

OTS Statement No. 1
Witness: David F. Keim

*DK
9-22-05
phila*

**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

DOCKETED
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**DOCUMENT
FOLDER**

Direct Testimony

of

David F. Keim

Office of Trial Staff

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SEP 26 2005

PA PUBLIC UTILITY COMMISSION
SECRETARY'S BUREAU

Concerning:

Merger Savings and Costs as it Relates to Rates

1 **Q. PLEASE PROVIDE YOUR NAME AND BUSINESS ADDRESS.**

2 A. My name is David F. Keim. My business address is P.O. Box 3265, Harrisburg,
3 Pennsylvania, 17105-3265.

4
5 **Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?**

6 A. I am employed by the Pennsylvania Public Utility Commission as a Fixed Utility
7 Financial Analyst in the Office of Trial Staff (OTS).

8
9 **Q. WHAT IS YOUR EDUCATIONAL, PROFESSIONAL AND**
10 **EMPLOYMENT EXPERIENCE?**

11 A. A summary of my educational, professional, and employment experience is
12 attached as Appendix A.

13
14 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS**
15 **PROCEEDING?**

16 A. The purpose of my testimony is to address the Joint Application of PECO
17 Energy ("PECO") and Public Service Electric and Gas Company ("PSEG") for
18 Approval of the Merger of Public Service Enterprise Group Incorporated with
19 and into Exelon Corporation ("Exelon").

1 **Q. WHAT DOES THE PROPOSED MERGER AGREEMENT PROVIDE?**

2 A. The proposed agreement provides, subject to certain state and federal regulatory
3 approval, that PSEG, a subsidiary of Public Service Enterprise Group, which
4 provides regulated electric and natural gas service in New Jersey, will become a
5 subsidiary of Exelon Energy Delivery Company, LLC (“EEG”). EEG is a first
6 tier subsidiary of Exelon and the immediate parent of PECO and PECO’s
7 Illinois-based affiliated utility, Commonwealth Edison Company (“ComEd”).

8

9 **Q. WHAT IS YOUR RECOMMENDATION REGARDING THE PROPOSED**
10 **MERGER?**

11 A. I recommend that the proposed merger, as filed, be disapproved by the
12 Commission.

13

14 **Q. IN ORDER TO BE APPROVED BY THE COMMISSION, WHAT**
15 **STANDARDS MUST THE PROPOSED MERGER SATISFY?**

16 A. I am advised by counsel that the legal standard this Commission must apply in
17 the review of this merger is found under Chapter 11 of the Public Utility Code,
18 specifically 66 Pa. C.S. §1102 and §1103(a). Section 1103(a) requires the
19 parties to show that the transaction is “necessary or proper for the service,
20 accommodation, convenience, or safety of the public.” The Pennsylvania
21 Supreme Court in City of York v. Pennsylvania Public Utility Commission,

1 295 A.2d 825, 449 Pa.136, (1972) interpreted this statutory requirement in the
2 context of a merger application on p. 141 as follows:

3 Section 203 of the Public Utility Law makes it clear that a
4 certificate of public convenience approving a merger of
5 public utilities is not to be granted unless the Commission is
6 able to find affirmatively that public benefit will result from
7 the merger.

8 The Court further states, at p. 141, that:

9 Section 203 of the Public Utility Law requires that those
10 seeking approval of a utility merger to demonstrate more
11 than mere absence of any adverse effect upon the public.
12 Section 203 requires that the proponents of a merger
13 demonstrate that the merger will affirmatively promote the
14 service, accommodations, convenience, or safety of the
15 public in some substantial way.

16

17 **Q. WHAT IS EEG'S POSITION IN RESPECT TO THE AFFIRMATIVE**
18 **PUBLIC BENEFIT OF THE MERGER?**

19 A. The testimony of Denis O'Brien (PECO St. No. 1, pp.6-8) provides the
20 affirmative public benefits of the merger. These claimed benefits are:

- 21 1. Increased Scale, Scope and Diversity. The merger will
22 increase the scale and scope of the combined energy
23 delivery and generation businesses. For retail utility
24 operations, this means a larger geographic "footprint" and,
25 as a result, a more diverse customer base. For the
26 generation business, the combined company's larger
27 portfolio of generation assets will enable it to capture
28 economies of scale and will provide more balance and
29 diversification in terms of geographic location, fuel mix,
30 dispatch and load-serving capacity. Additionally, EEG's
31 overall operations will be more balanced, with
32 approximately half its earnings and cash flow coming

1 from its three regulated utilities and approximately half
2 from the generation business. This greater scale, scope
3 and diversification of the combined company's operations
4 should provide more stable cash flows and greater
5 earnings predictability, thus allowing EEG to maintain a
6 strong balance sheet and continued access to capital at
7 favorable rates.

- 8 2. Financial Strength and Flexibility. Following the merger,
9 EEG will have \$70 billion in assets, a market
10 capitalization of \$40 billion, annual revenues of \$26
11 billion and annual net income of approximately \$2.6
12 billion. Also, the PECO balance sheet will not change as
13 a result of the merger.
- 14 3. Commitment to High-Quality Service; Sharing of Best
15 Practices. As a result of the merger, PECO will benefit
16 from the opportunity to share best practices with PSEG,
17 while enhancing its ability to continue to provide high-
18 quality service.
- 19 4. Synergies. The proposed merger will create the
20 opportunity to achieve meaningful cost savings not only
21 through the sharing of best practices, but also through the
22 elimination of duplicative functions, improved operating
23 efficiencies in nuclear and other generation operations and
24 supply-chain benefits.
- 25 5. Commitment to Competition. The proposed merger will
26 allow EEG to be even more active in promoting
27 competitive markets and developing energy-related
28 services. In addition, it is anticipated that the knowledge
29 and experience of each company will enhance EEG's
30 ability to manage the transition to competition, which will
31 provide benefits for customers and shareholders.

32

33 **Q. DOES THE PROPOSED MERGER PROVIDE SUBSTANTIAL BENEFITS**
34 **TO BOTH CUSTOMERS AND SHAREHOLDERS?**

35 A. No. While the merger will provide substantial benefits to shareholders, the merger
36 provides no identifiable benefits to its customers.

1 **Q. HAS EEG DEMONSTRATED SUBSTANTIAL BENEFITS TO PECO'S**
2 **RATEPAYERS THAT WILL RESULT FROM THE MERGER?**

3 A. No.

4
5 **Q. WHY NOT?**

6 A. In order to meet the burden of establishing substantial benefit to PECO's
7 ratepayers, EEG must first identify the benefits, and then establish that the
8 benefits will occur. Although EEG has identified benefits, it has failed to
9 establish that the benefits are genuine or realistic.

10

11 **Q. WHY DO YOU BELIEVE THAT EEG HAS FAILED TO SATISFY THE**
12 **SUBSTANTIAL BENEFIT STANDARD?**

13 A. With respect to the five "benefits" that I listed from EEG's position, these are
14 general statements that fail to delineate anything quantifiable that will provide
15 actual tangible benefits to PECO's ratepayers.

16

17 **Q. WOULD YOU PLEASE ADDRESS EEG'S FIRST ALLEGED BENEFIT**
18 **THAT THE COMBINATION WILL RESULT IN INCREASED SCALE,**
19 **SCOPE AND DIVERSITY?**

20 A. EEG's claim that the combination will result in increased scope, scale and
21 diversity is speculative. In this regard, EEG states that EEG will be larger and

1 therefore, able to take advantage of economies of scale. However, while EEG
2 has projected future net savings for the years 2006 through 2009 (OTS Ex. No.
3 1, Sch. 1), it has not proposed how these savings would be reflected in rates,
4 other than a speculative reference to future economies that will offset future
5 increases in the cost of providing reliable regulated electric and gas distribution
6 service and result in lower rates than what might otherwise be the case (PECO
7 St. No. 1, p. 10).

8
9 **Q. WOULD YOU ADDRESS THE POTENTIAL BENEFITS TO**
10 **RATEPAYERS FROM MORE BALANCED OPERATIONS OF EEG?**

11 A. While EEG claims that ratepayers will benefit from more balanced operations, it
12 cannot provide any quantification other than that the benefits will be at the
13 Exelon parent level (OTS Ex. No. 1, Sch. 2).

14
15 **Q. WOULD YOU PLEASE ADDRESS EEG'S SECOND ALLEGED BENEFIT**
16 **THAT FINANCIAL STRENGTH AND FLEXIBILITY WILL RESULT**
17 **FROM THE MERGER?**

18 A. EEG's position that there will be no changes in PECO's balance sheet as a result
19 of the merger equates to a maintenance of the status quo and clearly does not
20 identify a benefit resulting from the merger.

1 Q. WOULD YOU PLEASE ADDRESS EEG'S THIRD ALLEGED BENEFIT
2 THAT THERE WILL BE A COMMITMENT TO HIGH QUALITY
3 SERVICE?

4 A. This, again, is nothing more than a maintenance of the status quo. The Public
5 Utility Code currently requires PECO to provide safe, adequate and reliable
6 service. EEG has done nothing more than promise that after the merger the new
7 company will adhere to the Public Utility Code and Commission regulations.
8 Their promise to do what they are already required to do adds nothing in the way
9 of benefits to the public.

10
11 Q. WOULD YOU PLEASE ADDRESS EEG'S FOURTH ALLEGED BENEFIT
12 THAT THE MERGER WILL RESULT IN SYNERGIES?

13 A. EEG claims these synergies are representative of future benefits. However, EEG
14 has not identified the impact of these synergies on the future rates of PECO
15 customers.

16
17 Q. WOULD YOU PLEASE ADDRESS EEG'S FIFTH ALLEGED BENEFIT
18 REGARDING THE COMMITMENT TO COMPETITION?

19 A. PECO already is a competitive provider in Pennsylvania. It is difficult to see
20 how this will provide benefits to PECO ratepayers beyond the competitive
21 opportunities that they already have at their disposal. Furthermore, marketing of

1 power will take place on the non-regulated generation side of EEG, so it
2 becomes difficult to see how and when the PECO ratepayers would benefit from
3 this.

4
5 **Q. DOES PECO QUANTIFY THE EFFECT OF THE MERGER ON ITS**
6 **RATES?**

7 A. Mr. O'Brien states that the merger will have no effect on rates in the short term.
8 This is due to the existence of rate caps on transmission and distribution service
9 which will expire on January 1, 2007 and rate caps on generation service which
10 will be in place until January 2011. Mr. O'Brien further states that the economies
11 of scale which will result from the merger "will help offset future increases in the
12 cost of providing reliable regulated electric and gas service, and thus, may give
13 rise, over time, to lower rates than would otherwise be the case." (PECO St. No. 1,
14 p. 10). Obviously, there is no definite quantifiable plan to lower rates as a result
15 of the merger. Thus, the effect in the future is unknown. Moreover, OTS Ex. No.
16 1, Sch. 2, is PECO's response to an OCA Interrogatory that requests an itemized
17 estimate of the annual dollar savings resulting from the merger and how these
18 reductions will impact PECO's electric distribution ratepayers. In its response,
19 PECO identifies future savings for the years 2006-2009, but does not identify how
20 the customers would directly benefit from these estimated future savings.

21 **Q. IN YOUR OPINION, DOES THE MERGER SATISFY THE LEGAL**
22 **STANDARD PERTAINING TO MERGERS?**

1 A. No. EEG has failed to provide definitive evidence that the merger will provide
2 substantial public benefit. The ratepayers will be no better off after the merger
3 with respect to rates or quality of service.

4

5 **Q. IN YOUR OPINION, SHOULD THE COMMISSION APPROVE THE**
6 **MERGER AS FILED BY PECO?**

7 A. No. The Commission should not approve the merger as filed by PECO. PECO
8 has not provided definitive evidence that the merger will result in substantial
9 public benefit. PECO has not demonstrated that ratepayers would benefit from the
10 merger with respect to rates and the provision of safe, adequate and reliable
11 service.

12

13 **Q. HOWEVER, IF THE PROPOSED MERGER IS APPROVED BY THE**
14 **COMMISSION, DO YOU HAVE A RECOMMENDATION?**

15 A. Yes. If the proposed merger is approved by the Commission, I recommend that
16 the net savings from the new total merged Exelon be allocated 50/50 between the
17 regulated and non-regulated entities in order to determine the proper allocation for
18 PECO distribution customers.

1 **Q. WHAT PERCENT OF NET SAVINGS WAS ALLOCATED TO THE**
2 **REGULATED ENTITIES IN THE FILING?**

3 A. Exelon has proposed to allocate 13% (\$155 million/\$1.184 million) of net savings
4 to the regulated entities. (OTS Ex. No. 1, Sch. 4; PECO St. No. 2, p. 50).

5
6 **Q. WHAT IS THE BASIS FOR YOUR RECOMMENDATION?**

7 A. I have several reasons for my recommendation that net savings be allocated 50/50
8 for regulated and non-regulated entities. First, it is my opinion that it is reasonable
9 to allocate a share of unregulated net savings to PECO ratepayers, since in
10 addition to paying non-regulated generation costs to PECO, these ratepayers also
11 have been bearing, and will continue to bear, the cost of generation stranded costs
12 through the payment of transition charges through 2010. Also, PECO retail rate
13 payers are paying nuclear decommissioning costs through rates, again bearing
14 generation-related costs.

15
16 **Q. ARE PECO RATEPAYERS PAYING FOR STRANDED GENERATION**
17 **COSTS IN THEIR RATES?**

18 A. Yes. Under the terms of the Commission's Final Order in PECO's restructuring
19 proceeding at Docket Nos. R-000973953 and P-00971265, entered May 14, 1998,
20 PECO was authorized to impose on its customers non-bypassable charges to
21 collect Competitive Transition Charges and Intangible Transition Charges in order
22 to recover stranded costs of PECO's generation assets. PECO was authorized to

1 collect these charges through December 31, 2010. Since ratepayers are bearing
2 these generation-related costs through the payment of stranded costs, it is only
3 logical that they should benefit from the proposed merger savings related to
4 generation.

5
6 **Q. WHAT ARE NUCLEAR DECOMMISSIONING COSTS?**

7 A. These are unique costs that electric utilities which own nuclear plants are obligated
8 to pay. These costs are recovered from ratepayers to provide a fund which will be
9 used for the shutdown costs of a nuclear power plant at the end of its useful life.

10
11 **Q. ARE PECO RATEPAYERS RESPONSIBLE FOR NUCLEAR**
12 **DECOMMISSIONING COSTS?**

13 A. Yes. PECO's ratepayers are responsible for the nuclear decommissioning costs
14 for those nuclear generating plants which were owned at December 31, 1999, prior
15 to the completion of the PECO/Unicom merger. Again, this demonstrates a nexus
16 between PECO's regulated customers and its non-regulated operations.

17
18 **Q. HAS PECO IDENTIFIED THE AMOUNT OF NET SAVINGS IT**
19 **BELIEVES SHOULD BE ALLOCATED TO ITS DISTRIBUTION**
20 **RATEPAYERS?**

1 A. Yes. The amount of net savings allocated to PECO's distribution ratepayers is
2 \$35 million over 4 years, or approximately \$9 million per year (PECO St. No. 2,
3 p. 50).

4
5 **Q. HAS PECO PROPOSED TO FLOW ANY OF THESE NET SAVINGS**
6 **BACK TO ITS RATEPAYERS?**

7 A. No.

8
9 **Q. HAVE YOU QUANTIFIED THE TOTAL AMOUNT OF SAVINGS**
10 **ALLOWABLE TO PECO'S RATEPAYERS THAT YOU ARE**
11 **RECOMMENDING?**

12 A. Yes. As shown on OTS Ex. No. 1, Sch. 4, total new company merged net savings
13 are projected to be \$1.184 billion over four years. As shown on OTS Ex. No. 1,
14 Sch. 3, PECO electric ratepayer's share of these savings would be approximately
15 \$134 million over 4 years, or \$33 million per year, as opposed to the \$35 million
16 (over 4 years) or \$9 million (per year) identified by PECO (PECO St. No. 2, p.
17 50). My regulatory net savings allocation to PECO distribution operations is
18 developed on the same basis as that proposed in the filing.

19
20 **Q. HOW DO YOU PROPOSE THAT PECO'S RATEPAYERS BENEFIT**
21 **FROM YOUR RECOMMENDATION?**

1 A. I recommend that PECO's electric distribution rates be reduced by \$33.5 million
2 per year for four years, beginning January 1, 2007. I further recommend that
3 PECO's current electric transmission distribution rate cap be extended until
4 January 1, 2009.

5
6 **Q. WHY DO YOU RECOMMEND A FOUR-YEAR RATE REDUCTION**
7 **ALONG WITH A TWO-YEAR RATE CAP EXTENSION?**

8 A. A \$33.5 million annual reduction per year for four years along with the rate cap
9 extension will provide real, quantifiable benefits to PECO's ratepayers.
10 Additionally, making the reduction effective January 1, 2007 will allow for the
11 effective development of the merger synergies and savings. Furthermore, due to
12 the significant synergies and savings that Exelon will experience in the 2006-2009
13 period, a two year rate cap extension should not be a significant burden for
14 Exelon.

15
16 **Q. WILL PECO'S ELECTRIC CUSTOMERS SEE AN INCREASE IN RATES**
17 **IN 2006 SEPARATE FROM THESE MERGER PROCEEDINGS?**

18 A. Yes. Under the terms of the Joint Petition for Settlement in the PECO/Unicom
19 merger at Docket No. A-00110550F0147, Opinion and Order entered June 22,
20 2000, the parties agreed that:

1 “Over the four-year period beginning January 1,
2 2002 ending December 31, 2005, PECO will
3 reduce its retail electric rates by a total of \$200
4 million. PECO will reduce its retail electric
5 rates by \$60 million in each of the first two
6 years and by \$40 million in each of the last two
7 years.” (p. 8)

8 Since the \$40 million rate reduction will expire at the end of this year,
9 PECO’s retail customers will see an automatic increase in their distribution rates.

10
11 **Q. HOW DOES YOUR RECOMMENDATION IN THE MERGER**
12 **PROCEEDING COMPORT WITH THE EFFECT OF THIS \$40 MILLION**
13 **INCREASE?**

14 A. As a result of my recommendation, PECO rate payers will again experience a
15 measure of rate relief beginning in 2007, along with the extension of the
16 restructuring rate caps.

17
18 **Q. HAS PECO PROPOSED A REDUCTION IN ELECTRIC RATES IN THIS**
19 **PROCEEDING?**

20 A. As I stated previously, PECO has not proposed a reduction in electric rates in this
21 proceeding.

22
23 **Q. DO YOU HAVE A RECOMMENDATION CONCERNING PECO’S GAS**
24 **RATES?**

1 A. Yes. The original proposed savings for PECO's gas operations were \$7 million
2 for 2006-2009, or an average of \$2 million per year (PECO St. No. 2,
3 p. 50). Therefore, I recommend that gas rates be capped for three years until
4 January 1, 2009.

5
6 **Q. WHAT IS THE BASIS FOR YOUR RECOMMENDATION?**

7 A. Since PECO has identified at least \$7 million in net savings for the 2006-2009
8 period and since PECO has not proposed any gas rate reductions in this
9 proceeding, a three-year rate cap will provide gas ratepayers with a measure of
10 reasonable rate stability.

11
12 **Q. HAS PECO PROPOSED CORPORATE SAFEGUARDS TO ENSURE
13 THAT PECO'S CUSTOMERS ARE NOT EXPOSED TO THE RISKS OF
14 EEG'S NON-JURISDICTIONAL OPERATIONS?**

15 A. At pp. 10-11 of Mr. O'Brien's St. No. 1, he addresses the 2000 PECO/Unicom
16 merger in which PECO agreed that the cost of capital used in establishing PECO's
17 retail electric and natural gas rates would "not reflect any risk adjustment
18 associated with its corporate parent Exelon, or any affiliate not regulated by the
19 Commission." In addition, PECO agreed not to guarantee the debt or credit
20 instruments of Exelon or any affiliate not regulated by the Commission; and, not
21 to mortgage utility assets on behalf of Exelon or non-regulated affiliates or extend
22 credit to Exelon or such affiliates for a term of one year or more. Finally, PECO

1 agreed to maintain reasonable accounting controls and pricing protocols to govern
2 transactions with affiliates, and to provide the Commission, OTS, OCA and OSBA
3 reasonable access to the books, records, and personnel of PECO's affiliates, where
4 necessary, in order to adequately review PECO's purchases of goods and services
5 from those affiliates. Mr. O'Brien has reiterated the same pledges in this
6 proceeding (PECO St. No. 1, p. 11).

7
8 **Q. DO YOU BELIEVE THESE CORPORATE SAFEGUARDS WILL BE**
9 **ADEQUATE WITH REGARD TO THE NEWLY MERGED COMPANY?**

10 A. No. While I have no reason to doubt that PECO will adhere to safeguards
11 identified by Mr. O'Brien, I believe this Commission should articulate additional
12 requirements that will further ensure the protection of PECO's ratepayers.

13
14 **Q. WHAT ARE THESE ADDITIONAL REQUIREMENTS?**

15 A. The additional requirements are as follows:

- 16 1. Within 45 days of the end of calendar years 2006-2009,
17 PECO shall file detailed annual reports regarding actual
18 savings and cost reductions which result from the merger.
- 19 2. Exelon or its subsidiaries shall not subsidize their
20 activities by allocating or directly charging PECO,
21 expenses not authorized by the Commission to be so
22 allocated or directly charged.

1 **Q. WHY IS THE FIRST ADDITIONAL CORPORATE SAFEGUARD**
2 **NECESSARY?**

3 A. My first safeguard recommendation is necessary because it is important that the
4 Commission be kept apprised of PECO's and Exelon's progress in implementing
5 the merger goals and realizing the projected saving synergies. Since the proposed
6 merger has such a large impact on Pennsylvania's ratepayers; it will be the largest
7 electric utility in the United States, with multi-state jurisdictions; it is critical that
8 the Commission has the necessary information to ensure that PECO's customers
9 are receiving their appropriate share of the merger benefits.

10

11 **Q. WHY IS THE SECOND ADDITIONAL CORPORATE SAFEGUARD**
12 **NECESSARY?**

13 A. This recommendation firmly delineates the responsibility of PECO to ensure that
14 its ratepayers are bearing their appropriate revenue requirement and not
15 subsidizing the customers of other jurisdictions.

16

17 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

18 A. Yes.

**Professional and Educational Experience of
David F. Keim**

Professional Certification

Certified Public Accountant, Pennsylvania, 1982.

Professional Experience

September 1984 to Present: Pennsylvania Public Utility Commission, Harrisburg, Pennsylvania.- Fixed Utility Financial Analyst - Responsible, primarily for the review of rate design and revenue and expenses as part of the evaluation and recommendation process for water, electric, gas and telephone utility rate filings.

June 1979 to September 1984: Pennsylvania Public Utility Commission, Harrisburg, Pennsylvania - Public Utility Auditor - Participated in the coordination of the Management Audit program of the thirty largest utilities within Pennsylvania. Selected national consulting firms for management audits and monitored their progress to ensure an objective report. Performed, as in-charge auditor, financial audits of gas and electric utilities.

Education

Bachelor of Science, Accounting, Pennsylvania State University, 1978

Various AICPA and PICPA sponsored courses for continuing professional education.

Continuing education in utility regulation and accounting.

Testimony

Before the Pennsylvania Public Utility Commission:

R-842769 - Equitable Gas Company

R-860296 - National Fuel Gas Distribution Corp.
R-860314 - Columbia Gas of Pennsylvania, Inc.
R-850287 - National Fuel Gas Distribution Corp.
R-870665 - UGI Corp. - Gas Division
R-870719 - National Fuel Gas Distribution Corp.
R-870832 - Columbia Gas of Pennsylvania, Inc.
R-880961 - The Peoples Natural Gas Company
R-881089 - Philadelphia Electric Company
R-891218 - National Fuel Gas Distribution Corp.
R-891468 - Columbia Gas of Pennsylvania, Inc.
R-901670 - National Fuel Gas Distribution Corp.
R-901726 - Pennsylvania Gas and Water Company
R-901873 - Columbia Gas of Pennsylvania, Inc.
R-911886 - Columbia Gas of Pennsylvania, Inc.
R-911921 - Columbia Gas of Pennsylvania, Inc.
R-911912 - National Fuel Gas Distribution Corp.
R-910699C002 - Pennsylvania Gas & Water Co. - Gas Division
R-911963 - Roaring Creek Water Company
R-912064 - Bloomsburg Water Company
R-912060 - Shenango Valley Water Company
R-912117 - Fawn Lake Forest Water Company
R-922168 - The York Water Company
R-922314 - Metropolitan Edison Company
R-922428 - Pennsylvania American Water Company
R-922420 - Shenango Valley Water Company
R-922493 - LP Water & Sewer Company
R-00922375 - Colony Water System, Ltd.
R-00932676 - Pennsylvania Gas and Water Company
R-00932667 - Pennsylvania Gas and Water Company
R-00932665 - Roaring Creek Water Company
R-00932862 - UGI Utilities, Inc. - Electric Division
R-00942991 - National Fuel Gas Distribution Corporation
R-00943098 - Borough of Media Water Works
R-00943124 - City of Bethlehem Water Fund
R-00943152 - General Water Works of Pennsylvania, Inc.
R-00943177 - Roaring Creek Water Company
R-00943231 - Pennsylvania-American Water Company
R-00953343 - Philadelphia Suburban Water Company
R-00953300 - Citizen's Utilities Water Company of Pennsylvania
R-00963612 - PG Energy Inc.
R-00973931 - Columbia Gas of Pennsylvania, Inc.
R-00963858 - Equitable Gas Company
R-00974128 - Commonwealth Telephone Company

A-220005 - Township of Falls, Bucks County
R-00974149 - Pennsylvania Power Company
R-00984275 - Manufacturers Water Company
P-00981425 - Pennsylvania Telephone Association
P-00981449 - GTE Chapter 30
R-00994682 - PFG Gas Inc.
R-00994788 - PFG Gas, Inc./North Penn Gas Company
R-00994785 - National Fuel Gas Distribution Corporation
R-00994788 - PFG Gas Inc./North Penn Gas Company
R-00005110 - Columbia Gas of Pennsylvania, Inc.
A-310125 - Application of ATT/TCG
R-00005109 - City of Lancaster Sewer Fund
R-00006042 - Philadelphia Gas Works
R-00016179 - Columbia Gas of Pennsylvania
R-00016297 - City of Lancaster – Water Fund
R-00016339 - Pennsylvania - American Water Company
R-00016750 - Philadelphia Suburban Water Company
P-00021973 - Verizon
R-00027389 - PFG Gas Inc, and North Penn Gas Company
R-00037245 - Columbia Gas of PA, Inc.
R-00038304 - Pennsylvania - American Water Company
R-00038805 - Aqua Pennsylvania, Inc.
R-00049108 - NFG Gas Distribution
R-00049313 - Wellsboro Electric Co.
R-00049424 - PFG Gas, Inc.
R-00049557 - Falls Township - Sewer
R-00049884 - Pike County L&P - Gas Division

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PECO Energy Company and Public Service Electric and Gas Company
Docket No. A-110550F0160

OCA - SET III- QUESTION #6:

Please describe in detail how electric customers in Pennsylvania will benefit from more balanced operations, with half of earnings and cash flow coming from unregulated operations. Provide a list of savings and a four-year itemized estimate.

OCA - SET III -RESPONSE #6

The benefits of balanced operations reside at the Exelon parent level. The stability provided by a business that is equally balanced between regulated and non-regulated operations reduces exposure to potential adverse events that may affect particular business operations and offers greater protection from short-term market dislocations.

However, at this point, any benefits to ratepayers from the above qualitative factors cannot be quantified. Please see responses to OCA-III-7 and OCA-III-8

Responsible Witness: Denis P. O'Brien

PECO Energy Company and Public Service Electric and Gas Company
Docket No. A-110550F0160

OCA - SET III- QUESTION #5:

Regarding page 6, please describe in greater detail how electric customers in Pennsylvania will benefit from Increased Scale, Increased Scope, and Increased Operational Diversity that could result from the merger. Specifically, provide a four-year, itemized estimate of the annual dollar savings to ratepayers in Pennsylvania for each of these merger benefits.

OCA - SET III -RESPONSE #5

The Company has not quantified the benefits in the manner envisioned in the question. Total synergies have been quantified and are summarized as shown in PECO Statement No. 2, Direct Testimony of William D. Arndt, page 50 and WDA Exhibit 6, indicating the total four-year net regulated savings assignable to PA are \$45.5 Million. The net regulated savings on an annual basis for the four year period (2006-2009), are as follows: 2006: (\$16.5M), 2007: \$11.0M, 2008: \$22.2M, 2009: \$28.8M. The identified synergies as created as a result of the increased scale, scope and operational diversity of the consolidated entity.

Responsible Witness: Denis P. O'Brien

**OTS Exhibit No. 1
Schedule 3**

**Docket No. A-1105F0160
PECO Energy Company
OTS Allocation of Merger Savings to PECO Electric Customers**

Total Merged Company Regulated Savings	\$1,185 (a)
OTS 50% recommended savings allocation to regulated customers	<u>50%</u>
OTS Net regulated savings	\$593
PA Share of Total four - year electric distribution net savings percentage	<u>22.6% (b)</u>
PECO Energy share of electric distribution net savings	<u><u>\$134</u></u>

(a) OTS Exhibit No. 1, Schedule 4.

(b) (\$35/\$155) per Arndt testimony, p. 50.

note: all dollars in millions of dollars.

OCA SET XI- QUESTION #1:

WDA Exhibit 6 is a chart that depicts how regulated savings are allocated amongst the various regulated entities. Please provide a similar chart of unregulated entities. Also fill in the following table, correcting any existing entries.

FOUR YEAR SAVINGS

<u>Synergy</u>	<u>Regulated</u>	<u>Unregulated</u>	<u>Total Merged Co.</u>
Alloc Corp / SS	\$298.759	\$447.446	\$746.205
Direct Savings	\$235.947		
Gross savings	\$534.706		
Cost to Achieve	\$357.748	\$333.175	\$690.923
pre merger initiatives	\$22.349		
Net Savings	\$154.609		

OCA SET XI- RESPONSE #1:

The table above has been completed for the unregulated entities. Corporate and shared services savings have not been allocated to unregulated businesses in any further detail than as described in the table above..

FOUR YEAR SAVINGS			
<u>Synergy</u>	<u>Regulated</u>	<u>Unregulated</u>	<u>Total Merged Co.</u>
Alloc Corp / SS	\$298.759	\$447.446	\$746.205
Direct Savings	\$235.947	\$937.979	\$1,173.926
Gross savings	\$534.706	\$1,385.425	\$1,920.131
Cost to Achieve	\$357.748	\$333.175	\$690.923
pre merger initiatives	\$22.349	\$22.240	\$44.589
Net Savings	\$154.609	\$1,030.010	\$1,184.619

Responsible Witness: William D. Arndt

OTS Statement No. 1-SR
Witness: David F. Keim

JK
9-22-05
Phila

**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

DOCKETED
NOV 10 2005

Surrebuttal Testimony

of

David F. Keim

Office of Trial Staff

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SEP 26 2005

PA PUBLIC UTILITY COMMISSION
SECRETARY'S BUREAU

Concerning:

Merger Savings and Costs as it Relates to Rates

1 **Q. WOULD YOU STATE YOUR NAME AND BUSINESS ADDRESS?**

2 A. My name is David F. Keim. My business address is P. O. Box 3265,
3 Harrisburg, PA, 17105-3265

4
5 **Q. HAVE YOU PREVIOUSLY SUBMITTED DIRECT TESTIMONY IN**
6 **THIS PROCEEDING?**

7 A. Yes. My OTS Statement No. 1 and OTS Exhibit No. 1 were submitted on June
8 28, 2005.

9
10 **Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?**

11 A. The purpose of my surrebuttal testimony is to respond to the rebuttal testimonies
12 of PECO witnesses Denis P. O'Brien, William D. Arndt, and J. Gregory Sidak,
13 and OSBA witness Brian Kalcic.

14
15 **Denis P. O'Brien**

16 **Q. WOULD YOU SUMMARIZE MR. O'BRIEN'S REBUTTAL TESTIMONY?**

17 A. Yes. Mr. O'Brien addresses the direct testimonies of those parties, including
18 myself, who have recommended the sharing of the merger savings through rate
19 reductions and rate cap extensions. Mr. O'Brien cites numerous reasons why such
20 actions present numerous problems and risks for PECO (PECO St. No. 1-R, p. 43).

1 Q. WHAT ARE SOME OF THE PROBLEMS AND RISKS CITED BY MR.
2 O'BRIEN?

3 A. Mr. O'Brien claims that there are many unforeseen market and regulatory
4 variables driving PECO's costs and it is unknown what these future costs will be.
5 These costs include rising labor rates and benefits, weather, normal increases in
6 materials, inflationary pressures that drive credit and cost of capital, and the
7 ongoing potential for costly changes to the federal and state regulatory landscape
8 (PECO St. No. 1-R, p. 44). Furthermore, he states that the interveners have
9 ignored the enormous market and regulatory risks associated with a guaranteed
10 rate reduction package coupled with a rate stay-out period beyond December 31,
11 2006, and that costs to achieve the merger savings are heavily front-loaded in the
12 first few years following the merger.

13
14 Q. HAS MR. O'BRIEN RECOMMENDED THE SHARING OF MERGER
15 SAVINGS WITH PECO'S CUSTOMERS?

16 A. He states that PECO has always recognized that its regulated synergy savings
17 should be shared with its customers. However, he still maintains that this should
18 be accomplished through alleviation of future rate increases, rather than rate
19 discounts and rate stability (PECO St. No. 1-R, p. 45).

20
21 Q. DID MR. O'BRIEN ADDRESS THE AMOUNT OF MERGER SAVINGS
22 OF THE INTERVENERS?

1 A. Yes. At p. 46, lines 13-16 of his rebuttal testimony, Mr. O'Brien cites an amount
2 of over \$900 million, which represents the total of shared merger savings
3 demanded by the interveners. Obviously, the total of these amounts has no
4 relevance to the individual positions of the parties since the maximum shared
5 amount was \$347 million, as recommended by OSBA, while the minimum was
6 \$134 million, as recommended by OTS. OTS represents the public interest in this
7 proceeding and our conservative recommendation satisfies the concerns expressed
8 by Mr. O'Brien.

9
10 **Q. WOULD YOU ADDRESS THE FUTURE PROBLEMS AND RISKS CITED**
11 **BY MR. O'BRIEN?**

12 A. I agree with Mr. O'Brien that there may be unknown future market and regulatory
13 variables that will drive costs. However, as I will explain in my response to Mr.
14 Arndt's rebuttal testimony, whether or not such increases will occur in the future,
15 based on past occurrence, is unknown. While I understand the concerns of Mr.
16 O'Brien regarding the alleviation or postponement of future rate increases as
17 opposed to rate discounts or rate stability, it is my opinion that employment of my
18 two-year recommended rate cap extension, along with a total rate reduction of
19 \$134 million, based upon the annual merger savings reports that I proposed to be
20 filed yearly with the Commission, is a reasonable compromise between PECO's
21 position and that of the other intervening parties, while at the same time, offering
22 rate relief to PECO's customer stakeholders.

1 Q. UNDER PECO'S POSITION REGARDING FUTURE RATE INCREASES,
2 COULD YOU JUSTIFY A RATE INCREASE?

3 A. Irrespective of the proposed merger, it is not known if PECO could justify a base
4 rate increase after the expiration of the rate caps in 2006. PECO argues that the
5 postponement of future rate increases benefits the customers. However, delaying
6 rate increases that may never be filed presents no benefit to PECO's ratepayers.
7 By not allocating the projected merger savings to the customers, all synergies and
8 savings would flow to the bottom line.

9
10 William D. Arndt

11 Q. WOULD YOU SUMMARIZE MR. ARNDT'S REBUTTAL TESTIMONY?

12 A. Yes. Mr. Arndt takes exception to my recommendation that PECO be required to
13 file detailed annual reports with the Commission regarding actual savings and cost
14 reductions that would result from the merger within 45 days of the end of calendar
15 years 2006-2009. Mr. Arndt claims that due to changing market and business
16 environment conditions, it will be difficult for PECO to measure actual savings
17 and cost reductions arising from the merger (PECO St. No. 2-R, pp. 12-13). He
18 goes on to cite the changes that the newly created Exelon had to make due to the
19 California energy crisis, collapse of Enron, general economic slowdown, emphasis
20 on deregulated markets, and increasing generation reserves. These events resulted
21 in a complete organization re-assessment because of the changing business
22 conditions. As such, the anticipated synergies made possible by the merger, and

1 the benefits of restructuring and cost containment after the merger, were difficult
2 to determine.

3 Mr. Arndt further states that a requirement to specifically identify the
4 savings and costs attributable to the merger would be an artificial and onerous
5 condition, and one whose benefit is unclear due to the questionable results it
6 would produce. He also states that such a reporting requirement, as proposed by
7 OTS, was not adopted in the PECO-Unicom merger, or any other utility merger in
8 Pennsylvania. Mr. Arndt maintains that Exelon has used the same method used in
9 the prior merger to identify and quantify the merger synergies and costs to achieve
10 in the current proposed merger. In addition, a broad group of experienced
11 management personnel from Exelon, PSEG, and consultants from Booz Allen
12 Hamilton participated in the determination of the merger synergies and savings.

13
14 **Q. DO YOU AGREE WITH MR. ARNDT'S REBUTTAL TESTIMONY?**

15 **A.** No, I do not. There are several reasons why my recommendation is necessary
16 despite Mr. Arndt's claims. First, the sheer size of the new Exelon with its various
17 multi-state jurisdictions, both regulated and unregulated, will make it difficult for
18 the Commission to determine that PECO rate payers are receiving their share of
19 realized merger savings and cost reductions. Second, since Exelon has not
20 proposed reducing the rates of PECO ratepayer's based on its savings and cost
21 reduction estimates, it is critical that the Commission have the necessary
22 information in order to monitor the ongoing progress of the implementation of the

1 merger on PECO operations. Third, even though a safeguard recommendation
2 similar to the one I have proposed has never been adopted by the Commission in
3 any prior merger, in my opinion, the sheer size and scope of the new Exelon calls
4 for a monitor to guide the Commission in meeting its mandate of fair and
5 reasonable rates. Finally, Mr. Arndt's reliance on the California energy crises, the
6 Enron collapse, general economic slowdown and structural changes in the electric
7 industry are the very reasons that OTS has recommended that its safeguard
8 recommendations be part of the Commission's decision in this proceeding.

9
10 **Q. WOULD YOU ADDRESS MR. ARNDT'S CLAIM THAT THE EVENTS**
11 **THAT OCCURRED AFTER THE PECO-UNICOM MERGER AFFECTED**
12 **THE ACHIEVEMENT OF MERGER SAVINGS AND COST**
13 **REDUCTIONS?**

14 **A.** While the events stated by Mr. Arndt in his rebuttal certainly had an impact on the
15 electric utility industry, it is not possible to say that such events will occur in the
16 future following this proposed merger. While one cannot forecast the future, the
17 possibility of future events occurring is not justification for the Company to not
18 make an attempt to quantify actual merger savings and implement cost reductions.

1 **J. GREGORY SIDAK**

2 **Q. WOULD YOU SUMMARIZE MR. SIDAK'S REBUTTAL TESTIMONY?**

3 A. Yes. Mr. Sidak states that my recommendation to allocate 50% of the generation
4 net merger savings to the distribution function is inconsistent with the Electric
5 Generation Customer Choice and Competition Act (Act). He maintains that non-
6 regulated generation costs are stranded costs, and therefore, are immune from
7 regulatory action since the OTS proposal to capture the merger synergies and asset
8 sale proceeds for the benefit of PECO's customers is an attempt to reopen the
9 Commission's Order approving the Restructuring Settlement and unilaterally
10 change its terms.

11
12 **Q. DOES MR. SIDAK EQUATE YOUR PROPOSED ALLOCATION OF**
13 **GENERATION RELATED COSTS WITH THE RECOVERY OF**
14 **STRANDED GENERATION COSTS?**

15 A. Yes. Mr. Sidak essentially bases his argument on the fact that generation costs are
16 stranded costs and may not be revisited for the purpose of regulatory allocation.
17 He cites a Commonwealth Court decision, *Arippa v. Pennsylvania Public Utility*
18 *Commission*, 792 A. 2d 636 (Pa. Commonwealth 2002), which prevented the
19 Commission from altering previous stranded cost decisions.

20
21 **Q. WOULD YOU ADDRESS THE ARIPPA CASE AND ITS EFFECT ON**
22 **YOUR PROPOSED ALLOCATION?**

1 A. Yes. I have been advised by Counsel that Arippa defined what constitutes
2 stranded costs. The Court stated:

3 “[s]tranded cost determinations are backward looking
4 in that stranded cost recovery provides a means to pay
5 former monopolies for costs previously incurred or
6 obligated in a regulatory environment that they would
7 be unable to recover through prospective competitive
8 market-determined prices...They were not meant to
9 pay for costs associated with current delivery and
10 generation of electricity.” 792 at 658 n. 42.

11

12 **Q. HOW DOES THIS AFFECT YOUR RECOMMENDATION REGARDING**
13 **THE ALLOCATION OF GENERATION-RELATED MERGER SAVINGS?**

14 A. I have been advised by Counsel that my proposed allocation of generation-related
15 merger savings is distinct from stranded costs in that my allocation deals with
16 prospective merger savings and not retrospective stranded costs. As such, my
17 proposed allocation does not violate the Act’s provisions regarding stranded cost
18 recovery.

19

20 **Q. WOULD YOU ADDRESS MR. SIDAK’S CLAIM THAT YOUR**
21 **RECOMMENDED MERGER SAVINGS ALLOCATION IS CONTRARY**
22 **TO DUE PROCESS AND WOULD HARM ECONOMIC WELFARE?**

23 A. Yes. One facet of this argument has to be kept in mind: the merger savings
24 allocation I have recommended is based on estimates of the Company over a four-
25 year period. It is possible that savings could be greater than that projected by the

1 Company. In any case, I would not recommend that PECO allocate more savings
2 than the amount I've recommended; only that PECO ratepayers experience some
3 semblance of rate reduction based on the current merger savings projections.
4 PECO has not recommended that any of its original regulated net merger savings
5 be passed back to its customers; only that it may be able to avoid larger rate
6 increases in the future. In my opinion, the customer stakeholders deserve better
7 than the future possibility of lesser rate increases.

8
9 **Brian Kalcic**

10 **Q. WOULD YOU SUMMARIZE MR. KALCIC'S REBUTTAL TESTIMONY?**

11 A. Yes. Mr. Kalcic criticizes my proposal contained in OTS St. No. 1, p. 13, to pass
12 back my calculation of net merger savings to all PECO's distribution rate classes.

13
14 **Q. WHAT IS THE BASIS FOR MR. KALCIC'S POSITION?**

15 A. Mr. Kalcic includes his rebuttal of my position with his rebuttal of the position of
16 OCA witness Richard LaCapra. Mr. LaCapra recommended a \$200 million
17 reduction over five years on an across the board basis to all distribution rate
18 classes (OCA St. No. 1, p.23). Mr. Kalcic maintains that the adoption of my
19 position, or OCA's, ignores inherent inter-class subsidization within PECO's retail
20 rate classes (OSBA St. No. 2, p. 4). According to Mr. Kalcic, Mr. LaCapra has
21 made his recommendation without the guidance of a class cost of service study.

1 **Q. IS MR. KALCIC CORRECT?**

2 A. In my opinion, no. Mr. LaCapra lays out several arguments that refute the claims
3 of Mr. Kalcic, which I support. Among them are that his distribution revenue
4 requirement is derived from the 1998 PECO Restructuring filing, which utilized
5 1996 costs (OCA St. No. 1-R, p. 3). Mr. LaCapra further asserts that the
6 allocation methodology was from a 1989 base rate case, or earlier. Finally, Mr.
7 LaCapra states that the appropriate proceeding to determine class rate of return
8 *differentials is within the context of a base rate proceeding, where all aspects of*
9 *cost allocation can be determined.* This would include not only the cost of service
10 methodology and the allocators employed, but also rate structure criteria such as
11 the principle of gradualism can be considered and that cost of service study results
12 are a guide and are not an absolute determination of rates for customer class (OCA
13 St. No. 1-R, p. 4). Therefore, I recommend that my allocation of my proposed rate
14 reduction to PECO's distribution rate classes be adopted.

15

16 **Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?**

17 A. Yes.

OTS Statement No. 2-SR
Witness: Michael J. Gruber

OK
9-22-05
Phila

**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

Surrebuttal Testimony

of

Michael J. Gruber

Office of Trial Staff

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NOV 10 2005

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SEP 26 2005

PA PUBLIC UTILITY COMMISSION
SECRETARY'S BUREAU

Concerning:

**Virtual Divestiture
Purchase Limitations
Proceeds From the Sale of Generation Assets**

1 **Q. WOULD YOU PLEASE STATE YOUR NAME AND BUSINESS**
2 **ADDRESS?**

3 A. My name is Michael J. Gruber. My business address is P.O. Box 3265,
4 Harrisburg, Pennsylvania 17105-3265.

5
6 **Q. ARE YOU THE SAME MICHAEL J. GRUBER WHO PRESENTED OTS**
7 **STATEMENT NO. 2?**

8 A. Yes.

9
10 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

11 A. I am responding to PECO's ("PECO" or "Company") rebuttal testimony in PECO
12 Statement No. 12-R, PECO Statement No. 1-R, and PECO Statement No. 3-R.

13
14 **Q. WHAT SPECIFIC ISSUES ARE YOU ADDRESSING IN YOUR**
15 **TESTIMONY?**

16 A. I am addressing how the proceeds from the sale of generation should be used,
17 virtual divestiture of the nuclear generation, and the limits imposed by Exelon on
18 which entities would be permitted to purchase its generation.

19
20 **Q. WHAT COMMENTS DO YOU HAVE CONCERNING THE DISPOSITION**
21 **OF THE PROCEEDS FROM EXELON'S SALE OF SOME OF ITS**
22 **GENERATING UNITS?**

1 A. As indicated in my prior testimony, it is my opinion that a portion of the proceeds
2 from the sale of generation should be used to offset PECO's Intangible Transition
3 Charges ("ITC") or Competitive Transition Charges ("CTC"). With regard to this
4 recommendation, Company witness Sidak has accused me of trying to "capture
5 value from an unregulated subsidiary of Exelon for the benefit of PECO's
6 regulated business." (PECO Statement No. 12-R, pp. 24-25). However, this
7 criticism misses the point. My recommendation is that the regulated Company not
8 be allowed to continue charging ratepayers for the stranded cost associated with
9 plant that is sold. The overall level of stranded cost approved by the Commission
10 will not change. My proposal simply changes where the revenue to pay for the
11 stranded cost comes from.

12
13 **Q. WHY DO YOU BELIEVE THAT THERE COULD BE GENERATION-**
14 **RELATED STRANDED COSTS CONTAINED IN THE CTC OR ITC**
15 **ASSOCIATED WITH THE GENERATION UNITS WHICH WILL BE**
16 **DIVESTED?**

17 A. Section 2803 of the Competition Act states that the purpose of the CTC is to
18 recover an electric utility's transition or stranded costs. It further defines
19 transition or stranded costs to include net electric generation costs which include
20 net plant investments and costs attributable to the utility's existing generation
21 plants and facilities.

1 **Q. WHAT PORTION OF THE PROCEEDS SHOULD BE CREDITED**
2 **AGAINST THE CTC AND ITC?**

3 A. The level of stranded generation costs for PECO was determined in the
4 Company's restructuring proceeding and based in part upon PECO's investment in
5 generation as of December 31, 1998. The CTC and the ITC were set up to collect
6 the stranded costs. Each generating unit owned by PECO at that time contributed
7 to the total overall stranded costs. In the intervening years the Company has been
8 collecting the stranded costs associated with the generation through a levelized
9 charge. The collection of the CTC and ITC is scheduled to continue until 2010.
10 This indicates that the ratepayers will continue paying for generation plant through
11 these charges.

12 My recommendation is to determine the value of each generation unit's
13 level of unrecovered stranded costs and deduct that from the proceeds of the sale
14 of those units. This calculation would be made for each divested unit which is
15 part of the CTC and ITC collection. Consequently, if a unit being divested was
16 *not part of the stranded cost, the ratepayers would not receive any of the revenue*
17 *from the sale. Once the remaining associated stranded costs were satisfied, any*
18 *revenue over and above the stranded cost would go to the generating company.*

19
20 **Q. COULD YOU GIVE AN EXAMPLE OF HOW YOUR PROPOSED**
21 **ADJUSTMENT WOULD BE CALCULATED?**

1 A. Yes. Assume the value of a unit being divested was included in stranded cost and
2 valued at \$100 million. Assume further that the sale price is \$100 million. The
3 adjustment would need a determination of the level of stranded cost collected in
4 the CTC and/or ITC that is associated with this unit. Assume the amount collected
5 was \$50 million. Accordingly, the difference between the original stranded cost
6 value (\$100 million) and the recovered stranded cost (\$50 million) would result in
7 a \$50 million remaining value. The sale price of \$100 million would be used to
8 cover the remaining \$50 million value of stranded costs, be deducted from the sale
9 price and credited to the remaining CTC or ITC totals, giving the generating
10 company a profit of \$50 million.

11

12 **Q. WHY SHOULD PECO USE THE PROCEEDS OF THE SALE OF**
13 **DIVESTED GENERATION TO OFFSET THE CTC AND ITC CHARGES?**

14 A. In approving PECO's restructuring settlement agreement, the Commission
15 determined that:

16 "...PECO's generating assets have a residual value
17 that will be available for PECO's use in easing its
18 transition to competitive markets, even if such value
19 was not directly quantified in the determination of the
20 stranded cost. For example, a generating asset may
21 have additional value because of existing connection
22 to the transmission system or more intensive use of the
23 site. Once stranded investment recovery is complete,
24 PECO is free to operate, shut down, or sell the plant as
25 it deems fit."

26 *Application of PECO Energy Company for Approval of its Restructuring*
27 *Plan, 181 P.U.R. 4th 517, 562 (December 23, 1997).*

1 Further, the Commission also stated that:

2 Section 2808(a) makes the recovery of stranded costs
3 for a generation asset “contingent on continued
4 operation at reasonable availability levels of the
5 generation facilities for which recovery has been
6 approved, except when the generation facility is
7 uneconomic on a production cost basis because of the
8 transition to a competitive market.” Thus, upon
9 transfer, stranded costs associated with the asset would
10 be removed from the CTC.

11 *Id.* at FN. 101. (Emphasis added)

12 I believe this statement indicates that the proceeds from the sale of any
13 generation unit covered by the CTC or ITC should have its stranded cost paid off
14 before the generating unit could be sold. However, if a generating unit is sold
15 prior to the complete recovery of its stranded costs, the remaining value of the
16 CTC and/or ITC attributable to that particular unit should be credited from the
17 proceeds of the sale up to the full unrecovered portions of those charges.

18
19 **Q. HOW WOULD THE RATES CHARGED TO PECO’S REGULATED**
20 **CUSTOMERS BE AFFECTED?**

21 A. In the short run there would probably be no impact on PECO’s rates. The biggest
22 impact would be that the CTC and ITC obligation of PECO’s customers would be
23 met sooner. This would bring about the end of the rate cap and it would allow the
24 Company to transition to competition based rates sooner.

1 **Q. THE COMPANY CONTENDS THAT YOUR ADJUSTMENT VIOLATES**
2 **THE COMPETITION ACT BY REGULATING GENERATION PLANT.**
3 **DO YOU AGREE?**

4 A. No. I am sure my recommendation does not violate the Competition Act since it
5 states that a company is not entitled to any proceeds from the sale of its stranded
6 generation until the CTC recovery period is completed. The Commission will not
7 be regulating the generation companies if it accepts my recommendation; the
8 Commission will only be following its mandate by protecting the Pennsylvania
9 jurisdictional ratepayers by ensuring that any proceeds from the sale of generation
10 will be used to offset PECO's CTC.

11

12 **Q. DO YOU HAVE ANYTHING FURTHER TO ADD?**

13 A. Yes. On Page 11 of PECO Statement No. 12-R, Mr. Sidak seems to use the
14 ARIPPA decision to argue against my adjustment. I am informed by my attorney
15 that this decision deals with the level of the stranded costs as they were approved
16 in the restructuring proceeding. As such, this argument has nothing to do with my
17 adjustment. I am not recommending any change in the approved level of stranded
18 cost. It is my position that to the extent there is any remaining stranded costs
19 associated with generation units which are being divested, such costs should be
20 recovered from the proceeds of the sale.

21

22

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1 Q. DOES THIS CONCLUDE YOUR TESTIMONY?

2 A. Yes.

OTS Statement No. 3
Witness: Kevan L. Deardorff

*gk
9-22-05
phila*

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

Docket No. A-110550F0160

**DOCUMENT
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Direct Testimony

of

Kevan L. Deardorff

Office of Trial Staff

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SEP 26 2005

**PA PUBLIC UTILITY COMMISSION
SECRETARY'S BUREAU**

Concerning:

Ring-Fencing

1 Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

2 A. My name is Kevan L. Deardorff. My business address is Pennsylvania Public
3 Utility Commission, P.O. Box 3265, Harrisburg, Pa. 17105-3265.

4

5 Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

6 A. I am currently employed by the Pennsylvania Public Utility Commission as a
7 Fixed Utility Financial Analyst. I am assigned to the Office of Trial Staff as an
8 expert witness.

9

10 Q. WHAT IS YOUR EDUCATIONAL AND PROFESSIONAL
11 BACKGROUND?

12 A. I have prepared this information and presented it in Appendix A which is
13 attached to my direct testimony.

14

15 Subject of Testimony

16 Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

17 A. The purpose of my testimony is to recommend actions that PECO Energy
18 Company ("PECO" or "Company") should take if the Commission decides to
19 approve the merger of Exelon Corporation ("Exelon") and Public Service
20 Enterprise Group Incorporated ("PSEG"). These recommendations are in
21 response to the inadequate safeguards PECO and Exelon have agreed to in order

1 to assure that PECO's customers are not exposed to the risks attendant to
2 Exelon's non-jurisdictional operations.

3
4 **Q. DOES YOUR DIRECT TESTIMONY INCLUDE AN EXHIBIT?**

5 A. Yes. OTS Exhibit No. 3 presents evidence in support of my position.

6
7 **Company Position**

8 **Q. WHAT IS THE COMPANY'S POSITION?**

9 A. The Company believes that the conditions agreed to in the 2000 PECO/Unicom
10 merger proceeding are sufficient to protect PECO's customers from the
11 heightened risks associated with Exelon's non-jurisdictional operations. This
12 protection is commonly referred to as "ring-fencing."

13
14 **Q. WHAT ARE THE CONDITIONS PECO AGREED TO IN THE 2000**
15 **PECO/UNICOM MERGER?**

16 A. The conditions set forth in that settlement were as follows:

- 17 • First, the cost of capital used in establishing PECO's retail electric and
18 natural gas rates would not reflect any risk adjustment associated with its
19 corporate parent Exelon, or any affiliate not regulated by the Commission.
20 • Second, PECO would not, without Commission authorization:

- 1 1. guarantee the debt or credit instruments of Exelon or any affiliate
- 2 not regulated by the Commission;
- 3 2. mortgage utility assets on behalf of Exelon or such affiliates; or
- 4 3. loan money or otherwise extend credit to Exelon or such
- 5 affiliates for a term of one year or more.

- 6 • Third, PECO will maintain reasonable accounting controls and pricing
- 7 protocols to govern transactions with affiliates, and provide the
- 8 Commission, the OTS, the OCA and the OSBA reasonable access to the
- 9 books, records and personnel of PECO's affiliates where necessary for the
- 10 Commission to adequately review PECO's purchases of goods or services
- 11 from those affiliates.
- 12 • Fourth, Pennsylvania retail customers would not be charged certain costs,
- 13 including nuclear decommissioning expense, associated with the ownership
- 14 and operations of any nuclear generating plants that it did not hold on
- 15 December 31, 1999.

16 (PECO St. No. 1, Direct Testimony of Denis O'Brian, p. 11)

1 **OTS's Position**

2 **Q. IN YOUR OPINION, ARE THE CONDITIONS PREVIOUSLY**
3 **AGREED TO BY PECO SUFFICIENT TO PROTECT PECO**
4 **CUSTOMERS IN CONNECTION WITH THE INSTANT PROPOSED**
5 **MERGER?**

6 A. No. It is my opinion that the four conditions listed above are not sufficient
7 “ring-fencing” to protect PECO’s customers from the additional risks associated
8 with Exelon’s non-jurisdictional operations¹.

9
10 **Q. WHY DO YOU BELIEVE THE RING-FENCING IS NOT SUFFICIENT?**

11 A. Schedule 1 of OTS Exhibit No. 3 presents the latest S&P research report on
12 PECO Energy Company. This report states that the ratings on Exelon and its
13 subsidiaries, including PECO, are on CreditWatch with negative implications in
14 response to the announced merger between Exelon and PSEG. If PECO were
15 properly ring-fenced, the merger would have no potential impact on PECO’s
16 ratings; thus, the CreditWatch on PECO would not have been necessary.

¹ Ring-fencing is any means employed to separate specific assets of a corporate group from the risk or creditworthiness of the entire group. Specific to debt capital markets, it refers to methods and techniques employed to isolate the credit risks of a subsidiary from the creditworthiness of the parent company or corporate group such that the credit rating of the subsidiary can be rated higher than the group as a whole.

1 Q. WHAT ADDITIONAL CONDITIONS SHOULD BE REQUIRED OF
2 PECO, IN YOUR OPINION, SO THAT RING-FENCING WOULD BE
3 STRENGTHENED?

4 A. I believe the following five conditions concerning the cost of capital would help
5 to better ring-fence PECO:

- 6 • First, PECO will continue to maintain separate debt;
- 7 • Second, the costs of capital for rate making purposes will not rise as a result
8 of a credit downgrade caused by the merger;
- 9 • Third, Exelon and PECO will provide the Commission unrestricted access
10 to all written information provided to common stock, bond, or bond rating
11 analysts, which directly or indirectly pertains to PECO or any affiliate that
12 exercises influence or control over PECO. This information would include
13 reports provided to and presentations made to common stock analysts and
14 bond rating analysts;
- 15 • Fourth, PECO will not make any distribution from common equity that
16 would cause PECO's common equity ratio to fall below 48 percent. All
17 parties may re-examine this minimum threshold as financial conditions
18 change, and may request that it be adjusted; and
- 19 • Fifth, Exelon shall notify the Commission of:

- 1 1. Its intention to transfer more than 5 percent of PECO's retained
2 earnings to Exelon over a six-month period at least 60 days
3 before such a transfer begins;
- 4 2. Its intention to declare a special cash dividend from PECO at
5 least 30 days before declaring the dividend; and
- 6 3. Its most recent quarterly common stock cash dividend payment
7 from PECO within 30 days after declaring the dividend.

8

9 **Q. WHY DID YOU CHOOSE 48 PERCENT AS A MINIMUM COMMON**
10 **EQUITY RATIO?**

11 A. The S&P report presented in Schedule 1 of OTS Exhibit No. 3 indicates that
12 *PECO has been assigned a business profile of 4 and a debt rating of "A-". In*
13 *order to maintain a credit rating of "A", S&P requires, as a minimum, a 48%*
14 *equity ratio for a utility with a business position of 4. PECO would risk a credit*
15 *down grade if they let their equity ratio fall below the 48% level.*

16

17 **Q. WHAT IS THE PURPOSE OF THE FIFTH CONDITION?**

18 A. The notification requirements for dividend payments and retained earnings
19 transfers for PECO would give the Commission advance warning to a possible
20 decline in PECO's equity ratio.

1 Q. **DOES THIS COMPLETE YOUR TESTIMONY?**

2 A. Yes. However, OTS reserves the right to file supplemental testimony if the
3 response to a cost of capital interrogatory warrants it.

Kevan L. Deardorff
Educational and Professional Background

I am a graduate of the Pennsylvania State University, where I received a Bachelor of Science Degree in Business Economics and Finance and a Master of Arts Degree in Economics. Before coming to the Pennsylvania PUC in 1983, I worked as a consultant for the United States Environmental Protection Agency between 1980 and 1981, and as a Research Economist for the Pennsylvania Department of Commerce during 1982.

I am currently employed as a Fixed Utility Financial Analyst III. I have completed rate of return analyses in a large number of rate cases and assisted in the analyses of many electric, gas, water and telephone rate cases. I have prepared testimony concerning rate of return, discount rate, price cap and merger benefits in the following rate cases:

Keystone Water Company	R-822211-12
	R-822215-19
	R-822221
Western Pennsylvania Water Company	R-832381
Philadelphia Suburban Water Company	R-842592
Duquesne Light Company	R-842583
Western Pennsylvania Water Company	R-842621-25
Riverton Consolidated Water Company	R-842675
Keystone Water Company	R-842755-56
	R-842759
Equitable Gas Company	R-842769
Western Pennsylvania Water Company	R-850096-97
West Penn Power Company	R-850220
Dauphin Consolidated Water Supply Co.	R-860350
Western Pennsylvania Water Company	R-860397
Philadelphia Electric Company (Gas Division)	R-870629
National Fuel Gas Distribution Corp.	R-870719
Western Pennsylvania Water Company	R-870825
Philadelphia Suburban Water Company	R-870840
Equitable Gas Company	R-880971
Chartiers Natural Gas Company	R-891283
Columbia Gas of Pennsylvania, Inc.	R-891468
Arrowhead Public Service Corp.	R-891557
Pennsylvania-American Water Co.	R-901652
Citizens Utilities Water Company of Pennsylvania	R-901663
Citizens Utilities Home Water Company	R-901664

National Fuel Gas Distribution	R-901670
York Water Company	R-901813
Columbia Gas of Pennsylvania, Inc.	R-901873
National Fuel Gas Distribution Corp.	R-911912
The Peoples Natural Gas Company	R-00922180
York Water Company	R-00922168
Pennsylvania & Southern Gas Company	R-00922312
North Penn Gas Company	R-00922276
North East Heat and Light Company	R-00922309
Shenango Valley Water Company	R-00922420
Mechanicsburg Water Company	R-00922502
National Fuel Gas Distribution Corp.	R-00932548
Roaring Creek Water Company	R-00932665
Shenango Valley Water Company	R-00932798
The Peoples Natural Gas Company	R-00932866
Blue Mountain Consolidated Water Co.	R-00932873
Allied Gas Company, et. al.	R-00932952
National Fuel Gas Distribution Corp.	R-00942991
Borough of Media Water Works	R-00943098
Newtown Artesian Water Company	R-00943157
Roaring Creek Water Company	R-00943177
Borough of Schuylkill Haven	R-00943156
Pennsylvania Power & Light Company	R-00943271
National Fuel Gas Distribution Corp.	R-00953299
Frontier Companies	P-00951005
PFG Gas, Inc. and North Penn Gas Company	R-00953524
Commonwealth Telephone Company	P-00961024
PECO Energy Company	R-00973877
PECO Energy Company	R-00973953
Pennsylvania Power & Light Company	R-00973954
Ironton Telephone Company	P-00971182
Metropolitan Edison Company	R-00974008
Pennsylvania Electric Company	R-00974009
Pennsylvania Power Company	R-00974149
PG Energy, Inc.	R-00984280
ALLTEL Pennsylvania, Inc.	P-00981423
Pennsylvania Telephone Association Small Group	P-00981425, <u>et al</u>
United Telephone Company of Pennsylvania	P-00981410
City of Lancaster Water Fund	R-00984567
York Water Company	R-00994605

Pittsburgh Thermal, L.P.	R-00994641
PECO Energy Company	A-110550F0147
City of Lancaster Sewer Fund	R-00005109
PG Energy	R-00005119
City of Lancaster Sewer Fund	R-00005109
PFG Gas, Inc. and North Penn Gas Company	R-00005277
Emporium Water Company	R-00005050
T.W. Phillips Gas and Oil Company	R-00005459
Verizon North, Inc.	P-00001854
Metropolitan Edison Company	P-00001860
Pennsylvania Electric Company	P-00001861
Philadelphia Gas Works	R-00006042
Pennsylvania American Water Company	R-00016339
Wellsboro Electric Company	R-00016356
Verizon Pennsylvania Inc.	R-00016683
Philadelphia Suburban Water Company	R-00016750
Philadelphia Gas Works – Extraordinary Rate Relief	R-00017034F
Verizon Pennsylvania Inc.	P-00930715F0002
The York Water Company	R-00027975
National Fuel Gas Distribution Corp.	R-00038168
Pennsylvania American Water Company	R-00038304
Aqua Pennsylvania, Inc.	R-00038805
Duquesne Light Company	P-00032071
PPL Electric Utilities Corporation	R-00049255
Valley Energy Inc.	R-00049345
Wellsboro Electric Company	R-00049313
National Fuel Gas Distribution Corporation	R-00049656
Pike County Light & Power Company	R-00049884
Township of Falls – Sewer Fund	R-00049557

OTS Exhibit No. 3
Witness: Kevan L. Deardorff

*JK
4.22-05
phila*

**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

Exhibit to Accompany

the

Direct Testimony

of

Kevan L. Deardorff

Office of Trial Staff

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PA PUBLIC UTILITY COMMISSION
SECRETARY'S BUREAU

Concerning:

Ring-Fencing

Research:
PECO Energy Co.

Publication date: 04-Mar-2005
 Primary Credit Analyst(s): John Kennedy, New York (1) 212-438-7670;
 john_kennedy@standardandpoors.com

Corporate Credit Rating

A-/Watch Neg/A-2

Business Profile

1 2 3 **4** 5 6 7 8 9 10

Financial policy

Moderate

Debt maturities

2005 \$427 mil.
 2006 \$446 mil.
 2007 \$271 mil.
 2008 \$942 mil.
 2009 \$85 mil.

Bank lines/Liquid assets

Parent Exelon Corp. has access to a \$500 million revolving credit facility that matures in October 2006, a \$1 billion facility that matures in July 2009, and about \$528 million of unrestricted cash and cash equivalents as of Dec. 31, 2004. Exelon and its subsidiaries meet their short-term liquidity needs with commercial paper, which the credit facilities back up. As of Dec. 31, 2004, there was \$490 million of commercial paper outstanding.

Outstanding Rating(s)

PECO Energy Co.

Sr unsecd debt	
Local currency	BBB+/Watch Neg
Sr secd debt	
Local currency	A-/Watch Neg
CP	
Local currency	/Watch NegA-2
Pfd stk	
Local currency	BBB/Watch Neg

Exelon Corp.

Corporate Credit Rating	A-/Watch Neg/A-2
Sr unsecd debt	
Local currency	BBB+/Watch Neg
CP	
Local currency	/Watch NegA-2

Commonwealth Edison Co.

Corporate Credit Rating	A-/Watch Neg/A-2
Sr unsecd debt	
Local currency	BBB+/Watch Neg

Sr secd debt Local currency	A-/Watch Neg
CP Local currency	/Watch NegA-2
Pfd stk Local currency	BBB/Watch Neg
Preference Stock Local currency	BBB/Watch Neg
Exelon Generation Company LLC	
Corporate Credit Rating	A-/Watch Neg/A-2
Sr unsecd debt Local currency	A-/Watch Neg
CP Local currency	/Watch NegA-2

Corporate Credit Rating History

Apr. 2, 1992	BBB+/A-2
May 3, 1999	A-/A-2

Major Rating Factors

Strengths:

- Supportive electric utility restructuring legislation,
- Stable revenue stream, and
- Ownership of lower-risk electric transmission and distribution system.

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Weaknesses:

- Rate freezes expose the company to nonrecovery of excessive costs.
- Exelon's large off-balance sheet obligations, and
- Noncontiguous service territory with affiliate Commonwealth Edison Co.

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Rationale

The ratings on Exelon Corp. and its subsidiaries PECO Energy Co., Commonwealth Edison Co., and Exelon Generation Co. LLC are on CreditWatch with negative implications in response to the announced merger between Exelon and Public Service Enterprise Group Inc. (Enterprise). If completed, the merger will create the largest utility holding company in the U.S.

Chicago, Ill.-based Exelon has about \$10 billion in debt outstanding, net of stranded-cost securitization bonds. Similarly, Newark, N.J.-based Enterprise has about \$10 billion in outstanding debt, net of stranded-cost securitization bonds.

Standard & Poor's expects to resolve the CreditWatch listings on or near the completion of the merger, after reviewing the business strategy and financial risk profile of the newly combined entity. The transaction is subject to approval from various state and federal agencies, with a closing date targeted for Dec. 31, 2005.

The negative CreditWatch listing for the Exelon companies is an outgrowth of several factors. The ratings for the several Exelon companies had already borne negative outlooks prior to the announcement of the merger because of concerns related to the company's pursuit of growth initiatives that can heighten financial and operating risk. Regulatory uncertainties facing Commonwealth Edison were also factored into the negative outlook.

The merger with Enterprise is emblematic of Exelon's pursuit of growth and will likely place pressure on financial margins in the near term because of the operational challenges that have been plaguing Enterprise's nuclear fleet in the past year and are expected to continue at least through 2005. The combination will also lead to a larger trading and marketing operation, which could heighten risk.

Consequently, these factors mandated a negative CreditWatch listing for Exelon. At the same time, Standard & Poor's recognizes that Exelon has operated the country's largest nuclear fleet efficiently and without incident for several years and can introduce economies of scale and a higher level of operating discipline to Enterprise's nuclear units.

Pending the merger, Exelon will continue to derive its cash flow from the following business segments: 70% from regulated electric transmission and distribution (T&D) operations, which serve a customer base in northern Illinois and southeastern Pennsylvania, and regulated natural gas sales and distribution in southeastern Pennsylvania and 30% from nonregulated owned and contracted electric generation facilities. The company also operates several other nonregulated, diversified businesses.

Exelon's slightly below-average business profile is supported by the utilities' low-risk electric and gas T&D operations, the low production costs of the company's nuclear generating assets, strong transmission links to the Mid-American Interconnected Network (MAIN) and Mid-Atlantic Area Council (MAAC) regions, and supportive restructuring legislation and commission orders in Illinois and Pennsylvania. Restructuring rulings for Commonwealth Edison and PECO Energy in their respective states have minimized the financial risks related to their old nuclear assets by providing an accelerated recovery of the related capital invested in these facilities.

In addition, the company benefits from full-requirements purchased-power contracts between Exelon Generation, Commonwealth Edison, and PECO Energy. These contracts not only mitigate uncertainty associated with the utilities' provider-of-last-resort obligations, which mandate that the companies provide generation services to customers who do not choose alternative suppliers, but also provide substantial certainty to most of the company's power sales.

Minimal fuel source diversity, rate freezes that expose the utilities to nonrecovery of excessive costs, and the company's significant exposure to nuclear assets temper the strengths of Exelon's business profile. The company's nuclear assets consist of 19 operating nuclear units with an equity ownership of 17,000 MW, which represent more than 65% of the company's total owned generation capacity. Although the company's nuclear operations are well diversified, attract talented personnel, and have strong track records, nuclear generation inherently poses numerous operating, regulatory, and environmental risks. In addition, Exelon's disappointing history with and decision to walk away from its investment in Boston Generating LLC demonstrate the inherent market risk associated with the company's nonnuclear merchant assets.

The company's financial strength comes from a strong capital structure, which has been enhanced by securitization financings of \$5 billion by PECO Energy and \$3.4 billion by Commonwealth Edison, healthy internal cash generation, a low dividend payout ratio, and

continued cost-control efforts. However, adjusted for off-balance-sheet obligations (including purchased-power commitments, operating leases, accounts receivable sold, contingent liabilities associated with energy marketing and trading operations, a spent nuclear fuel obligation, and postretirement obligations), credit measures are weak for the current ratings, with adjusted funds from operations (FFO) interest coverage around 4x and adjusted FFO to total debt of roughly 25%. FFO interest coverage of at least 4.5x and FFO to total debt of about 30% would reflect adequate credit measures for the existing rating.

Short-term credit factors

The short-term rating on the company is 'A-2'. During the short term, Standard & Poor's expects cash flow from operations to fully fund maintenance capital expenditures and dividends, despite the potential for material discretionary pension contributions due to the company's underfunded postretirement obligations. The company's cost-reduction program should meaningfully contribute to cash flow, and the its business profile will marginally strengthen as Exelon continues its efforts to sell many of its remaining nonregulated, diversified businesses. However, the expiration of Commonwealth Edison's full-requirements contract in 2006 creates tremendous uncertainty for the consolidated entity. Thus, developments along the regulatory front will be a key credit driver during the short term.

Exelon's liquidity should adequately support working capital needs throughout the year, assuming the company continues to prudently manage risk, particularly at Exelon Generation. Exelon has access to a \$500 million revolving credit facility that matures in October 2006, a \$1 billion facility that matures in July 2009, and about \$528 million of unrestricted cash and cash equivalents as of Dec. 31, 2004. The company and its subsidiaries meet their short-term liquidity needs with commercial paper, which the credit facilities back up. As of Dec. 31, 2004, there was \$490 million of commercial paper outstanding.

Other points of note regarding the company's liquidity include:

- None of Exelon's or its subsidiaries' borrowings are subject to default or prepayment due to a rating downgrade of its securities.
- Aside from securitized debt--the interest and principal payments of which are recovered through rates--the company maintains a reasonable debt maturity profile.
- Failure to maintain an investment-grade rating would allow some of Exelon Generation's counterparties to terminate derivatives and settle transactions on a net present value basis.

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Accounting

Exelon's financial statements are presented in accordance with U.S. GAAP and are audited by PriceWaterhouseCoopers LLP. The financial statements include Exelon's own accounts and the accounts of its majority owned direct and indirect subsidiaries. The company has adopted the provisions of the following accounting standards, which resulted in the changes noted below:

- Statement of Financial Accounting Standards (SFAS) 143 (accounting for asset retirement obligations)--The company restated assets and liabilities for its nonregulated nuclear business and recorded a gain of \$112 million due to a one-

time cumulative effect of accounting change in 2003.

- FIN 46 (consolidation of variable interest entities)--Exelon deconsolidated its interests in seven trusts that were used as financing subsidiaries. This occurred because the expected losses were limited to \$149 million and therefore not considered the primary beneficiary from an economic perspective. The amounts owed to these deconsolidated trusts were recorded as debt to financing trusts or affiliates totaling \$5.342 billion.

The company has also adopted SFAS 150 (accounting for certain financial instruments with characteristics of both liabilities and equity), SFAS 133 (accounting for derivative instruments and hedging activities), EITF 02-03 (issues involved in accounting for derivative contracts held for trading purposes and contracts involved in energy trading and risk management activities), and SFAS 149 (amendment to SFAS 133 on derivative instruments and hedging activities). The adoption of these standards had no material impact on the company's financial statements.

Table 1 Exelon Corp. Peer Comparison			
--Average of past three fiscal years--			
	Exelon Corp.	Dominion Resources Inc.	Southern Co.
Rating	A-/Watch Neg/A-2	BBB+/Negative/A-2	A/Stable/A-1
<i>(Mil. \$)</i>			
Sales	14,735.3	12,089.3	11,234.0
Net income from cont. oper.	1,434.7	1,191.7	1,441.3
Funds from oper. (FFO)	3,718.3	3,267.8	2,916.2
Capital expenditures	1,995.3	2,139.0	2,224.7
Total debt	15,018.3	16,696.1	12,845.0
Preferred stock	256.3	1,080.0	1,234.0
Common equity	8,556.0	10,725.7	9,545.3
Total capital	23,870.3	28,501.8	23,624.3
Ratios			
Adj. EBIT interest coverage (x)	3.9	2.5	4.2
Adj. FFO interest coverage (x)	5.5	3.6	5.5
Adj. FFO/avg. total debt (%)	25.5	17.0	23.0
Net cash flow/capital expenditures (%)	152.6	104.7	86.0
Adj. total debt/capital (%)	63.7	61.0	55.6
Return on common equity (%)	17.1	10.8	17.4
Common dividend payout (%)	47.0	67.4	69.5

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Table 2 Exelon Corp. Financial Summary					
--Fiscal year ended Dec. 31--					
	2004	2003	2002	2001	2000

<i>(Mil. \$)</i>					
Sales	14,515	15,812	13,879	15,140	7,499
Net income from cont. oper.	1,841	793	1,670	1,428	566
Funds from oper. (FFO)	4,138	3,640	3,377	3,243	1,491
Capital expenditures	1,921	1,954	2,111	2,006	752
Cash and equivalents	528	590	469	485	840
Total debt	13,551	15,760	15,744	7,680	7,681
Preferred stock	87	87	595	0	630
Common equity	9,423	8,503	7,742	8,230	7,215
Total capital	23,103	24,350	24,158	15,910	15,526
Ratios					
Adj. EBIT interest coverage (x)	3.7	3.4	5.1	2.9	5.4
Adj. FFO interest coverage (x)	5.4	4.9	6.7	3.5	7.7
Adj. FFO/avg. total debt (%)	27.6	22.4	26.9	37.1	24.0
Net cash flow/capital expenditures (%)	172.1	154.3	133.1	132.6	177.4
Adj. total debt/capital (%)	59.5	65.2	66.3	51.7	52.9
Return on common equity (%)	20.5	9.8	20.7	18.3	12.6
Common dividend payout (%)	45.1	78.8	34.0	40.8	27.7

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OTS Statement No. 3-SR
Witness: Kevan L. Deardorff

JK
9-22-05
Phelan

**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

DOCKETED
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Surrebuttal Testimony

of

Kevan L. Deardorff

Office of Trial Staff

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PA PUBLIC UTILITY COMMISSION
SECRETARY'S BUREAU

Concerning:

**Regulatory Insulation Criteria
(Ring-Fencing)
Directed Questions**

1 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

2 A. My name is Kevan L. Deardorff. My business address is P.O. Box 3265,
3 Harrisburg, Pa. 17105-3265.

4
5 **Q. HAVE YOU PREVIOUSLY SUBMITTED TESTIMONY IN THIS**
6 **PROCEEDING?**

7 A. Yes, I have. Please refer to OTS Statement No. 3 and OTS Exhibit No. 3.

8
9 **Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?**

10 A. I have two reasons for presenting surrebuttal testimony. First, I want to briefly
11 respond to the rebuttal testimony of Mr. J. Barry Mitchell, PECO Statement No.6-R.
12 Second, I will respond to the Directed Questions.

13
14 **Q. FIRST, MR. MITCHELL FINDS YOUR USE OF THE WORD "RING-**
15 **FENCING" TROUBLING. WOULD YOU CARE TO COMMENT?**

16 A. Yes. Since Mr. Mitchell has trouble with the use of the term ring-fencing, I will
17 refrain from the further use of this term. Rather, to be concise, I will use Standard
18 & Poor's ("S&P") term, "Regulatory Insulation Criteria" (OTS Exhibit No. 3-SR,
19 Schedule No. 1).

1 **Q. AT PAGE 3 OF HIS REBUTTAL TESTIMONY, MR. MITCHELL STATES**
2 **THAT THE SEC AND FERC HAVE PROCEDURES IN PLACE THAT**
3 **CONTRIBUTE TO CREDIT PROTECTIONS. HAVE THESE**
4 **COMMISSIONS EVER USED THEIR AUTHORITY TO PREVENT A**
5 **COMPANY THAT THEY REGULATE FROM ESTABLISHING**
6 **INAPPROPRIATE DIVIDEND POLICIES OR FROM ALLOWING THE**
7 **EQUITY RATIO TO FALL BELOW DESIRABLE LEVELS?**

8 **A.** I am not aware of any instance where both of these Commissions have acted upon
9 these types of activities. Mr. Mitchell has acknowledged in response to an
10 interrogatory that PECO has not conducted a review of Commission enforcement
11 actions on this issue (OTS Ex. No. 3-SR, Sch. 2).

12
13 **Q. AT PAGES 6 AND 7 OF HIS REBUTTAL TESTIMONY, MR. MITCHELL**
14 **CRITICIZES YOUR CONCLUSION THAT THE S&P CREDIT WATCH,**
15 **WITH NEGATIVE IMPLICATIONS, IS PROOF THAT THE CURRENT**
16 **CREDIT PROTECTION OF PECO IS NOT ADEQUATE. HE CONCLUDES**
17 **THAT EFFECTIVE AND ADEQUATE CREDIT PROTECTION IS IN**
18 **PLACE. IS HIS CONCLUSION SUPPORTED BY THE S&P RESEARCH**
19 **STAFF?**

20 **A.** No. S&P has just the opposite conclusion in their latest research report, which I
21 have attached as Schedule No. 1 of OTS Exhibit No. 3-SR. S&P has identified six
22 states where the state regulators are legislatively empowered and have proactively

1 protected utility's credit profile from its non-regulated parent and affiliates. As
2 noted, S&P has not included Pennsylvania among these six states.

3
4 **Q. WHY IS PENNSYLVANIA NOT AMONG THE STATES ON THE S&P**
5 **LIST?**

6 A. The S&P report lists several restrictions and mandates that they look for in
7 *determining sufficient regulatory insulation. As provided by S&P:*

8 If a Commission is able and willing to regulate
9 the relationship between utility and non-
10 regulated parent or affiliate, some combination
11 of the following restrictions and mandates may
12 allow S&P to determine that a utility is
13 sufficiently insulated from a weaker, non-
14 regulated parent or affiliate.

- 15
- 16 • Mandates equity layers at the utility
17 subsidiary;
- 18
- 19 • Pre-approval and limitations on dividends
20 from the utility subsidiary to the parent;
- 21
- 22 • Pre-approval and limitations on non-
23 regulated investments;
- 24
- 25 • Restrictions on the flow of funds
26 throughout the organization; and
- 27
- 28 • Threat of monetary fines or imprisonment
29 for officers, agents, or employees of a
30 utility who neglect or violate mandates
31 specified by law or Commission Order.

1 **Q. MR. MITCHELL BELIEVES THAT A BOND RATING DOWNGRADE OR**
2 **A RATING DIFFERENTIAL CAUSED BY THE MERGER SHOULD BE AN**
3 **ISSUE IN FUTURE RATE CASES. DO YOU AGREE?**

4 A. No. I believe the issue should be resolved by proper regulatory insulation in the
5 present case for two reasons. First, any effort to reduce the number of issues in
6 future rate cases will reduce rate case expense and, as a result, reduce the size of
7 future rate increases. Second, proper regulatory insulation implemented now will
8 allow more accurate estimation of the cost of capital in future rate cases. If S&P
9 determines that sufficient regulatory insulation is not in place, a risk adjustment to
10 the cost of debt will become necessary in future rate case. The risk adjustment will
11 be estimated by the cost of capital witnesses, thereby adding another layer of
12 estimation error in the rate making process. Proper regulatory insulation should be
13 in place now to insure efficiency in future rate cases.

14
15 **Q. DO YOU AGREE WITH PECO'S EXPLANATION AS TO WHY THE**
16 **COMPANY IS RELUCTANT TO PROVIDE "CONFIDENTIAL"**
17 **INFORMATION TO THE COMMISSION?**

18 A. No. PECO witness Mitchell failed to understand that the Commission and its
19 employees have a long history of experience and procedures that have withstood
20 numerous tests in the handling of confidential information gathered from utilities.
21 Moreover, Mr. Mitchell's assertion that the providing of this information would be

1 “potentially burdensome and cumbersome” is without merit, since the Company is
2 providing the information to S&P.

3
4 **Q. YOU STATED THAT YOU ARE GOING TO RESPOND TO DIRECTED**
5 **QUESTIONS. PLEASE STATE THE DIRECTED QUESTIONS.**

6 A. The Commissioners have asked the following five questions:

- 7 1. Neighboring states have availed themselves of opportunities to enhance
8 their economic competitiveness through access to economical energy
9 resources. What opportunities exist from this proposed merger in terms of
10 economic development for Pennsylvania? Specifically, does this proposed
11 merger present us with an opportunity to strengthen the State’s ability to
12 remain competitive during periods of economic recession and volatile energy
13 pricing?
14
- 15 2. The innovative and controversial nuclear “virtual divestiture” component of
16 the FERC decision appears to present intriguing opportunities for the
17 Commonwealth. Does the proposed merger present this Commission with an
18 opportunity to create an additional economic development program designed
19 to improve Pennsylvania’s business climate by creating strategic partnerships
20 with the public and private sector that support product development and the
21 use of energy-efficient technologies?
22
- 23 3. Would it be possible to set aside 10% or some relatively small share of the
24 “virtually” divested generation to augment economic development and
25 economic competition within the Commonwealth? For example, could the
26 parties consider and comment on creating a pool of energy and capacity of at
27 least 260 MWs which could be used at the discretion of the Secretary of the
28 Department of Community and Economic Development to attract and retain
29 business in the Commonwealth?
30
- 31 4. Could the Commonwealth through one of its agencies and/or in conjunction
32 with a licensed Electric Generation Supplier facilitate the use of the output of
33 this generation?
34
- 35 5. Would the combination of the PSE&G gas division with the PECO gas
36 division and the Philadelphia Gas Works (“PGW”) provide critical mass for a
37 viable, profitable, shareholder owned public utility, assuming a revenue

1 stream from off system sales from an LNG facility, and separate resolution of
2 the problem of a billion dollar debt?

3

4 **Q. WHAT IS OTS'S POSITION ON QUESTIONS NUMBER 1, 3 AND 4?**

5 A. OTS believes that the opportunities for economic development in these questions
6 are worthwhile endeavors and should be considered in a statewide collaborative.

7 Such a non-litigated process by all stakeholders would benefit both utilities and
8 customers.

9

10 **Q. WHAT IS OTS'S POSITION ON QUESTION NUMBER 2?**

11 A. OTS believes that the other interveners such as Penn Future or Action Alliance
12 would be better suited to answer this question.

13

14 **Q. WHAT IS OTS'S POSITON ON QUESTION NUMBER 5?**

15 A. OTS believes that the combination of the three gas operations into a shareholder-
16 owned public utility should be considered in a statewide collaborative, such as
17 recommended by OTS in a previous PGW proceeding at Docket No. P-00042090.

18 A collaborative process will properly address the problems associated with PGW.

19

20 **Q. PLEASE EXPLAIN THE REASONS FOR YOUR RECOMMENDATION.**

21 A. First, while the combined entity would most likely have critical mass (ratebase of
22 approximately \$4 to \$5 billion) and would rank among the largest distribution

1 networks in the U.S., the combination may have market power implications which
2 cannot be fully examined unless the application is amended. Second, while the
3 question assumed separate resolution of the long-term debt problem, the fact
4 remains that PGW has more debt than plant¹, and any serious discussion concerning
5 a combination of the three gas operations cannot begin until the terms of such debt
6 resolution are defined.

7
8 **Q. DOES THIS COMPLETE YOUR SURREBUTTAL TESTIMONY?**

9 **A. Yes.**

¹ At August 31, 2004, Philadelphia Gas Works' depreciated plant was \$950 million, and long-term debt was \$953 million.

OTS Exhibit No. 3-SR
Witness: Kevan L. Deardorff

*g/k
9-22-05
Phila*

**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

DOCKETED
NOV 10 2005

Exhibit to Accompany
the
Surrebuttal Testimony
of
Kevan L. Deardorff
Office of Trial Staff

**DOCUMENT
FOLDER**

RECEIVED

SEP 26 2005

PA PUBLIC UTILITY COMMISSION
SECRETARY'S BUREAU

Concerning:

**Regulatory Insulation Criteria
(Ring-Fencing)
Directed Questions**

Research:

Regulatory Insulation Criteria For U.S. Utilities Reinforces High Hurdle For Ratings Separation

Publication date: 17-May-2005
Primary Credit Analyst(s): Jeanny Silva, New York (1) 212-438-1776;
jeanny_silva@standardandpoors.com

(Editor's note: This article, published earlier today, had an incorrect short-term rating for Portland General Electric Co. The rating has been corrected in the text below.)

Standard & Poor's criteria for establishing separate default ratings for a utility, its affiliates, and holding company on the basis of regulatory insulation limits eligibility significantly. In its assessment of the credit quality of affiliated corporate entities in the U.S. utility sector, Standard & Poor's considers management's ability to shift funds to where they are most needed. *Where this ability is effectively unimpeded, affiliation with a family of companies generally affects the credit quality of all members equally.* In cases where regulatory restrictions restrict a parent's ability to exploit the affiliation, rating differentials between stronger and weaker related entities may occur. However, even though the ratings for an entity may be separated from the ratings of its affiliates because of regulatory insulation, the entity is never rated strictly on a stand-alone basis.

The ratings on a regulated utility subsidiary may be higher than the ratings on its affiliates if the following two conditions are met:

- The utility subsidiary demonstrates sufficient stand-alone credit strength to warrant a *ratings differential from its affiliates*; and
- There is evidence that regulators will proactively shield the utility's credit profile from exposure to the higher risk nonregulated activities of its affiliates.

While many utility subsidiaries exhibit credit attributes that, absent their relationship to a weaker parent or other related entity, would support higher ratings, rating differentials between a regulated utility and its affiliates are few. In the regulated U.S. utility sector, Standard & Poor's affords regulatory insulation to only about 10 regulated operating subsidiaries of holding companies with nonregulated affiliates. *These regulated utilities are deemed to have sufficient protection for their ratings to rise above the rating applied to the consolidated entity.* Most of these companies operate in Wisconsin, California, and Oregon where commissions are legislatively empowered to place restrictions on the relationship between the utility and its nonregulated parent and affiliates.

It should be noted that the ratings on Oregon's Portland General Electric Co. (PGE; BBB+/Developing/A-2) incorporate the establishment in 2002 of structural protections that greatly enhanced the existing regulatory protections from bankrupt parent, Enron Corp. These structural protections include legal elements that, most importantly, create economic disincentives for Enron or creditors to file PGE into Enron's bankruptcy estate (see "Ring-Fencing a Subsidiary" published on RatingsDirect.)

Over the last two years, Standard & Poor's has eliminated rating differentials between several utility subsidiaries and their parents, most notably in Virginia, Delaware, and Arizona. These differentials were eliminated based on Standard & Poor's assessment of the ability and willingness of state regulators to proactively protect the utility's credit profile from a weaker affiliate in times of financial stress.

Regulators must demonstrate their willingness to protect the utility subsidiary before its credit profile begins to deteriorate, not after the fact. If a commission is able and willing to regulate the relationship between regulated utility and nonregulated parent or affiliate, some combination of the following restrictions and mandates may allow Standard & Poor's to determine that a utility is sufficiently insulated from a weaker nonregulated parent or affiliate.

- Mandated equity layers at the utility subsidiary,
- Pre-approval and limitations on dividends from the utility subsidiary to the parent,
- Pre-approval and limitations on nonregulated investments,
- Restrictions on the flow of funds throughout the organization, and
- Threat of monetary fines or imprisonment for officers, agents, or employees of a utility that neglect or violate mandates specified by law or commission order.

Mandated equity layers should be supportive of a higher rating. Of the utility companies whose ratings are enhanced by regulatory insulation, most have mandated equity layers equal to or in excess of 45%, while some are much higher, such as Wisconsin Power & Light Co. (A-/Negative/A-2), which is required to maintain a 54.01% equity layer. In effect, such a mandate safeguards cash at the utility by preventing dividend declarations that would cause an equity layer to fall below its required level.

Restrictions on a holding company's ability to make nonregulated investments can also offer credit protection to a regulated utility. However, restrictions should be robust. In most cases, they are not. For example, while state law caps nonutility investments by a Wisconsin holding company at 25% of total assets, the list of allowed investments is too broad to offer any meaningful protection to the utility. As per Wisconsin state law, investments in higher-risk oil and gas exploration and production assets are exempt from regulatory rules prohibiting nonregulated investments.

Regulatory restrictions on the flow of funds throughout the organization (i.e. limitations on intercompany lending and subsidies) may further limit a nonregulated parent's ability to harm a utility's credit profile. Prohibitions against intercompany lending and subsidies make it especially difficult for a parent to skirt regulatory restrictions that may limit payment of dividends by the utility to the parent. In Wisconsin, all regulated utilities face dividend restrictions of some form or another, as well as prohibitions on intercompany lending and subsidies. Together, these factors provide evidence that regulators will seek to safeguard cash generated at the regulated entity from use by the nonregulated parent or affiliate. Still, restrictions on the flow of funds may be difficult for regulators to enforce. There are many less obvious and often temporary ways for managers to funnel cash out of a utility subsidiary, including charging stronger utility subsidiaries ever-increasing overhead costs for rent or payroll.

If proactively imposed by vigilant regulators, restrictions on the flow of funds can provide meaningful credit support to a utility subsidiary, as was evidenced in Oregon in 2001. The *Oregon Public Utilities Commission's restrictions on intercompany transactions* prevented parent Enron from accessing PGE's assets during the parent's financial crisis. In contrast, Transwestern Pipeline and Northern Natural Gas, both FERC-regulated gas pipeline subsidiaries of Enron at the time, pledged assets as collateral for the parent's loans totaling \$1 billion. Loan proceeds were then directed to Enron through promissory notes just weeks before Enron's collapse. Despite every financial incentive to do so, Enron was, as a result of regulatory restrictions, unable to similarly borrow from PGE.

Restrictions limiting the control of a parent over a regulated utility are only as good as the commission's ability and willingness to enforce them. To that end, the argument for ratings separation is enhanced if a utility or its officers and employees face civil or criminal liability in the event that regulatory orders are neglected or violated. In Wisconsin, neglect or violation of regulatory restrictions governing the relationship between utility subsidiary and nonregulated parent could result in civil penalties for the utility, its officers, agents, or employees. In California, neglect or violation of state law could result in the imprisonment of officers, agents, or employees of the public utility.

For diversified energy companies that continue to sell or rationalize their higher-risk nonregulated assets and subsidiaries, there is less basis for ratings separation between utility subsidiary and parent. Still, exposure to underperforming nonregulated affiliates with stand-alone or parent-guaranteed debt remains material for some utility subsidiaries. As such, when in place and if sufficiently robust, regulatory restrictions can provide meaningful credit protection to utility subsidiaries.

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

OCA-XXV-2

Page 3, Mr. Mitchell states that the SEC and FERC have procedures in place that contribute to credit protections. Please describe in detail all instances where the SEC or FERC has prevented a company that they regulate from establishing inappropriate dividend policies or from allowing the equity ratio to fall below desirable levels.

RESPONSE

PECO has not conducted a review of Commission enforcement actions on this issue. Moreover, there are numerous methods of contributing to credit protections other than “prevent[ing] a company . . . from establishing inappropriate dividend policies or from allowing the equity ratio to fall below desirable levels.”

Responsible Witness: J. Barry Mitchell