Statement or with the DOJ Merger Guidelines,⁶² and thus, is not reasoned decision-making.⁶³ PaOCA also argues that the virtual divestiture will allow Applicants to retain full operational control of the nuclear units, where the Applicants can control retirement and expansion of facilities.⁶⁴ Finally, PaOCA states that Applicants have not demonstrated that the proposed virtual divestiture plan will be effective or sufficient in mitigating the merger-related harm.⁶⁵

2. Commission Determination

53. Hoosier Energy's argument that Applicants will be able to raise short-term energy market prices, which would, in turn, result in higher prices for long-term energy sales from the virtual divestiture, ignores that fact that Applicants do not have market power in the short-term energy market. The merger-related harm to competition is mitigated by the divestiture of 6,600 MWs of generation in the PJM markets. In addition, in order to obtain market-based rate authority, Applicants have previously shown that they lack market power in the relevant markets. Therefore, Applicants lack the market power they would need to effect the strategy proposed by Hoosier Energy. Hoosier Energy's argument is circular; it concludes that the mitigation will not be effective based on its assumption that it will not be effective.

54. We also reject Hoosier Energy's argument that Applicants will be able to maintain control over this virtually divested capacity by the way they schedule outages. Hoosier ignores the fact that Applicants' commitment is to provide 2,400 MWs of baseload energy, not energy from a specific nuclear unit. If the merged company withheld output by strategic outages for maintenance or refueling of a specific nuclear unit, it would have to provide baseload energy from another source at the long-term contract price; therefore, there can be no net withholding of baseload capacity.

⁶² 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) (DOJ Merger Guidelines).

⁶³ PaOCA at 15.

⁶⁴ *Id.* at 16.

⁶⁵ *Id.*

55. We also reject arguments that the virtual divestiture is inconsistent with the Merger Policy Statement. The Merger Policy Statement recognizes that there are a number of ways to mitigate merger-related increases in market power.⁶⁶ In a horizontal merger such as this, the elimination of a competitor may harm competition by increasing the merged firm's ability to raise price by withholding output. The virtual divestiture ensures that 2,400 MWs of baseload energy will, in fact, be available at all times, so the Applicants will not be able to withhold output.

56. The arguments that the merged firm will have the ability and incentive to withhold the output of nuclear plants make little economic sense. As we have stated in a number of cases, the operational characteristics of, and regulatory scrutiny over, nuclear units virtually eliminates the possibility of withholding output to drive up prices.⁶⁷ Profit-maximizing firms may have the incentive to withhold marginal units in order to increase the price they receive on other sales, but withholding the output of low variable cost nuclear units would rarely be profitable. PP&L argues that our approval of virtual divestiture fails to consider several "key attributes of ownership" that would permit Applicants to retain control over the virtually divested units: (1) perfect knowledge of the condition and operation of each nuclear unit; (2) the ability to control the units' maintenance schedules; (3) the timing of shutdown and restart after maintenance; and (4) the timing of restart after an unscheduled outage. Applicants will retain those attributes of ownership, but as we stated in the Merger Order, the terms of the baseload energy sales, along with the operational characteristics and profitability of running nuclear units, eliminate the ability and incentive to use those attributes of ownership to adversely affect competition. Regarding the "key attributes of ownership" referred to by PPL, the contractual provisions in the energy sales, discussed in P134 of the Merger Order, along with the auction manager, the independent auction monitor, and the Public Compliance Website, ensure that the merged firm will not be able to use its retained ownership to affect the energy sales themselves.

57. PPL argues that the Commission will have to constantly supervise the virtual divestiture to ensure that it adequately mitigates any merger-related harm to competition. However, we addressed that issue in detail in the Merger Order. We relied, in part, on Applicants' commitments to establish: (1) an independent monitor to oversee the baseload auction and Applicants' compliance with the long-term energy contracts; and (2) a public compliance website that will show how they are complying with the virtual divestiture and other mitigation requirements. We directed Applicants to make a compliance filing within 30 days of the Merger Order detailing the process for the

⁶⁶ Merger Policy Statement at 30,136 - 137.

⁶⁷ See *Commonwealth Edison Co.*, 91 FERC ¶ 61,036 (2000).

selection of the independent monitor. On August 1, 2005, Applicants submitted a compliance filing addressing their commitment to retain an independent party to administer the baseload energy auction as well as a template for their Public Compliance Website. In that filing, Applicants stated that they would add an additional layer of independence by hiring both an auction manager and an independent auction monitor.⁶⁸

M. Did the Commission Err in Reasoning that the Merger Will Not Harm Competition Because Mitigation Will Restore HHIs to Minimum Pre-Merger Levels?

1. Requests for Rehearing

58. PaOCA and Illinois argue that the Commission erred in relying only on its analysis of the post-merger and mitigation HHI levels in evaluating the merger's effect on competition, given Applicants' proposed mitigation. According to PaOCA, the Commission "relies upon the post-mitigation HHI that simply restores the HHIs to the bare minimum to avoid screen violations, as the foundation for its finding that Applicants have met their burden for the Commission to approve the proposed merger."⁶⁹ PaOCA argues that there are many other factors that the Commission should have considered.⁷⁰

2. Commission Determination

59. We reject this argument. As we state in P 132 of the Merger Order, there are a number of ways to mitigate increases in market power (such as 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. The key element of any mitigation plan is addressing the specific harm to competition that could result from a transaction. In the Merger Order, we explained that Applicants' proposal to divest sufficient capacity to reduce market concentration enough to pass the screen is a reasonable way to mitigate the merger-related harm to competition. This is because the HHI conveys information about the likelihood of both coordinated and unilateral exercises of market power – the exact harm to competition that could result from a large horizontal merger such as the one before us. Moreover, in a straightforward horizontal merger, where market concentration (rather than other competitive issues such as transmission access or barriers to entry) is the key issue, divesting sufficient generation to restore pre-merger levels of market concentration is appropriate mitigation.

⁶⁸ August 1 Compliance Filing, pp 4-8, Docket No. EC05-43-000.

⁶⁹ PaOCA at 11.

⁷⁰ *Id.* at 12.

N. Did the Commission Err in Approving a Megawatt-for-Megawatt Reduction in Baseload Energy Mitigation?

1. Requests for Rehearing

60. Hoosier Energy challenges the Commission's decision to allow Applicants to reduce their required baseload energy mitigation megawatt-for-megawatt (MW-for-MW) for any reduction in their nuclear generating capacity due to derating, decommissioning or sales of nuclear capacity in the PJM East market. It states that the Commission's approval of this MW-for-MW reduction assumes that all of any increased nuclear capacity would be used by entities other than the Applicants themselves.⁷¹ Hoosier Energy argues that there is no evidentiary basis for this assumption.⁷²

61. PPL argues that allowing Applicants to reduce mitigation requirements MW-for-MW for any retired nuclear assets is an error. PPL states that allowing such a reduction based on retirement is tantamount to withholding capacity from the market and should not be the basis for a reduction in mitigation obligations. Thus, PPL argues that Applicants should not be able to reduce their mitigation obligations MW-for-MW based on retirement of facilities.⁷³

62. APPA/NRECA states that derating or retirement of Applicants' nuclear generation capacity should not allow a MW-for-MW reduction in baseload energy mitigation.⁷⁴ Rather, APPA/NRECA argue that Applicants should be required to demonstrate that the existing mitigation is appropriate in the event of an unforeseen derating or retirement of some part of Applicants' nuclear generating capacity.⁷⁵

⁷¹ Hoosier Energy at 11.

⁷² *Id.*

⁷³ PPL at 32.

⁷⁴ APPA/NRECA at 16.

⁷⁵ *Id.* at 17-18.

2. Commission Determination

63. We deny rehearing requests regarding the MW-for-MW reduction in baseload energy mitigation for increases in import capacity into PJM East. As we stated in the Merger Order, increasing transfer capability into PJM East would enable competitive suppliers to defeat attempts to increase prices there. In fact, in *Oklahoma Gas and Electric Company*, we found that a transmission expansion mitigated the increase in market power associated the elimination of a rival generator.⁷⁶ If the merger eliminates a competitor in PJM-East, a transmission expansion would create new competitive alternatives to offset the merger's effect.

64. We also deny rehearing requests regarding the MW-for-MW reduction in baseload energy mitigation for any de-rating or retirements of Applicants' nuclear plants. As we stated in the Merger Order, Applicants made a convincing argument that a decrease in their nuclear capacity would mitigate market power, because the incentive to exercise market power is directly related to the amount of inframarginal capacity they control that could benefit from higher prices. For the numerous reasons discussed in the Merger Order (e.g. operational realities, regulatory oversight, and profit-maximization) the merger did not increase Applicants' ability or incentive to withhold *nuclear* capacity; rather, it increased their incentive to withhold *marginal* capacity in order to increase their profits from baseload sales. Even if operationally feasible, withholding output from low cost nuclear units would rarely be profitable. We agreed with Applicants' argument that the incentive to withhold output of marginal units is a function of the amount of baseload capacity from which the merged firm could profit due to higher energy prices. Therefore, reducing the amount of baseload capacity under Applicants' control would reduce their incentive to withhold marginal capacity in order to raise the market price, which is the key concern in a horizontal merger creating a large supplier with a large portfolio of generation capacity along all portions of the supply curve.

O. Did the Commission Fail to Appropriately Evaluate the Northern PSEG Market?

1. Requests for Rehearing

65. NJ Ratepayer Advocate challenges the Commission's decision that Applicants' commitment to divest 100 MW of generation in the Northern PSEG market would remedy any concentration issue in that market.⁷⁷ It contends that Applicants did not

⁷⁶ *Oklahoma Gas and Electric Company*, 108 FERC ¶ 61,044 at P 32 (2004) (OG&E).

⁷⁷ NJ Ratepayer Advocate at 11.

explicitly commit to divesting 100 MW of generation from the Northern PSEG market, so the Commission erred in approving the merger based on the vague mention of this divestiture.⁷⁸

2. Commission Determination

66. We reject NJ Ratepayer Advocate's argument that Applicants failed to show that the merger would not harm competition in the Northern PSEG. As discussed in P 32 above, Applicants committed to divest 200 MWs of generating capacity consisting of 100 MWs of coal-fired capacity and 100 MWs of mid-merit capacity in the Northern PSEG market. We relied on that commitment in making our finding that the merger would not adversely affect competition. As a result of the mitigation, the markets will be unconcentrated or moderately concentrated for all season/load levels and the change in market concentration does not exceed 100 HHI in any of the season/load levels. Therefore, as we stated in the Merger Order, Applicants have shown that the proposed mitigation adequately addresses any merger-related harm to competition in the Northern PSEG energy market.

P. Does the Commission Lack Jurisdiction Over Key Aspects of the Mitigation Plan?

1. Requests for Rehearing

67. Public Citizen claims that EAct 2005 will lead to a corrosion of the required mitigation by altering the Commission's jurisdiction over generation, which could permit Applicants to simply reacquire divested facilities and generation without Commission approval.⁷⁹

2. Commission Determination

68. While the new section 203 language in EAct 2005 increases the monetary value required for Commission authorization of the disposition of facilities, as a practical matter, the increased dollar threshold will easily be met in most cases. Particularly in the geographic markets at issue in this transaction, any generation facility that would sell for less than \$10 million would be *de minimis*. Therefore, we do not believe that the new \$10 million threshold under section 203 would lead to Applicants' ability to buy back divested generation without Commission approval. Additionally, the new statute provides the Commission with greater authority in some respects, since we have authority

⁷⁸ *Id.*

⁷⁹ Public Citizen at 17.

over the disposition of facilities involving generation only, which we did not have under pre-EPA Act 2005 section 203.⁸⁰

Q. Should the Commission Clarify the Timing and Content of the Required Compliance Filings?

1. Requests for Rehearing

69. In order to ensure that the Commission can verify that the mitigation eliminates the merger-related increase in market concentration, APPA/NRECA requests that the Commission require Applicants to file a single, comprehensive Appendix A market analysis of the generation divestitures before the divestitures begin and then another compliance filing demonstrating that the required divestitures have been completed.⁸¹ This would ensure that Applicants are meeting all their obligations.⁸²

70. Similarly, APPA/NRECA argues that the Commission should establish a strict deadline for Applicants to complete generation divestitures, with consequences for failure to meet that deadline.⁸³

71. APPA/NRECA also requests that the Commission establish a specific procedure for Applicants' divestiture of generation, such as requiring Applicants to auction off the pool of generating units they have identified as eligible for divestiture and appointing an independent auction monitor to oversee the auction process and ensure the transparency and fairness of the auction.⁸⁴

2. Commission Determination

72. We find the requests of APPA/NRECA reasonable. The Commission required Applicants to make compliance filings to ensure that the mitigation is alleviating market power concerns. Requiring Applicants to file a comprehensive Appendix A analysis

⁸⁰ Energy Policy Act of 2005 §§ 261 *et seq.*, Pub. L. No. 109-58, 199 Stat 594 (2005).

⁸¹ APPA/NRECA at 8.

⁸² *Id.* at 9.

⁸³ *Id.* at 10.

⁸⁴ *Id.* at 13-14.

before the generation divestitures begin will provide the Commission with a solid basis on which to analyze the progress of the mitigation. Similarly, after the required divestitures are complete, the Commission will require Applicants to make another filing to demonstrate that the divestitures have complied with the necessary actions ordered by the Commission.

73. On August 1, 2005, Applicants submitted a compliance filing that outlined the baseload energy auction and explained the independent oversight of the auction through an auction manager and an independent auction monitor to serve as an additional layer of independence in the baseload energy auction. The City of Philadelphia protested the compliance filing and argued that the plan did not contain any requirement that the auction manager and independent auction monitor not have any ownership interests in one another and will not collude in the auction proceedings. The City of Philadelphia requests that we require Applicants' to include language in the agreements that neither the auction manager nor the independent auction monitor will have ownership interests in one another and will not collude in the auction proceedings. We find the City of Philadelphia's request reasonable and will require Applicants to provide a new agreement with such language incorporated.

74. Additionally, we find that Applicants' compliance filing addresses APPA/NRECA's concerns about the independence and transparency of the auction process. Therefore, that aspect of APPA/NRECA's request for rehearing is moot.

R. Did the Commission Accept Unsupported Claims of Benefits?

1. Requests for Rehearing

75. PaOCA and Illinois argue that the Commission approved the merger based, in part, on unsupported evidence offered by Applicants that the proposed merger benefits the public interest. While Applicants claim that the merger will provide benefits to the public interest, such as lower costs, higher capacity and greater stability in the electricity market, PaOCA asserts that Applicants fail to produce substantial evidence to support these claims.⁸⁵ It argues that Applicants did not demonstrate that the claimed benefits and efficiencies could only result from the proposed merger, as allegedly required under the Commission's Merger Policy Statement and the DOJ Merger Guidelines.⁸⁶

⁸⁵ PaOCA at 17.

⁸⁶ *Id.* at 17-18.

2. Commission Determination

76. The Commission approved the merger under the standard set forth in section 203 of the FPA, upon a finding that the proposed merger is consistent with the public interest. The Commission determined that, based on the market analysis and Applicants' proposed mitigation, Applicants demonstrated that the proposed merger would not adversely affect competition, rates or regulation. PaOCA and Illinois are correct that Applicants cite a more efficient nuclear operation, which would provide the market with increased energy for sale in the PJM wholesale market, as one of the chief benefits of the merger. However, we did not rely on Applicants' efficiency argument in our conclusion that the merger, as mitigated, would not harm competition in any relevant wholesale market. Therefore, Applicants did not need to make a showing that efficiency gains from the merger would benefit the public interest in order for us to conclude that the merger is consistent with the public interest.

S. Whether the Commission Should Have Expanded Its Analysis Beyond the Merger Policy Statement

1. Requests for Rehearing

77. Philadelphia Gas argues that the Commission's "refusal to consider elements of the public interest beyond those described in the [Merger Policy Statement]" was arbitrary, capricious, an abuse of discretion and a violation of section 557(c)(3)(A) of the Administrative Procedure Act.⁸⁷ Among the public interest elements Philadelphia Gas claims that the Commission ignored are the effects the merger may have on the price and availability of natural gas in the Philadelphia area, the Philadelphia area spot market for natural gas and the price of electricity in the Philadelphia area.⁸⁸

2. Commission Determination

78. Under the Commission's Merger Policy Statement, the Commission generally evaluates three factors in determining whether a proposed merger is consistent with the public interest: the proposed merger's effect on competition, on rates and on regulation.⁸⁹ While these three factors are generally the basis for the Commission's determination, each of these three general factors consider many specific circumstances that influence the Commission's analysis. Among those additional circumstances are the

⁸⁷ Philadelphia Gas at 13.

⁸⁸ *Id.* at 11.

⁸⁹ Merger Policy Statement at 30,111.

proposed merger's effects on markets and market concentration in the relevant geographic and product markets, the possibility of unnecessary rate increases and additional ratepayer protection stemming from the proposed merger and the impact of the merger on state regulation.

79. Specifically, in our review of the merger's effect on competition in wholesale electricity markets, we considered Applicants' and intervenors' analysis of the relevant upstream natural gas markets and concluded that Applicants had shown that the upstream natural gas markets were not highly concentrated, a necessary condition for the concerns about natural gas prices and availability expressed by Philadelphia Gas. Regarding the price of electricity in the Philadelphia area, we did find that the merger, as mitigated, would not harm competition in PJM-East, where Philadelphia is located. To the extent Philadelphia Gas is referring to retail electricity prices in Philadelphia, we found that the merger would not adversely affect regulation in any state, including Pennsylvania.

80. Philadelphia Gas argues that the Commission violated section 557(c)(3)(A) of the Administrative Procedure Act. Section 557(c)(3)(A) states that the Commission must include a statement of the findings and conclusions and a basis for the decision on all issues of law or fact discussed in the record. Throughout the 75 page Merger Order, the Commission explained the basis for its decision to approve the merger as consistent with the public interest. The Commission explained in the discussion of each issue how its decision was consistent with and based on the analysis of the Merger Policy Statement and other antitrust principles. Therefore, the Commission did provide a basis for the conclusions of each decision on all issues of law and fact discussed in the record, as required by section 557(c)(3)(A) of the Administrative Procedure Act.

T. Should the Commission Consider the Effect on Regulation of the Repeal of PUHCA?

1. Requests for Rehearing

81. Public Citizen argues that the Commission should analyze the effect that the repeal of the PUHCA 1935⁹⁰ would have on the regulation of the merger. It states that the Commission shifted the question of effective regulation to the NJBPU and other state commissions. Upon the repeal of PUHCA, no federal or state body will have jurisdiction over the finances of the interstate holding companies and their interactions with utility subsidiaries.⁹¹

⁹⁰ 15 U.S.C. §§ 79 *et seq.*

⁹¹ Public Citizen at 14.

82. Similarly, NJBPU also argues that the Commission failed to evaluate the effect the PUHCA 1935 repeal would have on the states' regulation and review of this merger. While the NJBPU intends to consider the effect the repeal of PUHCA 1935 may have and any changes in the regulation that may be necessary, NJBPU argues that the Commission erred in failing to conduct such an evaluation.⁹²

2. Commission Determination

83. The Commission approved this merger on June 30, 2005; PUHCA 1935 was in effect at that time and the Commission took account of that fact.⁹³

84. Effective February 8, 2006, the Energy Policy Act of 2005, replaces PUHCA 1935 with PUHCA 2005.⁹⁴ The Commission issued an order repealing PUHCA 1935 and implementing PUHCA 2005.⁹⁵

85. The Commission cannot make decisions based on what laws Congress *may* enact; we can only regulate according to those laws that exist when we make our decisions. At the time the Commission approved Applicants' merger, PUHCA 1935 was in effect and the Commission considered the effect that PUHCA 1935 would have on the proposed transaction.⁹⁶

U. Did the Commission Improperly Rely on State Regulation to Ensure Just & Reasonable Wholesale Rates?

1. Requests for Rehearing

86. Public Citizen argues that the merger will lead to higher rates for residential customers, and that residential consumers will have no alternatives to the higher

⁹² NJBPU at 46.

⁹³ Merger Order at P 217.

⁹⁴ Energy Policy Act of 2005 (EPA 2005) §§ 261 *et seq.*, Pub. L. No. 109-58, 199 Stat. 594 (2005).

⁹⁵ Order No. 667, *Repeal of the Public Utility Holding Company Act of 1935 and Enactment of the Public Utility Holding Company Act of 2005*, 113 FERC ¶ 61,248 (2005).

⁹⁶ Merger Order at 72-3.

wholesale prices created by the market power of the Exelon-PSEG merger.⁹⁷ It accuses the Commission of abdicating its responsibility to ensure just and reasonable wholesale rates to the relevant state commissions.⁹⁸

2. Commission Determination

87. We deny Public Citizen's rehearing request on two grounds. First, as discussed above and in the Merger Order, we find that the increased market power that would otherwise occur will be mitigated by the various required divestitures. Therefore, we do not agree that there will be "higher wholesale prices created by the market power of the Exelon-PSEG merger." Second, Applicants have committed to hold wholesale customers harmless from any merger-related costs that exceed demonstrated merger-related benefits and we have found that such a commitment protects customers.⁹⁹

V. Did the Commission Improperly Accept Applicants' May 10, 2005 Answer as an Amendment to the Filing?

1. Request for Rehearing

88. Philadelphia Gas argues that the Commission violated its own regulations, the FPA and the Administrative Procedure Act in treating Applicants' May 10, 2005 answer as an amendment under Rule 215 of the Commission's regulations rather than as an answer under Rule 213.¹⁰⁰

2. Commission Determination

89. Applicants May 10, 2005 filing responded to many concerns raised by protestors by clarifying Applicants' market power analysis and offering additional mitigation. Such an amendment to a pleading is permitted under rule 215(a)(3)(i) of the Commission's regulations.¹⁰¹

⁹⁷ Public Citizen at 16.

⁹⁸ *Id.*

⁹⁹ Merger Policy Statement at 30,124.

¹⁰⁰ 18 C.F.R. § 385.215 and § 385.213 (2005).

¹⁰¹ 18 C.F.R. § 385.215(a)(3) (2005).

90. While Applicants titled their May 10, 2005 filing an Answer, in fact it contained new information. Therefore, under Rule 215, the Commission accepted the filing as an amendment and provided an opportunity to comment on it, which benefited all parties.

W. Did the Commission Violate *Ex Parte* Rules and the Administrative Procedure Act by Holding Pre-Filing Meetings with Applicants?

1. Requests for Rehearing

91. Public Citizen and Illinois argue that the Commission should have discussed in the Merger Order their objections to pre-filing meetings between the Commissioners and Applicants.¹⁰² It claims that the failure to produce a record of these meetings violates the parties' rights under the Administrative Procedure Act,¹⁰³ to an impartial decision maker. Without a record of these meetings, the public has no way of knowing that the Commissioners are not biased.¹⁰⁴

2. Commission Determination

92. We reject Public Citizen's argument that the Commissioners' pre-filing meetings were in violation of either the Commission's own regulations or the APA. First, the regulations prohibit off-the-record communications in any "contested on-the-record proceedings."¹⁰⁵ The regulations define a "contested on-the-record proceeding" as "any proceeding before the Commission to which there is a right to intervene and in which an intervenor disputes any material issue ..."¹⁰⁶ The regulations prohibit such off-the-record

¹⁰² Public Citizen at 4.

¹⁰³ 5 U.S.C. § 551 *et seq.* (2005).

¹⁰⁴ Public Citizen at 9.

¹⁰⁵ 18 C.F.R. § 385.2201(a) (2005).

¹⁰⁶ 18 C.F.R. § 385.2201 (c)(1) (2005). In Order No. 607, the final rule implementing the Commission's *ex parte* rules, we noted that "[t]he explicit requirement that the proceeding be 'contested' before *ex parte* rules attach reflects the notion that procedural requirements and constraints originally developed to preserve the rights of parties in an adjudication have no place in an administrative proceeding in which there is no 'contest' comparable to the controversy in a judicial case." *Regulations Governing Off-the-Record Communications*, Order No. 607, FERC Stats. & Regs. ¶ 31,079 at 30,881, 64 Fed. Reg. 51,222 at 51,230 (1999).

communications in a contested on-the-record proceeding “from the time of filing of an intervention disputing any material fact that is the subject of a proceeding.”¹⁰⁷

93. At the time that employees of the Applicants met with the Commissioners, the Commission’s prohibition against off-the-record communications did not apply because there was no proceeding whatsoever, much less a contested on-the-record proceeding, nor were there any parties. As the prohibition against off-the-record communications did not apply at this point, we find that the Commissioners acted according to the rules set forth in the Commission’s regulations.

94. Second, we reject Public Citizen’s argument that any pre-filing meetings between the Commissioners’ and the Applicants violated the APA because, when the pre-filing meetings occurred, there was no “proceeding”, so the pre-filing meeting was not an *ex parte* communication. The APA defines an “*ex parte* communication” as “an oral or written communication not on the public record with respect to which reasonable prior notice to all *parties* is not given.”¹⁰⁸ A “party” is “a person or agency named or admitted as a party, or properly seeking and entitled as of right to be admitted as a party, in an agency *proceeding*.”¹⁰⁹ Prior to filing, as there was no Commission proceeding, the APA’s prohibition on *ex parte* communication could not apply. Public Citizen’s protest would effectively read out of the statute the requirement that there be an agency proceeding to which parties are named, admitted, or are entitled as of right to seek admission, and we must therefore reject it as inconsistent with the APA’s definition of *ex parte* communication. Furthermore, we note that Public Citizen makes no effort to explain when, in its view of the APA, a “proceeding” begins. Under Public Citizen’s view, there is no limit to how early a “proceeding” begins.

95. In Order No. 607, we similarly concluded that pre-filing meetings are not *ex parte* communications, as defined by the APA. In the Notice of Proposed Rulemaking underlying that order, the Commission proposed to explicitly provide an exemption for pre-filing meetings.¹¹⁰ However, we determined in Order No. 607 that no pre-filing

¹⁰⁷ 18 C.F.R. § 385.2201(d)(1)(iv) (2005).

¹⁰⁸ 5 U.S.C. § 551(14) (2000) (emphasis added).

¹⁰⁹ 5 U.S.C. § 551(3) (2000) (Emphasis added).

¹¹⁰ *Regulations Governing Off-the-Record Communications*, Notice of Proposed Rulemaking, FERC Stats. & Regs. ¶ 32,534 at 33,506-07 (1998) (“pre-filing communications are often useful in educating applicants as to the appropriate format, content, and form that an application or other filing should take. Such consultations can therefore improve the chances that filings, once made, will be ready for evaluation on the merits.”).

exemption was necessary and thus that pre-filing communications were not covered by the APA prohibition on *ex parte* communications “because they take place prior to the filing of an application, and therefore prior to any ‘proceeding’ at the Commission.”¹¹¹

96. Public Citizen cites *Electric Power Supply Association v. FERC*¹¹² to support its argument that the Commissioners’ pre-filing meetings violated the APA. However, *EPSA v. FERC* dealt with *ex parte* communications related to a specific “pending on-the-record proceeding” and post-filing meetings. The Court indicated in *EPSA v. FERC* that the overriding concern of section 557 is to ensure that an adequate record exists for purposes of judicial review and that the fairness of the proceedings is above reproach.¹¹³ In the situation at hand, there was no “pending on-the-record proceeding” because no application had yet been filed. Therefore, the APA was not violated.

97. Finally, we note that the current proceeding is not the proper venue for Public Citizen to challenge the validity of the Commission’s regulations; its arguments are, in fact, a collateral attack on those regulations. We will not ignore our regulations because a party to a specific case argues that the regulations are invalid. If Public Citizen believes that the Commission should amend its regulations, Public Citizen should submit a petition for rulemaking setting forth the changes it believes are necessary.¹¹⁴

The Commission orders:

- (A) Parties’ requests for rehearing are hereby denied.
- (B) Applicants are ordered to submit the required updated market analysis and compliance filings, as discussed in the body of this order.
- (C) The Commission clarifies that we rely on Applicants’ 200 MW mitigation commitment in finding that the proposed mitigation adequately addresses any merger-related harm to competition in the Northern PSEG energy market.

¹¹¹ Order No. 607 at 30,879.

¹¹² *Electric Power Supply Association v. FERC*, 391 F.3d 1255 (2004) (*EPSA v. FERC*).

¹¹³ *EPSA v. FERC*, 391 F.3d at 1266 (2004).

¹¹⁴ 18 C.F.R. § 385.207(a)(4) (2005).

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(D) The Commission hereby accepts Applicants' August 1, 2005 compliance filing, as discussed in the body of this order.

By the Commission.

(S E A L)

Magalie R. Salas,
Secretary.

CERTIFICATE OF SERVICE

I hereby certify that I am this day serving a true copy of the Reply Exceptions of PECO Energy Company ("PECO") and Public Service Electric & Gas ("PSE&G") (collectively, "Joint Applicants") upon the participants listed below in accordance with the requirements of Section 1.54 (relating to service by a participant).

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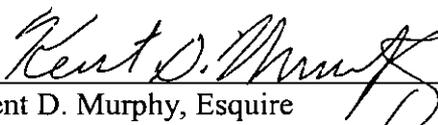
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Dated this 29th day of December, 2005 in Philadelphia, Pennsylvania.

COMMONWEALTH OF PENNSYLVANIA



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December 30, 2005

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

Dear Secretary McNulty:

Enclosed for filing are the original and nine (9) copies of the Reply Exceptions on behalf of the Office of Small Business Advocate in the above-docketed proceeding. As evidenced by the enclosed certificate of service, two copies have been served on all active parties in this case.

If you have any questions, please do not hesitate to contact me.

Sincerely,

Sharon E. Webb
Assistant Small Business Advocate

Enclosures

cc: Cheryl Walker Davis, Director
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Brian Kalcic

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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

DOCUMENT
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REPLY EXCEPTIONS
ON BEHALF OF THE
OFFICE OF SMALL BUSINESS ADVOCATE

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I. INTRODUCTION

A. Procedural History

On February 4, 2005, PECO Energy Company (“PECO”)¹ and Public Service Electric and Gas Company (“PSE&G”) (collectively, “Joint Applicants”) filed with the Commission their Joint Application for Approval of the Merger of Public Service Enterprise Group (“PSEG”) with and into Exelon Corporation (“Exelon”). By their Joint Application, PECO and PSE&G requested the Commission’s approval of the Proposed Merger under Chapters 11, 22, and 28 of the Public Utility Code, 66 Pa. C.S. Ch. 11, 22, and 28. In the alternative, the Joint Applicants requested a declaratory order to the effect that the Commission’s approval of the Proposed Merger is not required.

On March 2, 2005, the Office of Small Business Advocate (“OSBA”) filed a Notice of Intervention and Protest (“Protest”) with respect to the Joint Application. In its Protest, the OSBA identified several issues of concern, including the following:

- a. Whether the Proposed Merger would “affirmatively promote the ‘service, accommodation, convenience, or safety of the public’ in some substantial way,” as required by *City of York v. Pennsylvania Public Utility Commission*, 449 Pa. 136, 141, 295 A.2d 825, 828 (Pa. 1972);
- b. Whether the Proposed Merger would impede the development of the electric retail market, thereby negatively impacting the price ratepayers must pay for electricity; and

¹ PECO is a “public utility,” a “natural gas distribution company,” and an “electric distribution company,” as those terms are defined, respectively, in Sections 102, 2202, and 2803 of the Public Utility Code, 66 Pa.C.S. §§ 102, 2202, and 2803, and, therefore, is subject to regulation by the Commission. Application, Par. 5, p. 2.

- c. Whether the Proposed Merger would impede competition in the wholesale market for electricity, thereby negatively impacting the retail price ratepayers must pay for electricity acquired by the default service provider pursuant to Section 2807(e)(3) of the Public Utility Code, 66 Pa. C.S. § 2807(e)(3).

In addition to the OSBA, the active parties are the Joint Applicants; the Office of Consumer Advocate (“OCA”); the Office of Trial Staff (“OTS”); the Philadelphia Area Industrial Users Group (“PAIEUG”); Citizens for Pennsylvania’s Future, Joy Bergey and Lisa Z. Leighton (“PennFuture”); the Department of Environmental Protection (“DEP”); the Energy Coordinating Agency (“ECA”); Exelon Utility Coordinated Council, Locals 614 and 777 of the International Brotherhood of Electrical Workers and Frank Kuders (“Labor Parties”); PPL Electric Utilities Corporation, PPL EnergyPlus, PPL Brunner Island, PPL Holtwood, PPL Martins Creek, PPL Montour, PPL University Park, Lower Mount Bethel Energy, and PPL Susquehanna (collectively, “PPL”); the City of Philadelphia (“Philadelphia”); Metropolitan Edison Company, Pennsylvania Electric Company, Pennsylvania Power Company and FirstEnergy Solutions, Corp. (collectively, “FirstEnergy”); Action Alliance of Senior Citizens of Greater Philadelphia, Association of Community Organizations for Reform Now and Tenants’ Action Group (“Action Alliance”); The Reinvestment Fund, through its Sustainable Development Fund (“TRF”); Senator Anthony Williams (“Senator Williams”); and Philadelphia Gas Works (“PGW”).

The OSBA filed the direct, rebuttal, surrebuttal, and supplemental testimony of OSBA witness Brian Kalcic. *See*, respectively, OSBA St. No. 1, OSBA St. No. 2, OSBA St. No. 3, and OSBA St. No. 4. With the exception of certain redacted portions, each of

St. No. 3, and OSBA St. No. 4. With the exception of certain redacted portions, each of these statements was admitted into the record of this proceeding pursuant to an agreement with the other parties.

The OSBA actively participated in the negotiations which led to the filing, on September 12, 2005, of the Joint Petition for Settlement (“Settlement”). The signatories to the Settlement are the Joint Applicants; the OSBA; the OTS; the OCA; the DEP; PennFuture; Action Alliance; the ECA; PAIEUG; TRF; and Senator Williams (collectively, the “Joint Petitioners”).

The parties not joining in the Settlement are FirstEnergy, PPL, Philadelphia, PGW, and the Labor Parties. FirstEnergy, the Labor Parties, and PPL indicated that they would not oppose the Settlement. However, PGW, Philadelphia, and PPL continued to litigate their respective issues.

Evidentiary hearings were held in Philadelphia on September 22, 23, and 26, 2005, before Administrative Law Judge Marlane R. Chestnut (“ALJ”).

On October 13, 2005, PGW, Philadelphia, and the OCA filed main briefs and the DEP filed proposed findings of fact and conclusions of law. On October 14, 2005, the Joint Applicants, the OSBA, the OTS, PPL, PennFuture, First Energy, and TRF filed main briefs and Action Alliance filed proposed findings of fact and conclusions of law. Reply briefs were filed by First Energy, PPL, Philadelphia, PGW, the Joint Applicants, the OTS, the OCA, and the OSBA.

The Initial Decision (“I.D.”) of ALJ Chestnut was issued on November 30, 2005. Subsequently, on December 20, 2005, Exceptions were filed by Philadelphia, PPL, and PGW.

The OSBA submits these Reply Exceptions in response to certain Exceptions filed by Philadelphia and PGW.

B. Jurisdiction

By their Application, the Joint Applicants requested the Commission's approval of the Proposed Merger, if such approval is required, under Chapters 11, 22, and 28 of the Public Utility Code, 66 Pa. C.S. Ch. 11, 22, and 28. In the alternative, if the Commission determined that Commission approval of the Proposed Merger was not required, the Joint Applicants requested that the Commission issue a declaratory order setting forth that determination. The Joint Applicants based their argument that Commission approval of the Joint Application was not required on their interpretation of the Statement of Policy at 52 Pa. Code § 69.901.

In contrast, the OSBA took the position (beginning with its Notice of Intervention and Protest) that the approval of the Proposed Merger does come under the Commission's jurisdiction. Section 1102(a) of the Public Utility Code, 66 Pa. C.S. § 1102(a), permits a public utility to undertake certain actions only upon Commission approval evidenced by a certificate of public convenience. Among the activities that require Commission approval is the following:

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

66 Pa. C.S. § 1102(a)(3).

Exelon is an “affiliated interest” of PECO under Section 2101 of the Public Utility Code, 66 Pa. C.S. § 2101, in that Exelon is a “corporation . . . owning or holding directly or indirectly 5% or more of the voting securities of such public utility [PECO].”² PSE&G’s natural gas and electric service territories border PECO’s natural gas and electric service territories. PSE&G is, has been, or could be using its property for the purpose of providing natural gas, electricity, or both to retail customers in the PECO service territories.³ Therefore, because Exelon would acquire property of PSE&G that is “useful in the public service,” Commission approval of the Proposed Merger is required under Section 1102(a)(3).

Even though the Joint Applicants alleged that the Commission has no jurisdiction over the Proposed Merger, they “surrendered” to the Commission’s jurisdiction for purposes of settlement. *See* Joint Application, Vol. 1, Par. 18-20; Settlement, p. 26, Par. 45.

While noting the arguments of the parties pertaining to jurisdiction, ALJ Chestnut concluded that it was unnecessary to resolve the issue of jurisdiction in the context of this proceeding since the Joint Applicants “surrendered to the Commission’s jurisdiction” in

² PECO became a wholly-owned subsidiary of Exelon as part of a transaction approved by the Commission’s Order entered June 22, 2000, at Docket No. A-00110550F0147. Concurrent with that transaction, Unicom Corporation, the parent of Commonwealth Edison Company (“ComEd”), was merged with and into Exelon. Subsequent to a corporate alignment, PECO and ComEd transferred their generation assets, other non-regulated enterprises, and business service functions to separate corporations that also became wholly-owned subsidiaries of Exelon. Currently, PECO and ComEd are second tier subsidiaries of Exelon through their immediate parent, Exelon Energy Delivery Company, LLC. Joint Application, Vol. 1, Par. 6, p. 3.

³ An affiliate of PSE&G—PSEG Energy Technologies, Inc (“Energy Technologies”)—was licensed as an Electric Generation Supplier (“EGS”) under 66 Pa. C.S. Ch. 28 for more than five years. However, Energy Technologies has abandoned its license. *See* the Commission’s Order entered November 8, 2002, at Docket Nos. C-20028230 and A-110029. Similarly, Energy Technologies was licensed as a Natural Gas Supplier (“NGS”) under 66 Pa. C.S. Ch. 22 for about three years but has abandoned that license. *See* the Commission’s Order entered November 8, 2002, at Docket No. A-125040.

furtherance of having the proposed settlement reviewed and approved by the Commission. I.D., p. 14.

C. Standard of Review

When Section 1102(a) requires a certificate of public convenience prior to a transaction, Section 1103(a) of the Public Utility Code, 66 Pa. C.S. § 1103(a), allows the Commission to issue the certificate only upon a finding or determination that the granting of such certificate is “necessary or proper for the service, accommodation, convenience, or safety of the public.” According to the Pennsylvania Supreme Court, satisfying this standard requires the Commission to find that a proposed merger would “affirmatively promote the ‘service, accommodation, convenience, or safety of the public’ in some substantial way.” *York*, 449 Pa. at 141; 295 A.2d at 828. “Further, when the ‘public interest’ is considered, it is contemplated that the benefits and detriments of the acquisition be measured as they impact on *all affected parties*, and not merely on one particular group” *Middletown Township v. Pennsylvania Public Utility Commission*, 482 A.2d 674, 682 (Pa. Cmwlth. 1984). (emphasis in original) In addition, Section 1103(a) allows the Commission to impose upon its issuance of a certificate of public convenience “such conditions as it may deem to be just and reasonable.”

In accordance with Sections 1102(a)(3) and 1103(a) of the Public Utility Code, the Commission may not grant a certificate of public convenience with respect to the Proposed Merger unless the Commission determines that the Proposed Merger is “necessary or proper for the service, accommodation, convenience, or safety of the public.”

“The Commission encourages parties to seek negotiated settlements of contested proceedings in lieu of incurring the time, expense and uncertainty of litigation.” 52 Pa. Code § 69.391(a).

The OSBA submits that approval of the Settlement is in the public interest because the Settlement provides the affirmative public benefits required by *York* and satisfies the applicable statutory requirements in the Public Utility Code.

II. REPLY EXCEPTIONS

- A. **REPLY TO PHILADELPHIA’S EXCEPTION 1 AND PGW’S EXCEPTION 2—The price monitoring report will enhance the Commission’s ability to prevent anticompetitive behavior, discriminatory conduct, and unlawful exercise of market power. (Philadelphia’s Exceptions, p. 6; PGW’s Exceptions, pp. 33-35; I.D., pp. 38-49)**

The issue of market power did not settle. However, no party was prejudiced because all parties had the opportunity to litigate the issue. By facilitating the Commission’s work and acknowledging the parties’ rights under Section 2811 of the Public Utility Code, 66 Pa. C.S. § 2811, the Settlement addresses concerns expressed in the OSBA’s Protest regarding the effect of the Proposed Merger on electric rates.

Section 2811(a) requires the Commission to “monitor the market for the supply and distribution of electricity to retail customers and take steps . . . to prevent anticompetitive or discriminatory conduct and the unlawful exercise of market power.” Section 2811(b) provides for the Commission to “conduct an investigation of the impact on the proper functioning of a fully competitive retail electricity market, including the effect of mergers, . . . and anticompetitive or discriminatory conduct affecting the retail distribution of electricity.” The Settlement explicitly recognizes the right of any party (including the OSBA) to request a Commission investigation when the party “reasonably believes that PECO’s affiliated generation company (or any other affiliated entity) has unlawfully exercised market power in any PJM market, or for any other reason as set forth in 66 Pa. C.S. § 2811.” Settlement, Par. 53b.

The Settlement also requires PECO to “file . . . annually for each of the years 2007, 2008, 2009, 2010, 2011 and 2012 a report addressing wholesale market prices and

price trends in the Pennsylvania-New Jersey-Maryland Interconnection ('PJM') markets." Settlement, Pa. 53a. That report is to include "information regarding price differentials between PJM East and other PJM regions" as well as "other information necessary to assess prices and price trends in the PJM markets." Settlement, Par. 53a. The OSBA anticipates that the report will assist the Commission in fulfilling the monitoring responsibility under Section 2811(a) and will assist the OSBA in determining whether to request a Commission investigation under Section 2811(b).

Section 2811(b) does not explicitly recognize manipulation in the *wholesale* market as grounds for Commission action. However, the Settlement recognizes that manipulation in both the retail and wholesale markets are grounds for a party to seek a Commission investigation. Settlement, Par. 53a. The existence of a competitive retail market is based on the procurement of power from a competitive wholesale market. Combined with the recognition by Joint Applicants' witness Hieronymous that wholesale prices drive retail prices, the Settlement could simplify any request for an investigation of market power and, hence, provides additional benefit to ratepayers. Joint Applicants St. No. 3, pp. 8-9.

Philadelphia contends that the Settlement is deficient because the Settlement does not contain any preemptive measures, other than the reporting requirement, to protect the public from the potential negative impacts, or the illegal exercise of market power, that may occur as a result of the proposed transaction. Philadelphia's Exceptions, p. 6. However, contrary to Philadelphia's contention, the Settlement will serve to discourage the unlawful exercise of market power by Exelon or an affiliate.

Under the Settlement, *any* Joint Petitioner may request that the Commission initiate an investigation. Settlement, Par. 53b. If the Commission’s investigation leads to the reasonable belief that Exelon or an affiliated interest has unlawfully exercised market power, Section 2811(d) of the Public Utility Code, 66 Pa. C.S. § 2811(d), requires the Commission to refer its findings to the Attorney General of Pennsylvania, the U. S. Department of Justice, the Securities and Exchange Commission, and the Federal Energy Regulatory Commission and empowers the Commission to seek intervention before those agencies. The results of the investigation would also be available for parties to use in proceedings regarding the approval of PECO’s default service plan (*e.g.*, if PECO requests a risk premium or a reconcilable energy service charge), regarding the setting of the rate of return in a PECO distribution base rate proceeding, and regarding PECO’s annual Section 1307(f) filing.

PGW asserts that the Settlement contains no provision to protect the electricity market from potential abuses in the gas market, especially since the market price report required by the Settlement will be of electricity prices and not of gas prices. PGW’s Exceptions, p. 33. However, if PGW were to be correct that manipulation in the gas market will affect prices in the electricity market, the report of electricity prices should help identify any manipulation in the gas market. Furthermore, the Settlement recognizes the right of the parties to seek a Commission investigation of the effect on the retail electricity market from manipulation in *any* PJM market—which will include gas markets if the scenario predicted by PGW arises. Settlement, Par. 53b.

Additionally, as noted by the ALJ, “[n]ot only will PECO have to establish [in its annual proceeding under Section 1307(f)] that it uses its gas assets in a manner consistent

with a least cost gas procurement policy, it could be required to seek relief on behalf of its customers for any adverse effect under its gas contracts caused by market manipulation by Exelon, PSE&G, or any other affiliated interest.” I.D., p. 49.

B. REPLY TO PGW’S EXCEPTION 1—Any attempt by Exelon to influence gas prices can be addressed in PECO’s gas cost proceedings under Section 1307(f). (PGW’s Exceptions, pp. 28-29; I.D., pp. 38-49)

PGW is concerned with potential market manipulation through the merged entity’s alleged ability to restrict the release of upstream pipeline capacity. PGW’s Exceptions, pp. 28-29.

Citing the reasoning set forth in the OSBA’s Reply Brief, ALJ Chestnut properly concluded that PGW’s concerns can be addressed in the context of the company’s annual proceeding under Section 1307(f) of the Public Utility Code, 66 Pa. C.S. § 1307(f). I.D., p. 49.

Each year, every major natural gas distribution company undergoes a thorough examination of its gas purchasing performance under Section 1307(f). Any failure by PECO to use its gas assets in a manner consistent with a least cost procurement policy under Sections 1317 and 1318 of the Public Utility Code, 66 Pa. C.S. §§ 1317 and 1318, could be pursued in its annual gas cost proceeding.

According to PGW, the Section 1307(f) proceeding would be an inadequate oversight tool because the Commission would not have information about PECO’s non-jurisdictional affiliates. PGW’s Exceptions, p. 28. However, if the market price of gas were to rise as PGW hypothesizes, the effect of that increase presumably would be visible in PECO’s purchased gas costs. Given PGW’s prediction, a logical focus of

inquiry by the parties would be on possible market manipulation by PECO or an affiliated interest.

Furthermore, as affirmed in a recent Commission decision, PECO would be required to seek relief on behalf of its customers for any adverse effect under PECO's gas contracts caused by market manipulation by Exelon, PSE&G, or any other affiliated interest. *See Pennsylvania Public Utility Commission v. The Peoples Natural Gas Company, t/a Dominion Peoples*, Docket No. R-00050267 (Order entered September 30, 2005), Mimeo. pp. 11-14.

C. REPLY TO PHILADELPHIA'S EXCEPTION 2 AND PGW'S EXCEPTION 2.—The Settlement provides significant “affirmative public benefits.” (Philadelphia's Exceptions, pp. 7-15; PGW's Exceptions, pp. 32-33; I.D., pp. 10-38)

1. Philadelphia improperly criticizes the Settlement because it was the result of compromise.

On page 7 of its Exceptions, Philadelphia states that the “parties compromised their litigation positions in order to reach this Settlement” and that the Settlement does not meet the standards for approval because the compromises do not serve the public good overall. The OSBA submits that compromise is the essence of any settlement and that this Settlement provides many benefits that are in the public interest. The totality of the Settlement results in a Proposed Merger that meets the “affirmative benefit” test under *York*, 449 Pa. at 141, 295 A.2d at 828.

Each party must make its own judgments concerning the various offers and counteroffers that are made in settlement negotiations. Philadelphia participated in the negotiations leading to this Settlement and, evidently, did not procure as many concessions as it wanted. As a result, Philadelphia elected to continue litigation of its

issues and had an opportunity to object to the Settlement prior to the filing of its main brief. Philadelphia filed a statement in opposition to the Settlement but inexplicably failed to file any testimony against the Settlement. The Commission's regulations are clear that a party is not permitted to introduce evidence during the rebuttal phase of a proceeding which should have been included in the participant's case-in-chief. *See* 52 Pa. Code § 5.243(e). Because Philadelphia failed to file any testimony against the Settlement, it should not be afforded an opportunity to put in its case at the exceptions stage.

On page 8 of its Exceptions, Philadelphia states that the Application, as originally filed, professed only that the transaction may not harm ratepayers. The OSBA submits that the Application, as modified by the Settlement, provides significant affirmative benefits which the ALJ analyzed in the I.D. As stated in the OSBA's main brief, this Settlement provides \$120 million in rate reductions over the next four years in addition to \$43.6 million in other quantifiable ratepayer benefits. *See* OSBA M.B., pp. 11-12; Settlement, Par. 14, 33, 35a, 35c, 38, 50 and 52; I.D., p. 23. The Settlement also provides many tangible but unquantifiable benefits, such as rate cap extensions. Altogether, there are \$163.6 million of concrete benefits in addition to the rate cap extensions – all of which are legally enforceable. I.D., pp. 14-15 and 23.

A review of the Joint Applicants' filed case provides a dramatic illustration of the benefits provided by the Settlement. On pages 8 through 15 of its Exceptions, Philadelphia has recycled many of the arguments set forth in its main brief. Philadelphia has correctly observed that the Joint Application offered: (1) shareholder benefits but no ratepayer benefits (Philadelphia's M.B., p. 7; Philadelphia's Exceptions, p. 8); (2) no

improvement in day-to-day service (Philadelphia's M.B., p. 7; Philadelphia's Exceptions, p. 14); (3) no promises to increase community contributions (Philadelphia's M.B., pp. 7-8; Philadelphia's Exceptions, p. 9); (4) no sharing of merger savings from the non-regulated business segments (Philadelphia's M.B., p. 8; Philadelphia's Exceptions, p. 9); (5) no proposal to decrease PECO's rates (Philadelphia's M.B., p. 8; Philadelphia's Exceptions, p. 8); (6) and proposed reductions to PECO's workforce (Philadelphia's M.B., pp. 11-12; Philadelphia's Exceptions, p. 10-11). However, Philadelphia has again needlessly concentrated its attention and arguments on the original Application which is now history, its provisions having been greatly modified by the Settlement.

Philadelphia refuses to recognize the considerable benefits provided by the Settlement because Philadelphia believes that it should have received more from PECO in the way of contributions and commitments. Nonetheless, the Settlement provides benefits that might not have materialized as the result of litigation. In total, this Settlement meets the "affirmative benefit" test of *York* and should, therefore, be approved.

2. The rate caps and explicit rate reductions do not extend beyond 2010 because such relief was not requested by the parties in their litigation positions.

Philadelphia criticizes the Settlement because the benefits from the rate reductions and the rate caps do not extend beyond 2010. Philadelphia's Exceptions, p. 10.

However, that limitation is consistent with the litigation positions of the parties. Citing the reasoning set forth in the reply briefs of the OCA and the OSBA, the ALJ noted that none of the settling parties testified in favor of rate cuts or rate caps after 2010. I.D., pp. 23-24. Therefore, Philadelphia's complaint about the failure to cap rates beyond 2010

would not have been answered even if this case had been fully litigated. Furthermore, the monetary benefits of the merger will not cease after 2010 since 100 per cent of the distribution-related synergies will accrue to ratepayers via a reduced revenue requirement in PECO's next base rate case.

Philadelphia laments what it calls "short-term concessions." Philadelphia's Exceptions, p. 8. However, the expiration of PECO's generation rate cap is not a shortcoming of the Settlement, but rather a consequence of the provisions of the Electricity Customer Choice and Competition Act passed by the General Assembly in 1996, 66 Pa. C.S. § 2801, *et seq.* ("Competition Act"). In its Declaration of Policy, the General Assembly stated that "[c]ompetitive market forces are more effective than economic regulation in controlling the cost of generating electricity." 66 Pa. C.S. §2802(5). Rate caps on the cost of electric utility service are required to be in place during the transition period, but those rates caps expire when an electric utility completes the recovery of its stranded costs through its competitive transition charge ("CTC"). 66 Pa. C. S. § 2804(4). PECO's transition period runs through the end of 2010. At that time, the Competition Act requires that PECO charge its customers market rates for generation. 66 Pa. C.S. § 2807(e)(3); I.D., p.24

3. The Settlement provides "affirmative benefits" missing from the Application.

The OSBA agrees with Philadelphia and PGW that the Application, as filed, did not demonstrate that the Proposed Merger would result in an affirmative public benefit, as required under Section 1103(a) of the Public Utility Code, 66 Pa. C.S. § 1103(a), and under *York*, 449 Pa. at 141, 295 A.2d at 828.

Specifically, the Joint Applicants did not propose to flow merger savings through to ratepayers in any meaningful way. The Joint Applicants estimated only a meager \$155 million of net merger savings, in aggregate, for their regulated businesses over the four-year period of 2006-2009, and allocated only \$46 million of these savings to Pennsylvania operations. PECO St. No. 2, p. 4, and WDA Exhibit 6. Moreover, the Joint Applicants did not propose to flow any of these merger savings directly through to their ratepayers. Rather, the Joint Applicants offered only the vague assertion that economies of scale resulting from the Proposed Merger “may give rise, over time, to lower rates than would otherwise be the case.” PECO St. No. 1, p. 10.

Therefore, central to the review of the Proposed Merger was a determination of the reasonableness of the Joint Applicants’ estimate of \$155 million of net merger savings to the Joint Applicants’ regulated businesses as well as the reasonableness of the Joint Applicants’ methodology for allocating merger savings among their regulated and unregulated businesses and among the various states in which the Joint Applicants do business. Additionally, the fashioning of an appropriate plan for the direct sharing of the net merger savings with the ratepayers has been crucial to a resolution of this proceeding.

In its direct testimony, the OSBA recommended that the Commission require: (1) that a sharing of the merger savings from both the regulated and non-regulated business segments be imposed as a necessary condition for approval of the merger; (2) that the shared merger savings from the regulated electric business be used to mitigate the electric distribution subsidies currently provided by six PECO energy rate classes; and (3) that 50% of Pennsylvania’s share of all generation-related savings derived from the non-

regulated business be used to mitigate the generation-related rate increases scheduled to be paid by PECO electric customers beginning in 2006 and 2007. OSBA St. No. 1, p. 2.

During the course of the proceeding, the Joint Applicants admitted to four year generation-related savings of \$1,030 million after costs-to-achieve. If those savings were divided equally among the three jurisdictional states, Pennsylvania's share would be \$343.3 million. However, the Joint Applicants claimed that the generation-related savings belonged to stockholders because PECO no longer owns the generating plants. OSBA St. No. 3, pp. 8-10.

OSBA witness Brian Kalcic testified that ratepayers should receive 50 % of Pennsylvania's share of the generation-related savings (or \$43 million per year) through the end of the recovery of the Competitive Transition Charge ("CTC"). OSBA St. No. 3, p. 10. Mr. Kalcic also testified that about \$9.7 million in annual electric distribution-related savings and \$1.7 million in annual gas distribution-related savings should be flowed through to ratepayers each year until PECO's next rate case. OSBA St. No. 1, pp. 10-11.

The Settlement provides \$120 million in rate reductions to PECO's customers in comparison to the \$217.6 million to which the OSBA testified.⁴ However, the Settlement also provides for \$43.6 million in other quantifiable ratepayer benefits. *See* Settlement, Par. 14, 33, 35a, 35c, 38, 50 and 52. Therefore, the total amount of shared merger savings under the Settlement is at least \$163.6 million. The Settlement also provides some unquantifiable benefits, such as rate cap extensions. When all of the Settlement benefits are considered, the total is within range of the \$217.6 million to which Mr.

⁴ OSBA witness Kalcic recommended rate reductions of \$217.6 million. ((\$43million + \$9.7 million + \$1.7 million) x 4 years). OSBA St. No. 3, pp. 8-10.

Kalcic testified. Even though the merger savings will not be allocated exactly as Philadelphia proposed in its Exceptions (or, indeed, exactly as any other party may have wished), those savings will be used for the public benefit. Contrary to Philadelphia's position, the OSBA is satisfied that this Settlement is in the public interest.

4. The Settlement mitigates the distribution rate subsidy paid by small business customers.

PECO's electric distribution rates were established in its 1998 Electric Restructuring Case at Docket No. R-00973953. In its electric restructuring proceeding, PECO filed a cost of service study indicating that its small business class (Rate GS-General Service) was providing a rate of return of 11.18% in comparison to a system average rate of return of only 9.44%. OSBA Statement No. 1, pp. 9-11; OSBA Exhibit No. 1.

As a result of the PECO/Unicom Merger, PECO's distribution rates were reduced on an across-the-board basis over a four-year period. These reductions will expire on January 1, 2006, when PECO's distribution rates return to their original restructuring level. OSBA witness Kalcic testified that the distribution-related merger benefits should be used to mitigate the distribution subsidies existing under current rates. OSBA St. No. 1, pp. 9-10. The subsidy paid by the Rate GS class is about \$8 million per year under current distribution rates. *See* OSBA Exh. No. 1.

Mr. Kalcic also testified that the generation-related savings should be allocated among the rate classes on the basis of the CTC. OSBA St. No. 1, pp. 13-14. The OSBA's position was contrary to the positions of the OCA and the OTS, which both recommended the allocation of generation-related savings among rate classes on the basis of existing distribution rates. Under the OCA and OTS approaches, Rate GS customers

would have received no relief with respect to the distribution subsidy. OSBA St. No. 1, pp. 9-10.

Under the Settlement, the subsidy paid by Rate GS customers is mitigated. The table below illustrates the difference in the Rate GS customers' share of the \$120 million distribution rate reduction under the OSBA recommendation, the OTS/OCA recommendations, and the Settlement.

<u>Rate Reductions</u>	<u>OSBA</u>	<u>OCA/OTS</u>	<u>Settlement</u>
GS - % Share	26.43%	16.70%	24.64%
Litigation Position	Sch. BK-3,4, OSBA Exh. No. 1	Sch. BK-1R, OSBA Exh. No.2	Appendix A of Stipulation
GS \$ Share (% x \$120 million)	\$31.7 million	\$20.0 million	\$29.6 million

As can be seen in this table, the Rate GS class would realize significant relief from its subsidy under the Settlement. The result for the Rate GS class is very close to the result the GS class would have realized if the OSBA had prevailed after full litigation of this issue.

D. REPLY TO PHILADELPHIA'S EXCEPTION 3—The Settlement promotes significant economic development without an economic set-aside of nuclear power. (Philadelphia's Exceptions, pp. 15-17)

In their Directed Question No. 3, Commissioners Shane and Cawley asked the parties to consider and comment upon the creation of a pool of energy and capacity (approximately 260 MW) which could be used for economic development purposes at the discretion of the Secretary of the Department of Community and Economic Development. Philadelphia criticizes the Settlement for not incorporating a set-aside of energy via PECO's virtual divestiture to provide economic development for the city and others within the PECO service territory. Philadelphia's Exceptions., pp. 16-17. The

OSBA submits that Philadelphia has not adequately considered the various ramifications of a power set-aside.

In his Supplemental Testimony, OSBA witness Kalcic discussed several of the problems with setting aside a portion of power for economic development purposes. First, such a pool of assets would have to be made available to the Commonwealth at below-market prices in order to be useful as an economic development tool. If PECO were to provide this power at a discount, it is reasonable to conclude that the cost of the discounted power would be counted against the total pool of merger savings to be shared by ratepayers. The result would be fewer dollars for the rate cuts and other consumer, employee, and community benefits Philadelphia claims are already too meager. OSBA St. No. 4, pp. 3-4.

Second, setting aside a considerable amount of merger savings to be used only for economic development would lead to a misallocation of merger benefits across PECO's rate classes. Most of the savings created by the Proposed Merger would be generation-related. It is, therefore, reasonable to conclude that generation-related merger savings would be needed to pay for any below-market power set-aside for economic development. However, generation-related savings are possible only because *all* PECO ratepayers have paid (and continue to pay) for PECO's generation assets. Any attempt to restrict the benefits of generation-related merger savings to a subset of PECO's customers would result in a misallocation of merger savings. It is simply not appropriate to allocate a disproportionate share of the merger savings to any class of customers, including PECO's business classes. OSBA St. No. 4, pp. 3-4.

Philadelphia also fails to recognize that the Settlement does promote economic development in the PECO service territory by providing about \$30 million in rate cuts for small business customers. Economic development will also be enhanced by the transmission and distribution rate cap extension. These economic development benefits will be available sooner, will be shared by more customers, and will be allocated more fairly than the benefits from any power set-aside. OSBA M.B., pp. 11-13.

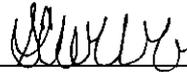
ALJ Chestnut properly disposed of the arguments set forth by Philadelphia for its set-aside recommendation because Philadelphia provided no support for its recommendation and “failed to address the substantial and substantive problems” noted by the OSBA and the other parties. I.D., p. 51.

III. CONCLUSION

For the reasons stated herein, the OSBA respectfully requests that the Commission:

1. Deny the Exceptions;
2. Approve the Settlement without modification; and
3. Approve the Proposed Merger and issue a certificate of public convenience subject to the conditions set forth in the Settlement.

Respectfully submitted,



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Dated: December 30, 2005

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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

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CERTIFICATE OF SERVICE

I certify that I am serving a copy of the Reply Exceptions in the above-captioned proceeding, on behalf of the Office of Small Business Advocate, by e-mail and first class mail (unless otherwise indicated) upon the persons addressed below:

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