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May 10, 2006

Via Electronic Mail and Hand Delivery
Honorable Richard McGill, A.L.J.
Office of Administrative Law
33 Washington Street
Newark, New Jersey 07102-3011

Re: Joint Petition of Public Service Electric and Gas Co. and Exelon Corp. for Approval of a Change in Control and Related Authorizations
BPU Docket No. EM05020106
OAL Docket No. PUCOT 01874-2005N

Dear Judge McGill:

Enclosed for filing please find an original and two (2) copies of the Division of the Ratepayer Advocate's Reply Brief and Appendix in the above-referenced matter.

Copies of the Reply Brief are being provided to all parties by electronic mail. Hard copies are being provided to Your Honor, the Joint Petitioners and counsel for the Staff of the Board of Public Utilities but will be made available to all parties upon request.

We are enclosing one additional copy of the materials transmitted. Please stamp and date the copy as "filed" and return it to our courier. Thank you for your consideration and assistance.

Respectfully submitted,
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BEFORE THE STATE OF NEW JERSEY
BOARD OF PUBLIC UTILITIES
OFFICE OF ADMINISTRATIVE LAW

I/M/O THE JOINT PETITION OF PUBLIC SERVICE ELECTRIC AND GAS COMPANY AND EXELON CORPORATION FOR APPROVAL OF A CHANGE IN CONTROL OF PUBLIC SERVICE ELECTRIC AND GAS COMPANY, AND RELATED AUTHORIZATIONS	:	BPU Docket No.EM05020106 OAL Docket No. PUC 1874-05

REPLY BRIEF AND APPENDIX OF THE DIVISION OF THE RATEPAYER ADVOCATE

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I. INTRODUCTION

A review of the Initial Briefs[1] of Joint Petitioners Public Service Electric and Gas Company ("Public Service" or "PSE&G") and Exelon Corporation ("Exelon") collectively known as Joint Petitioners ("Joint Petitioners"), the Staff of the Board of Public Utilities ("Board Staff"), and other intervenors is quite revealing. Joint Petitioners' Initial Brief, similar to their petition and case, contains little more than unsubstantiated, conclusory promises that the proposed merger will not adversely impact ratepayers and the State of New Jersey. The Division of the Ratepayer Advocate's ("Ratepayer Advocate") Initial Brief clearly identifies many of the deficiencies in the Joint Petitioners' case. The arguments in Joint Petitioners' Initial Brief do not refute the factual or policy arguments in the Ratepayer Advocate's case or Initial Brief. Therefore, as discussed in detail *infra,* based on the record in this matter, the Ratepayer Advocate maintains its position that the merger as filed, should be rejected, or if Your Honor and the Board decide to approve the merger, such approval should be granted only if the conditions and recommendations outlined in our Initial Brief and testimony are made explicit conditions of the approval.

[1] Joint Petitioners' Initial Brief will be cited at "JPIB"; Staff's Initial Brief as "SIB" and the Ratepayer Advocate's Initial Brief as "RPAIB". Similar abbreviations are used for other Initial Briefs.

II. STATUTORY REQUIREMENTS AND THE BOARD'S STANDARD OF REVIEW

Despite the Board's directive in its Order on Standard of Review issued in this matter on November 9, 2005, the Joint Petitioners' Initial Brief is replete with distortions of that order which would reduce it from the clearly stated requirement of positive benefits for ratepayers and the State of New Jersey to a lesser standard of no adverse impacts on any of the areas for review outlined in the merger statute. *N.J.S.A.48:2-51.1*. Your Honor and the Board should not accede to the degradation of the positive benefits standard so recently adopted and should reject the Joint Petitioners' attempts to do so.

One instance in which the Joint Petitioners argue to reduce the new positive benefits standard is when they cite the Merger Guidelines of the United States Department of Justice ("DOJ"), the Federal Trade Commission ("FTC"), and the Federal Energy Regulatory Commission ("FERC"). *JPIB at 26*. They cite those Merger Guidelines in the attempt to support the idea that the Board policy concerning electric utility mergers should be reduced to the "no harm" standard that the Board has already rejected for this case. As will be discussed in more detail below, those Merger Guidelines would allow a merger to be completed even though the merger is expected to increase market power. The Ratepayer Advocate urges Your Honor and the Board to reject this attempt to water down the new positive benefits standard to a standard that the Board has already decided should no longer be applied. It should also be noted that while the FERC has approved the instant merger using the Merger Guidelines, the Board has joined several other parties including the Ratepayer Advocate in filing an appeal of the FERC orders. That fact alone should present sufficient reason to deny the Joint Petitioners' argument concerning the standard of review.

The Joint Petitioners also make the dubious argument that all mergers are "naturally concentrating" in that "they reduce one competitor in a market" and that this is sufficient reason for Your Honor and the Board to interpret the positive benefits standard to allow some increase in market power in any merger case. *JPIB at 27.* This argument ignores those mergers in which the merging companies are not competitors in the same market. This argument also ignores those mergers which would increase market power, but in which the merging companies propose a real and effective market power mitigation plan that offsets the possible market power increase. The Joint Petitioners have failed to avail themselves of the opportunity to offer such a real and effective market power mitigation plan in this case. For that reason, the Ratepayer Advocate respectfully submits that the merger petition does not satisfy the Board's positive benefits standard concerning competition and should be rejected.

The Joint Petitioners also argue for a curious construction of the positive benefits standard as outlined in their Initial Brief:

> This is significant because the "no adverse impact on competition" test, as embodied in *N.J.S.A. 48:2-51.1*, and the "positive benefits" test, as adopted by the Board in its June 22, 2005 Order, are independent of one another, i.e., both must be met. Stated differently, the Board will only reach the issue of "positive benefits" if it first concludes that the proposed merger, coupled with the Joint Petitioners' proposed generation mitigation plan, will not adversely affect competition (or rates, service and employees).

JPIB at 35. Apparently, the Joint Petitioners believe that the Board would not require the showing of any positive benefits until a first step is reached in which the Board decides that no adverse impact on any of the four statutory areas will result from the proposed merger. The Ratepayer Advocate does not believe any particular procedure is necessary

for the Board to decide that a proposed merger does not provide sufficient positive benefits to ratepayers and the State of New Jersey. Regardless of which process Your Honor and the Board use to review the statutory areas, the Ratepayer Advocate respectfully submits that the evidentiary record is clear that the Joint Petitioners have failed to meet the positive benefits standard in the four statutory areas.

The Joint Petitioners also cite to the merger approval granted by the Pennsylvania Public Utility Commission ("PAPUC") and apparently believe that this approval should be rubber-stamped by Your Honor and the Board. *JPIB at 79.* The Ratepayer Advocate respectfully submits that Your Honor and the Board play a much more important part in the merger approval process than simply following the lead of a sister agency in another state. It should be noted that the merger docket in Pennsylvania does not involve the acquisition of a public utility by Exelon in that state. Exelon has already acquired PECO in the merger effective in 2000. Therefore, the review by the PAPUC did not include the same vital issues that are part of the instant docket in New Jersey. Exelon is also not acquiring any generation plant owned by PECO in that Pennsylvania docket. The Ratepayer Advocate respectfully submits that while it is true that the PAPUC has approved this merger, the evidentiary record in the instant docket contains issues that the PAPUC did not have to review and demonstrates conclusively that the Joint Petitioners have not met their burden of proving that the proposed merger provides sufficient positive benefits to ratepayers and the State of New Jersey.

III. SUMMARY OF POSITIONS

The Ratepayer Advocate's Initial Brief has provided Your Honor and the Board with our positions and recommendations. Accordingly, they will not be repeated in this Reply Brief and therefore are incorporated by reference herein.

IV. EVALUATION OF OVERALL BENEFITS

A. To Ensure New Jersey Enjoys the Promised Benefits From Increased Nuclear Output, Joint Petitioners Should Be Required to Flow Through Those Benefits as a Condition of Merger, if the Merger is Approved.

1. Joint Petitioners, Not the Ratepayer Advocate, Seek to Reinterpret the Import of the Board's Stranded Cost Determinations.

Joint Petitioners claim that the Ratepayer Advocate's proposed merger condition to ensure a sharing of benefits from increased nuclear output via reasonable cost tranches of power for New Jersey BGS customers is "a device to relitigate PSEG's 1999 electric restructuring proceeding and to recalculate the BPU's stranded cost findings in the process." *JPIB at 107, citing JP-25 at 8*. Exelon's CEO Mr. Rowe and Joint Petitioners go further and assert that the Ratepayer Advocate is trying through the tranche proposal "to grab value from the nonregulated side of PSEG's business." *Id.* The Joint Petitioners also mistakenly assert that the Ratepayer Advocate would attempt to re-regulate generating plant. *JPIB at 117*. As will be discussed below, Your Honor and the Board can see that our proposals do no such thing.[2]

As Ms. Brockway testified, her tranche proposal has nothing to do with the stranded cost determinations of the Board, which are long-settled. *RA-66 at 24-25.* Rather, the tranche proposal is a way Your Honor and the Board can assure that the benefits Joint Petitioners promise to New Jersey from increased nuclear production actually reach New Jersey consumers, regardless of what happens in the wholesale

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[2] The Joint Petitioners incorrectly argue that re-regulating generation would violate the Electric Discount and Energy Competition Act ("EDECA"). They ignore the fact that EDECA specifies that the Board is authorized, with the participation of and review by the Legislature, to determine to reclassify electric generation service as regulated. *N.J.S.A. 48:3-56d and -56k.* The Ratepayer Advocate is not proposing any such procedure in this matter, but provides the citation simply to show the error in the Joint Petitioners' broader argument.

markets. It is only the merger proceeding, in which the Joint Petitioners' promise lower wholesale prices from increased nuclear output, that gives rise to a New Jersey consumer claim on a share of the benefits of increased nuclear output from PSEG's nuclear fleet. Furthermore, despite the assurance of the Joint Petitioners' witness Mr. Schnitzer that market forces will pass through the benefits of the increased nuclear output to BGS customers, the Joint Petitioners have not provided a rate mechanism or other market mechanism that would sufficiently assure those benefits. The proposal by Ratepayer Advocate witness Ms. Brockway would provide such assurance and should be adopted. Such a result would be entirely in keeping with the Board's requirement that the proposed merger provide positive benefits to ratepayers and the State of New Jersey.

Joint Petitioners would have Your Honor and the Board rule, in effect, that once stranded cost determinations were made, there are no conceivable circumstances under which unregulated generation performance has any relevance to New Jersey regulation. This interpretation is beyond the scope of the stranded cost determinations. The Board has obviously already decided that the generation ownership and market power issues are of great importance in this proceeding. Yet, at the same time, Joint Petitioners ask Your Honor and the Board to approve a proposed merger with negligible regulated benefits and potential risks to ratepayers, and with potential dangers to the unregulated side, which approval would have to be based to a large extent on the strength of their promised nuclear benefits from the unregulated side.

As Ms. Brockway testified, Joint Petitioners would not be in front of Your Honor and the Board were it not for the merger of the unregulated side of the business. Apparently, the purchase of the regulated side of the business is necessary in order for

Exelon to reap the unregulated benefits, and the merger is not being pursued to reap the purported benefits to the regulated side. *RA-65 at 32-33.* It is hypocritical for Joint Petitioners to argue that Your Honor and the Board should take into account what Mr. Rowe calls the "considerable" public benefits of the merger, such as the increased nuclear output assertedly made possible by Exelon's nuclear management, but then label any effort to pin those benefits down for consumers as an effort to relitigate past stranded cost determinations. *RA-66 at 24-25, quoting from Mr. Rowe's Rebuttal, JP-25 at 21-22.*

Contrary to the Joint Petitioners' argument that the merger review should not apply to all the benefits espoused by merging parties, the Board has already stated its policy in opposition to that argument:

> The Board herein is cognizant, too, that although the Board in the foregoing cases stated that it was utilizing a no harm standard of review, <u>the Board in these matters also considered the appropriate treatment of the acquisition's claimed benefits, including but not limited to, merger savings,</u> and examined whether benefits had been properly derived and equitably shared with ratepayers. See, Conectiv, at 6-8; RECO, at 5; FirstEnergy, at 7; PEPCO, at 24-25. In fact, the Board's regulations governing petitions for approval of a merger or consolidation of a New Jersey public utility with that of another public utility have long required information regarding "[t]he various benefits to the public <u>and the surviving corporation</u> which will be realized as the result of the merger." N.J.A.C. 14:1-5.14(a)(10). Thus, irrespective of the use of a no harm test, <u>the Board has required and examined information on benefits of acquisitions of control as an integral part of its analysis.</u>

Order on Standard of Review at 16 (emphasis added).

2. The Ratepayer Advocate's Proposal for a Mechanism to Share Nuclear Benefits and Mitigate Merger-Related Risk Is Consistent With State Policy.

Joint Petitioners argue that the proposal to condition merger approval on Exelon's supply of tranches of reasonably-priced power "to assure that such lower-priced power ... will actually show up in New Jersey's customers' supply portfolios" is inconsistent with State policy, with the policy underpinnings and economic theory that is the basis for New Jersey's electric restructuring, and with Ms. Brockway's own statements on the benefits of competitive generation markets. *JPIB at 112 (quoting from RA-66 at 21-22) and 114*; *JP-149 (Nancy Brockway, Randall Smith, Charles Stalon, Principles Applicable to the Electric Industry Reform Legislation (Apr. 28, 1997)).* In support of this argument, Joint Petitioners quote at length from EDECA:

> In EDECA, "[t]he Legislature finds and declares that: it is the policy of this State to . . . [p]lace greater reliance on competitive markets, where such markets exist, to deliver energy services to consumers in greater variety and at lower cost than traditional, bundled public utility service; . . . [i]n a competitive marketplace, traditional utility rate regulation is not necessary to protect the public interest and that competition will promote efficiency, reduce regulatory delay, and foster productivity and innovation; . . . due to regulatory changes, technological developments and other factors, a competitive electric generation and wholesale supply market has developed over the past several years; . . . [t]he traditional retail monopoly which electric public utilities have held in this State for electric power generation and supply services should be eliminated, so that all New Jersey energy consumers will be afforded the opportunity to access the competitive market for such services and to select the electric power supplier of their choice; [and] [p]ermitting the competitive electric power generation and supply marketplace to operate without traditional utility rate regulation will produce a wider selection of services at competitive market-based prices." N.J.S.A. 48:3-50.

JPIB at 115, footnote 81(emphasis added).

Joint Petitioners confuse these policy choices of the New Jersey Legislature (and the Board) in favor of competition as a requirement to avoid regulatory solutions whenever a party (such as the Joint Petitioners) claims that competition, rather than regulation, will produce the particular result desired in any given case. The Ratepayer Advocate notes that EDECA does not say to use an allegedly market-based remedy whenever a party merely asserts it is available. The statute instead says it is the policy of the State "to place <u>greater reliance</u> on competitive markets," not to completely ignore regulatory solutions, especially to market problems. (Emphasis added).

The primary reason for the tranche proposal in this case is to lock in specific benefits promised in this specific merger transaction. Here, Joint Petitioners want the approval of Your Honor and the Board for a specific act: a merger that would subsume PSE&G under a gigantic Chicago-based holding company. It is consistent with EDECA to demand concrete and assured sharing of the particular dollars at issue in this merger proposal. While competitive markets balance risk and reward over the long run, in any given transaction they do not necessarily produce the balanced outcome. Indeed, in this case, the need for a more definitive remedy arises in part because of the risk this merger poses to the competitive markets the Legislature determined existed in 1999, when EDECA was passed.

Joint Petitioners' witness Mr. Sidak asserts that "reward should follow risk," and Ms. Brockway agrees rewards and risks should be "balanced." *JP-36 at 24-25 ("the overarching principle is that rewards should follow risks")*; T3262:L21 (3/31/06). However, the Joint Petitioners' merger proposal is not balanced. It would place the risks

of the merger on consumers, but allow Joint Petitioners to enjoy the rewards.[3] For this reason, the Ratepayer Advocate has proffered a more certain method to ensure that ratepayers share in the benefits of increased nuclear output, as Joint Petitioners promise they will.

Further, Joint Petitioners' points do not rebut the fact that the Ratepayer Advocate has carefully crafted the tranche proposal (for flowing through nuclear benefits promised New Jersey, as well as financial mitigation for merger-related risks such as increased wholesale electricity prices) so as to keep within the policies set forth in EDECA. Ms. Brockway testified that in developing her proposal, she considered the likely number of tranches (and associated megawatt-hours of output) that would be provided outside the BGS process, and the likely impact on the competitiveness of the BGS process as a result of the removal of this demand from the process. Asked to consider such a critique advanced in the Pennsylvania litigation over this merger, Ms. Brockway assured Your Honor and the Board that she had tailored her proposal to the needs of the BGS market:

> Impact in marketplaces by introducing artificial limits of market availability, that could be a concern definitely that the tranches were too large a proportion of the market that otherwise would go to BGS.
>
> When we looked at this we thought that's not likely to be a risk; it is going to be a small portion and there will still be a very vigorous market for the auction.

T3284:L15-23 (3/31/06)

The cost of BGS load has been valued in this record at about $3.4 billion. *S-10 at 78, Table 4.* Even if the merger were conditioned on a long-term tranche flow-through

[3] Staff witness Dr. Jonathan A. Lesser agrees that if increased nuclear output does not push wholesale prices down, "increased nuclear availability will benefit only PSEG and Exelon shareholders." *S-10 at 11, lines 1-2.* He goes on to note the significant downside risk to consumers if the merger opens the door to the use of market power to increase wholesale electric and gas prices. *Id. at lines 3-8.*

of the Ratepayer Advocate's entire recommendation ($134 million by 2008, after the end of the short-term job loss synergy portion),[4] this would amount to less than 4% of the value of the auction.[5] Further, Ms. Brockway made clear that her proposal could be adjusted by Your Honor and the Board to reduce the number of tranches that were taken out of the BGS auction, if there were a residual concern that the tranche flow-through mechanism would have an adverse impact on the auction's competitiveness. Similarly, as she testified, if the Board preferred less certainty in the flow-through of benefits to New Jersey consumers, and greater reliance on the (riskier) mechanism of the post-merger wholesale market, it could also reduce the amount of power provided through the tranche mechanism to adjust the balance of assured benefits and reliance on asserted competitive forces. T3269:L7 to T3270:L6 (3/31/06). Joint Petitioners ignore these aspects of Ms. Brockway's proposal.

Joint Petitioners baselessly accuse Ms. Brockway's testimony of being "somewhat confused" on this matter, when it is the Joint Petitioners themselves who misunderstand Ms. Brockway's proposal for the amount of nuclear benefit to be shared with consumers. *JPIB at 117*. Ms. Brockway's baseline of $200 million, from which she takes taxes, and the residual of which she proposes to split 50/50 between ratepayers and the Joint Petitioners, does not represent gross revenue, as claimed by Joint Petitioners. *JPIB at 117, note 84.* Rather, the base figure is comprised of net revenues, as can be readily inferred from the fact that she calculates the tax effect as a percentage of the total. *RA-65 at 36*. This can further be confirmed merely by looking at Ms. Brockway's source

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[4] *RA-66, Exh. NB-6* (comprised of $68 million in market power mitigation and $66 million in sharing of nuclear output benefits).

[5] The Board has valued the most recent BGS auctions at $7 billion. *BPU Press Release dated February 9, 2006*, available at http://www.bpu.state.nj.us/home/news.shtml?05-06. The Ratepayer Advocate requests that Your Honor take official notice of this document, per *N.J.A.C. 1:1-15.2*.

for the $200 million figure, the Synapse Direct Testimony. *RA-5 at 14, 92*. Synapse Exhibit BFS-11 (Not Confidential), page 13 of 15 from their Direct Testimony, shows that they drew this figure from an Exelon presentation as to the increased earnings it could expect to enjoy as a result of the nuclear power benefits of the merger.

Also, whether this estimate by Exelon was "static" or not is beside the point. *JPIB at 117, note 84.* It is an estimate of the increased earnings Exelon plans to enjoy upon acquiring the largest electric and gas utility in New Jersey. Further, the comparison Ms. Brockway makes to the calculation of net nuclear output benefits of Mr. Schnitzer and Dr. Lesser shows the scale of what is at stake. Accordingly, it cannot in any sense be called "specious," as Joint Petitioners erroneously do. *Id.*

3. Joint Petitioners' Initial Brief Distorts the Position of Ratepayer Advocate Witness Ms. Brockway; Ms. Brockway Testified That Certainty of the Joint Petitioners' Claimed Benefits Should Be a Condition of Merger Approval.

Joint Petitioners would have Your Honor and the Board believe that Ratepayer Advocate witness Ms. Brockway supports the assertion that the marketplace will definitely pass the benefits of increased nuclear output to New Jersey consumers:

> "As explained by Petitioners' witness Mr. Schnitzer, the improved performance of the PSEG Power nuclear facilities will result in lower electricity costs for all New Jersey electricity consumers – not only for customers of PSE&G. The net present value of this enhanced nuclear performance is expected to exceed $400 million, and may potentially exceed $1.3 billion. <u>The fact that this benefit will occur was acknowledged by witnesses for other parties, including Staff witness Dr. Lesser and Advocate witness Ms. Brockway."</u>

JPIB at 3-4 (emphasis added). To the same effect, Joint Petitioners argue:

> "The fact that an economic benefit from increased nuclear output will result from the merger is a generally accepted principle in this case can be seen in the [Direct Policy Testimony] of Ratepayer Advocate witness Ms. Brockway:
>
>> There are a number of estimates on the records of this proceeding concerning the likely benefit to New Jersey consumers from the increased nuclear output. Based on the Synapse panel estimate, I recommended an annual benefit of $62 million in my Direct Testimony filed November 28, 2005. As can be seen from my Exhibit NB-6, the net present value of this estimate is roughly $464 million. Dr. Lesser suggests that the benefit that should come from increased nuclear output would be between $24 and $30 million a year, with a 10-year net present value of just under $200 million. Ex. JAL-8.
>
> Exh. RA-66, pp. 25-26.

JPIB at 82 (emphasis added).

With these quotations taken out of context, Joint Petitioners try to commandeer Ms. Brockway's testimony to support their view of the case. However, they ignore those statements by Ms. Brockway that directly contradict their position. In fact, Ms. Brockway specifically rejected the Joint Petitioners' assertion that improved performance of the nuclear plants will result in lower electricity costs for all New Jersey electricity customers:

> Q. As the merger is structured, who will capture any benefits that might occur as a result of increasing the output of PSEG's nuclear plants?
>
> A. If Exelon improves the performance of the nuclear plants, it alone will capture the benefits of such improvement. There is no reason to believe that competition will force Exelon to share these benefits in the market. … Neither Mr. Rowe nor any other witness for

> Joint Petitioners has suggested to Your Honor or the Board that they will assure New Jersey customers enjoy the asserted benefits of the combined generation operations. …
>
> Contrary to the public claim that better nuclear operations will result in lower wholesale prices, the proposed merger would pose significant risks of higher wholesale rates, affecting all New Jersey electric and gas customers.

RA-65 at 23-24 (emphasis added).

Similarly, during cross-examination, Ms. Brockway referred to the Joint Petitioners' proposal not to guarantee any benefits from increased nuclear output, but rather to share them with New Jersey consumers only via assumed market forces, as "speculative and risky." T3270:L3 (3/31/06). On redirect, she explained further her reasons for proposing that, as a condition of the merger, Joint Petitioners provide sufficient BGS tranches at a cost to ensure the pass-through of $62 million in nuclear-output-related benefits:

> … the whole point of this tranche provision is to provide benefits and the way to do that is to capture the difference between cost and fair market value which is what the Petitioners promise is going to happen. We are just saying … put your money where your mouth is, put the dollars on the table at least to the extent that the Board wants to have that pinned down.

T3284:L3-11 (3/31/06) (emphasis added).

Ms. Brockway takes the Joint Petitioners at their word when they announce they will earn an additional $200 million from increased nuclear output. *RA-65 at 36, referring to RA-5 at 14, 92.* Her proposal does not support the Joint Petitioners' contention that ratepayers will necessarily benefit from the increased output; rather, she makes the point that to make sure ratepayers do in fact benefit, a reasonable sharing of

the benefit from increased output must be assured through the tranche proposal, direct cash payments, or some other similarly concrete mechanism.

B. Ensuring a Share of Nuclear Output Benefits by the Provision of Reasonably-priced BGS Tranches Would Not Lead to Double-benefits.

Joint Petitioners argue that, since customers will already be seeing the benefit of increased nuclear output through the PJM market, any mechanism to share the benefits, such as that proposed by Ms. Brockway, would result in providing more savings than the already substantial savings actually being produced through the improved operation of the facilities. *JPIB at 82-84*. Contrary to this allegation, the BGS tranche proposal has been fashioned so as to avoid this double-benefit result.

The power that would flow through to BGS customers through this proposal would be sold once, at the price Mr. Schnitzer and Dr. Lesser claim it will attract in the market. Once sold, it could not be sold again. New Jersey consumers could get its benefits only once. Thus, once the Board determines a fair portion of the promised nuclear output benefit to be provided as a firm condition of the proposed merger, the tranche provision would accomplish that result in such a way as to avoid double-counting.[6]

C. The Tranche Proposal to Distribute Assured Benefits and Protections is Clearly Described in Ratepayer Advocate Witness Ms. Brockway's Testimony.

[6] An alternative way to pin down the benefits would be to provide them in cash, but this approach could lead to double-benefits to consumers, since the Joint Petitioners would pay the cash, and then still have the lower-cost power to sell into the market. If the market worked as promised by Mr. Schnitzer, the result could be double-benefits.

Joint Petitioners distort Ms. Brockway's testimony concerning the process she suggests for implementing the tranche proposal for distributing assured benefits and protections to New Jersey consumers. In so doing, they treat optional aspects of the proposal as signs of indecision, rather than as devices to give the Board flexibility in fashioning conditions for the merger. They substitute sarcasm for a thoughtful response to Ms. Brockway's proposal:

> She [witness Brockway] has not given much thought to how her proposal would be implemented, other than to suggest that the Petitioners submit some kind of "compliance filing" setting forth a "more specific proposal", on an unspecified schedule. Exh. RA-66 (Brockway policy surrebuttal), p. 26; Tr. 3267:6–17.
>
> While her prefiled testimony is silent as to how the "cost" at which the "reasonable price" of power would be set, on cross-examination, Ms. Brockway acknowledged that she is essentially contemplating frequent rate cases, in which the Board would evaluate fuel cost, labor cost, capital cost, depreciation, service company costs, and cost of capital. See Tr. 3271:1 – 3272:12. While her prefiled testimony is silent regarding the timing of her price-setting proposal, on cross-examination, Ms. Brockway offered that "[t]he best way to tailor the results to present conditions would be to adjust annually." Tr. 3272:19-20. While she has not suggested the outlines of the procedure she contemplates, she does allow that it could be "as elaborate" as the instant merger proceeding (which, of course, has taken far more than a year to complete). Tr. 3273:7-13.

JPIB at 117-118 (emphasis added).

The underlined portions above mischaracterize Ms. Brockway's testimony and the Ratepayer Advocate's position. This mischaracterization began with Mr. Sidak's Rebuttal Testimony (*JP-36*) and has persisted into the Joint Petitioners' Initial Brief. For instance, the Joint Petitioners have deliberately distorted the record by omitting from the

above section of their Initial Brief a more relevant portion of Ms. Brockway's cross-examination:

> Q So we would have a compliance filing, an analysis of all of these additional factors, would we do that every year after your tranche proposal goes into effect and have a hearing like this one and dispute all these different elements of the cost structure for the tranche?
>
> A The best way to tailor the results to present conditions would be to adjust annually.
>
> <u>You certainly wouldn't have to have a hearing like this one to do that.</u>
>
> Q But people may, I don't know, but I have been told, may have different views on things like the cost of fuel, labor cost, capital costs, depreciation, how the market should have, might they not?
>
> A <u>Sure, but a hearing would look more like the fuel cost hearings, they are not as extensive.</u>
>
> <u>The issues are narrower, they don't take as long.</u>
>
> Q Your proposal here doesn't contemplate what that process would look like, correct?
>
> A No, but it could range from the minimum required by due process to if the Board wanted to something as elaborate as this, <u>but I certainly wouldn't recommend it, and I doubt very much that the Board would adopt such a process</u>.

T3272:L13 to T3273:L13 (3/31/06) (emphasis added). The Joint Petitioners' failure to include in their discussion Ms. Brockway's sworn testimony that the review process for the BGS tranche proposal would most likely be a much simpler hearing process than the instant one is another example of the Joint Petitioners' tactics that casts great doubt on the Joint Petitioners' credibility concerning their arguments in this matter. The Ratepayer Advocate respectfully submits that a thorough review of the evidentiary record in this

case will support our recommendation that the merger proposal should be denied, and that if Your Honor and the Board should decide that there are valid reasons to approve the merger, then that approval should be conditioned on our recommendations.

The tranche proposal was described in detail by Ms. Brockway. It is necessary to quote directly from the evidence, as Your Honor and the Board should not rely on Joint Petitioners' mischaracterization of the testimony. First, from Ms. Brockway's Surrebuttal:

> Q. Does Mr. Sidak accurately capture the mechanics of your proposal?
>
> A. No. Mr. Sidak has interpreted my testimony to mean that I propose a subsidization of prices by a transfer payment from Exelon. That was not my intention.
>
> Q. What was your proposal?
>
> A. In my direct testimony, I said that "New Jersey consumers should be assured a share of the benefits from increased nuclear generation promised by Mr. Rowe." Brockway November 28, 2005 Direct Testimony at 36.
> The point I was concentrating on in the November 28 testimony was that it is not reasonable to leave the question of whether the benefits of additional output would accrue to New Jersey consumers to chance or the workings of a hypothetical market structure. Rather, if as Exelon stated, such benefits were a key reason the merger should be considered a positive development, then Exelon should be willing to assure that the benefits materialize.
>
> Q. Mr. Sidak assumed that you were proposing a rate reduction for PSE&G customers. Is this the best way to assure consumers of these nuclear output benefits promised by Exelon?
>
> A. No, it is not. If the benefits were assured via a rate reduction, or other transfer payment, it could result in double-dipping in the event that the output did increase and market prices did in fact come down as a result. Also, such an approach would only benefit PSE&G customers,

whereas the benefits Mr. Rowe promised were to go to all New Jersey consumers.

Q. What then would be a better mechanism to assure that New Jersey consumers benefit from the promised increase in nuclear output and associated price reductions?

A. I propose that Exelon be required, as a condition of merger approval, to supply tranches of reasonably-priced power, to be used as part of the BGS supply in New Jersey which otherwise would be procured through the BGS auctions, in sufficient amounts to assure that such lower-priced power as was promised will actually show up in New Jersey customers' supply portfolios. The tranches could be priced at the cost of nuclear output, including a return.

Q. Can you give an example of how your proposed mechanism would work?

A. Yes. Suppose hypothetically that New Jersey will need 20 tranches of power to supply all BGS customers in the next auction. Say also that 3 tranches at a reasonable price would provide benefits relative to the anticipated BGS market-clearing price absent the tranches. Exelon would provide the 3 tranches to the BGS customers at the price specified as a condition of the merger, and the remaining 17 would be identified, priced and brought under contract through the normal BGS auction process.

Q. How would the amount of power to be provided in these tranches be determined under your proposal?

A. The first step would be to estimate a benefit per mWh of power provided. This would be estimated as the difference between the price of the power to be delivered and an estimate of the current market value of the power. Then this difference would be spread across sufficient mWh of output to provide the share of nuclear output benefit that is to be locked in for that period.

RA-66 at 20-22. Further, from cross-examination of Ms. Brockway by Joint Petitioners' counsel:

… [T]he first thing that the Board would do would be to determine what are the benefits to be had through the tranche mechanism, and I would actually say that the market, the job loss mitigation and market power mitigation ought to go through a tranche process also …but the first thing is how many dollars, the Board has to decide that. I have made my recommendation, or the RPA will make its global recommendation.

The second thing, … I certainly would love to see the Board put in place a hundred percent of the number because I like certainty in the benefits and in the protections against the risk. But I recognize that the Board may want to allow for some uncertainties, allow for some possibilities that things will work out the way Dr. Lesser is proposing, that things won't be so bad as Synapse has said on the market power or [I have] said on the job loss, and so forth. So I suggest here, for example, …the Board could go fifty-fifty, so half of the benefits in loss mitigation and market power mitigation would flow through a tranche proposal, and half would be left to the devices of the market in the hope that Synapse is actually wrong on the market power.

…I don't believe that the small number of tranches that would result from this would have an anti-competitive effect, but if the Board thought so and if the Board wanted to balance against that possibility it could again lower the amount of these dollars that flow through the tranches and leave the rest to these other mechanisms which I would call more speculative or risky but would dampen the impact. … <u>So these are the types of decisions that the Board should make in its judgment in setting what number of dollars.</u>

And then you have to decide what is the market price as the shadow price, and you can look backwards, you can project forwards. I am saying let the Company make a proposal as to whether you should do that or some other kind of mechanism for pegging where these things would come out in the market. Finally, you have the cost portion and there are more or less rigorous ways of defining costs which would have more -- greater or fewer analogs to the old regulatory way of doing things. Again I am saying, let the Company make a proposal about that, those two price

> points, defining the difference which would then give the
> amount of dollars we are looking for to find the tranches.

T3268:L14 to T3270:L25 (3/31/06) (emphasis added).

D. The Tranche Proposal Does Not Violate the Brooks-Scanlon Prohibition of Cross-Subsidization and Is Not Subject to Challenge Under the U.S. Constitution.

Joint Petitioners cite *Brooks-Scanlon v. Railroad Board of Louisiana*, 251 U.S. 396 (1920), as well as *Michigan Bell Telephone Company v. Engler*, 257 F.3d 587 (6th Cir. 2001), in support of their claim that the tranche proposal for sharing benefits and mitigating harms would violate a prohibition against appropriating profits from unregulated operations to support the operations of a regulated business. *JPIB at 119*. Joint Petitioners misapply the cases. The tranche proposal would not appropriate profits from unregulated assets to support regulated operations.

First, there is no proposal to "appropriate profits." Rather, in the case of the nuclear output, the proposal is to make concrete a share of the benefit that Joint Petitioners themselves promise to provide to the State. In the case of the mitigation of job loss and market power harms, the proposal is to compensate New Jersey for the risk of harms the merger brings in those areas, so as to bring at least to equipoise the balance of benefit and risk from the merger proposed by Joint Petitioners.

Second, if Your Honor and the Board adopt the tranche proposal, New Jersey would not be asserting the power to take profits from Exelon to support regulated operations. That is, if the Joint Petitioners felt that the merger conditions changed the deal to the point it was no longer to their liking, they could decide not to merge. They have in fact made public statements to this effect. The link between the tranche condition

and the unregulated profits is brought into play only because of Exelon's desire to acquire PSEG, and the fact that, as it suggests, the merger cannot be called beneficial to New Jersey unless the impact of the merger on the unregulated side of the business is included in the calculus. As stated above, the Board itself has already described its policy to review all of a proposed merger's claimed benefits, not just the synergy savings benefits of combining operations.

The proposal that the Joint Petitioners be required to set aside tranches of power for the use of New Jersey customers would also, if implemented, withstand a challenge under the Commerce Clause and the Supremacy Clause of the U.S. Constitution. *Compare JPIB at 120-124.* The proposal to set aside "tranches of reasonably priced power" for New Jersey does not discriminate against non-New Jersey interests. *Compare JPIB at 121-122.* The cases Joint Petitioners cite do not suggest otherwise.

Joint Petitioners first argue that the tranche proposal is analogous to the Kentucky statutory provision providing that when a utility experienced an emergency or other event necessitating a curtailment or interruption of service, it was not permitted to curtail or interrupt service within its own service territory "until after service has been interrupted to all other customers whose interruption may relieve the emergency or other event." *Kentucky Power Co. v. Huelsmann*, 352 F. Supp.2d 777, 782 (E.D. Ky. 2005). The court agreed with the plaintiffs that this provision "protects the reliability of electric service to Kentucky customers at the expense of out-of-state customers," and was thus unconstitutional.

By contrast, the tranche proposal does not provide a benefit to New Jersey consumers that would come at the expense of out-of-state customers. It merely reduces

to a contractual certainty some of the asserted nuclear benefits of the merger,[7] benefits that Joint Petitioners already claim will go to New Jersey consumers in any case.[8] The balance of the benefit would continue to flow, under the Joint Petitioners' theory of the case, to all the consumers within the reach of the affected plants. The tranche proposal also provides compensation to New Jersey to balance risks that are imposed on New Jersey by the proposal of Joint Petitioners to merge.

The tranche proposal does not require the use of in-state resources, contrary to Joint Petitioners' assertion in their Initial Brief at 123-124. The tranche proposal is unlike the Indiana law struck down in *Alliance for Clean Coal v. Bayh,* 72 F.3d 556 (7th Cir. 1995), or the Oklahoma law rejected in *Wyoming v. Oklahoma*, 502 U.S. 437, 438 (1992). As Joint Petitioners only promise that the nuclear output will bring dollar benefits to New Jersey, Ratepayer Advocate only asks (and Ms. Brockway's proposal only specifies) that enough reasonably-priced power be provided to ensure that the promise is kept.[9] The proposal does not specify what plants should be used, nor whether Exelon must own them. It only provides for a reasonable calculation of the difference between a nuclear unit price and the (presumably higher) prevailing market price, and a

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[7] Ratepayer Advocate does not argue that the small extent of contractual benefit that would be needed to meet this merger condition takes it outside the prohibitions of the dormant Commerce Clause. *Compare JPIB at 124, citing Wyoming v. Oklahoma, 502 U.S. 437, 438 (1992).* Rather, the tranche provision does not trigger the dormant Commerce Clause prohibitions, and would not even at larger sizes if they were tailored to the promises advanced by Joint Petitioners to justify this merger.

[8] Joint Petitioners complain that the tranche provision has no end date. *JPIB at 122.* No end date is provided (except for the job loss mitigation component, which would be finished two years after the merger closes) because Joint Petitioners do not suggest an end date for the promised nuclear benefits, and there is no suggested end date for the risk of market power. Those are the key drivers of the scope of the proposed tranche provision.

[9] As the Joint Petitioners would undeniably admit, the shareholders of both merging companies have already reaped enormous benefits from the proposed merger in their increased stock price. The BGS tranche proposal does nothing more than attempt to capture promised benefits for the ratepayers rather than leaving them only empty promises.

determination of the number of tranches provided at the lower price to assure the promised benefit is received by New Jersey consumers.

Furthermore, the tranche proposal does not prohibit the sale of certain power in interstate commerce. *JPIB at 123.* As noted, the tranche proposal does not even require Exelon to own the plants from which the reasonably-priced power is obtained.[10] To the extent Exelon does use plants it owns, the tranche proposal does not affect the ability to sell "certain power" elsewhere, including in interstate commerce, any more than a power purchase agreement would. Power purchase agreements to sell a certain amount of power to entities within one state are not unconstitutional because those counterparties are within one state.[11] T3273:L14 to T3274:L5 (3/31/06). To argue otherwise would turn the dormant Commerce Clause on its head, and create the rule that no seller may sell its product on a long-term basis if all the sales are to buyers in one state. Finally, the sales of the tranches are voluntary, in that they would be conditions of a merger to which Exelon has no absolute right, and as to which New Jersey has every right to ensure net benefits accrue to its ratepayers and citizens.[12]

The Joint Petitioners' final constitutional contention is that the FERC has exclusive jurisdiction over rates and that the tranche proposal amounts to "[d]ictating the

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[10] The Joint Petitioners' witness Kenneth W. Cornew testified that Exelon Generation enters into bilateral long-term power purchase agreements with other generation owners to obtain "low-cost energy supply sources" to serve its customers and sometimes sells any excess power not needed by its customers. *JP-10 at 8.*

[11] The Joint Petitioners have not argued that they are not permitted to enter into a power purchase agreement for their electric generation.

[12] While not in exactly the same circumstances as the instant case, the Board itself has previously seen fit to approve a voluntary supply arrangement between an electric public utility and its generation affiliate when it approved the agreement between PSE&G and PSEG Power in the utility's restructuring docket. In that agreement, PSEG Power agreed to provide electric supply for BGS service for the first three years of the transition period at regulated, not market, prices. *I/M/O Public Service Electric and Gas Company's Rate Unbundling, Stranded Costs and Restructuring Filings, BPU Docket Nos. EO97070461 EO97070462, AND EO97070463, Final Decision and Order, dated August 29, 1999, p. 100.*

use or disposition" of Exelon's generation, in contravention of the holding of the Supreme Court in *Mississippi Power & Light Co. v. Moore*, 487 U.S. 354 (1988)(finding that FERC has exclusive jurisdiction over rates and over power allocations that affect rates; "Congress has drawn a bright line between state and federal authority in the setting of wholesale rates . . . . States may not regulate in areas where FERC has properly exercised its jurisdiction to determine just and reasonable wholesale rates"). *JPIB at 125*. This argument is misplaced, as well.

The Ratepayer Advocate notes at the outset that under the tranche proposal Exelon need not even own the generation that it supplies at the reasonable price. This fact alone makes the tranche proposal a different fact pattern from the case at hand in Mississippi Power & Light Co. There, one state whose major electric utility had a FERC-approved all-requirements contract with an affiliated generation utility reduced the local utility's rates, finding that it should not have been allocated by the affiliate such a large share of an expensive nuclear power plant. The Supreme Court overruled the state decision, observing that the allocation of responsibility for the plant had been made pursuant to FERC order, and could not be changed by a state ruling. But here we are not talking about the allocation of responsibility for the output of a single plant, and the FERC has not directed Exelon to allocate the output of any plant in any particular way.[13]

Your Honor and the Board should also reject the implication that conditioning the merger approval on acceptance of the tranche proposal amounts to an attempt by New Jersey to set wholesale rates. If Your Honor and the Board adopt the tranche proposal,

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[13] While ER&T has authority from FERC to sell at market-based rates (*JP-9 at 5)*, such authority is more a privilege bestowed by FERC than a requirement. FERC does require transmission-owning utilities to open their grids to competitive suppliers, but does not bar a generator from selling its power at a price determined by the cost of generation of nuclear plants.

the result would be a condition on the merger, which the Joint Petitioners would be free to accept or reject. If accepted, it would be accepted voluntarily. But that result does not turn the condition into an exercise in ratemaking.[14] Again, the Joint Petitioners do not have a right to the proposed merger. Rather, they have the burden of showing that the merger will provide net positive benefits to New Jersey, and persuading Your Honor and the Board that the merger satisfies the Board's positive benefits standard. In this particular case, the Ratepayer Advocate asks Your Honor and the Board to order that the Joint Petitioners' promises of benefits and assurances against harm from the merger be reduced to a more reliable mechanism for the flow of such benefits and the mitigation of such harms.

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[14] In a similar case, the Arizona Court of Appeals determined that a merger condition requiring a three-year rate freeze did not constitute "ratemaking." *Arizona-American Water Company v. Arizona Corporation Commission*, 98 P.3d 624 (Ariz. Ct. App. App. 2004), citing *Arizona Public Service Co. v. Arizona Corp. Commission,* 939 P.2d 1345, 1347 (Ariz. Ct. App. 1997). Just because the merger condition affected rates, it was not thereby a ratemaking order. The Court also found that the merger approval condition requiring a rate freeze did not prevent the utility from seeking a rate increase unless the parent chose to complete the merger, which it did. Similarly, the Joint Petitioners can avoid the merger condition concerning the BGS tranche proposal if they decide not to complete the merger. By completing the merger, the Joint Petitioners would be volunteering to comply with the proposal.

V. IMPACT OF THE MERGER ON THE PROVISION OF SAFE AND ADEQUATE UTILITY SERVICE AT REASONABLE RATES.

A. Service Quality

1. Contrary to the Positive Benefits Standard of Review Required for Approval of Their Petition, the Joint Petitioners' Initial Brief Criticizes Other Parties' Positions Yet Fails to Satisfy Their Burden of Proving That Positive Benefits In the Areas of Service Quality and Reliability Will Flow to New Jersey Ratepayers.

a. Overview

Almost one year has passed since the Board decided at its June 22, 2005 agenda meeting that the Joint Petitioners must show that positive benefits will flow to the State of New Jersey and its ratepayers in order for Your Honor and the Board to approve this merger petition. Yet the Joint Petitioners, through their Initial Brief, continue to offer only vague, unsupported representations of positive benefits in the areas of service quality and reliability. Indeed, the Joint Petitioners' Initial Brief is drenched with criticisms of other parties' cases in a transparent attempt to conceal this crucial void in their own case.

As a preliminary matter, the Joint Petitioners appear to be confused as to applicable law for merger approval in New Jersey. The Joint Petitioners seem to forget that, as proponents of this merger petition, they bear the burden of proving their case to Your Honor and the Board, a burden which includes proving positive benefits. Compared to other parties to the case, including Board Staff and the Ratepayer Advocate, the Joint Petitioners have the greatest access to relevant information and appropriately bear this burden. *See J.E. on Behalf of G.E. v. State*, 131 *N.J.* 552, 569-70 (1993) (burdens of persuasion and production generally lie with the party with the greater access to relevant information). The Joint Petitioners' assertion, for example, that there is "no

record evidence suggesting that association with Exelon…will be detrimental to PSE&G and its customers from a quality-of-service perspective" not only ignores the positive benefits standard of review but inappropriately attempts to shift the burden of proving such positive benefits away from the Joint Petitioners by implying that other parties must demonstrate that the merger will have detrimental effects. However, other parties to this case, including Board Staff and the Ratepayer Advocate, are not required to prove such detrimental effects in order for Your Honor to recommend rejection of this merger to the Board. The Joint Petitioners seek to shirk their burden of proof. Instead, they favor distorted criticisms of other parties' positions in an attempt to distract Your Honor and the Board from reality. This reality is that the Exelon organization has very little to offer PSE&G customers in the areas of enhanced service quality or reliability.

b. The Joint Petitioners' Discussion Includes Several "Commitments" Which Are Unrelated to the Provision of Safe and Proper Service.

The Joint Petitioners' Initial Brief on service quality/reliability includes a section captioned "Capital, Employee and Other Commitments Ensuring The Continuation Of Safe and Proper Utility Service." *JPIB at 44*. The Joint Petitioners claim they "have made several commitments supporting a conclusion that this transaction will enhance PSE&G's ability to provide safe and adequate utility service in this State." *Id.* The Joint Petitioners then proceed to list several "commitments" in the areas of capital spending, charitable contributions, and support of the Board's clean energy objectives. *Id. at 44-48*.

With the exception of the capital spending issue, none of these topics is even remotely related to the issue of the provision of safe, adequate and proper service. While PSE&G's commitment to charitable contributions, for example, may be admirable, it is

misplaced in a discussion of the merger's effect on PSE&G's service quality and reliability. A PSE&G electric customer who begins to experience more frequent outages in a post-merger environment would hardly be comforted by PSE&G's charitable work. Your Honor and the Board should not be misled into believing that any "commitments" to charitable contributions and clean energy programs equate to positive benefits to service quality and reliability. The Joint Petitioners omit the fact that compliance with the Board's Clean Energy Program ("CEP") and continuing to collect ratepayer funds for the CEP is not a voluntary commitment, but is required by Board order and EDECA. A "commitment" to obey the law is not the type of "positive benefit" that the Board had in mind when it imposed the positive benefits standard on this case. This self-congratulatory, off-topic discussion by the Joint Petitioners is an attempt to mask the reality that they refuse to make any substantive commitments to maintain electric, gas, and customer services at PSE&G's current levels.

c. The Joint Petitioners' Discussion of Exelon's Post-Merger Management Structure Is Misleading.

The Joint Petitioners offer a brief, confusing discussion of Exelon's intended post-merger management structure in the customer service area. *See generally JPIB at 48-50.* Quoting from Mr. Izzo's testimony, the Joint Petitioners claim that "[a]ll operational and customer service functions of PSE&G will be headed up by individuals who report directly to Ralph LaRossa, who will be the new President of PSE&G, or who report directly to me." *Id. at 49*. However, the Joint Petitioners also admit that customer and marketing services will be consolidated to the Energy Delivery Shared Services area of the Exelon Services Company.

The Ratepayer Advocate would like to clarify that, although it may be true that customer service will be headed by an individual who reports to Mr. LaRossa, this individual will be Ms. M. Bridget Reidy, Senior Vice President of Exelon Energy Delivery Customer Operations, an Exelon employee who works out of Chicago. T588:L19 – T589:L5; T590:L5-17 (1/9/06). The chain of command, in other words, will be circuitous – from New Jersey, to the centralized customer operations in Chicago, and back to Mr. LaRossa in New Jersey. The Ratepayer Advocate reiterates our position that local decision-making authority in the customer service area will be diminished, with most authority transferred to Ms. Reidy's group in Chicago. The consequences of this loss of local authority are likely to be detrimental to New Jersey ratepayers, who will see flexibility to resolve their specific concerns diminished.

d. The Joint Petitioners' Abstract Representations Regarding Best Practices Sharing Should Not Be Credited by Your Honor and The Board as a Positive Benefit of This Merger.

Once again, the Joint Petitioners try to introduce the concept of best practices in the service quality area as a positive benefit of this merger. The Ratepayer Advocate asserts that the Joint Petitioners' argument is flawed in several respects. First, as Ms. Brockway testified, best practices can be shared without the need for a merger. *RA-1 at 10.* The Joint Petitioners have not identified a single best practice in the service quality area that necessitates a merger in order for best practices sharing to occur. The few examples of potential merger-related best practices provided by the Joint Petitioners illustrate this flaw. For example, the Joint Petitioners tout Automated Meter Reading ("AMR") as one area where PSE&G may benefit from Exelon. *JPIB at 43-44*. The AMR technology, however, existed long before the Joint Petitioners proposed this

merger, and the Joint Petitioners ignore the fact that PSE&G is more than capable of investigating this technology as a stand-alone company.

Moreover, given PSE&G's superior performance to Exelon in electric and gas reliability, it is difficult to see how PSE&G and New Jersey could benefit from best practices in these areas. PSE&G has already achieved superior performance in these areas. Indeed, although the Joint Petitioners tout the sharing of best practices as an alleged merger benefit, they seem to have little confidence in PSE&G's ability to benefit from such practices in the customer service and reliability areas, as they refuse to commit to maintaining current service quality levels through their adamant opposition to the Ratepayer Advocate's Service Quality Maintenance Plan ("Maintenance Plan").

e. The Joint Petitioners' Reference to the Improvements at ComEd and PECO Following the ComEd/PECO Merger Is a Red Herring And Should Be Disregarded By Your Honor and the Board.

The Joint Petitioners claim that "[t]he best evidence of how Exelon is likely to conduct business in New Jersey" in the service quality and reliability areas is how they have conducted business at PECO following the ComEd/PECO merger. *JPIB at 51*. However, the Joint Petitioners' purported "best evidence" is nothing more than a red herring.

The Joint Petitioners attempt to make much of the reliability improvements at PECO and ComEd following that merger. On this basis, the Joint Petitioners claim that there is "no record evidence suggesting, that association with Exelon, which has plainly benefited PECO and its customers, will be detrimental to PSE&G and its customers from a quality-of-service perspective." *Id. at 54*. As discussed above, the Joint Petitioners'

statement that no evidence exists to indicate that PSE&G's service quality will be harmed as a result of this merger not only ignores the positive benefits standard of review, but inappropriately attempts to shift the burden of proof away from the Joint Petitioners. In any event, as the Ratepayer Advocate has previously stated and reiterates now, post-merger reliability trends at PECO and ComEd are not indicative of what effect this merger may have on PSE&G's future reliability.

As the Ratepayer Advocate has already pointed out in this Reply Brief and in our Initial Brief, there are several flaws with this analogy. As the Ratepayer Advocate discussed at length in our Initial Brief, the Joint Petitioners incorrectly assume a causal connection between the ComEd/PECO merger and reliability improvements at those two companies. The Joint Petitioners failed to track the best practices they claim to have shared in the months and years following that merger. *RA-1 at 9*. There is no evidence, therefore, that the reliability improvements at ComEd and PECO can be attributed to shared best practices stemming from that merger. Additionally, as Ms. Brockway's undisputed testimony shows, there were clearly forces other than the ComEd/PECO merger responsible for the recent reliability improvements. ComEd's electric reliability in 1999 was so poor, and the resulting public outcry from politicians, regulators and the public so great, that the company was forced to make investments to improve reliability. *RA-11 at 35-41*.

Furthermore, the Joint Petitioners can hardly claim that reliability improvements at PECO and ComEd would result in similar consequences for PSE&G. Indeed, the Joint Petitioners do not even attempt to make this claim, rather they only assert that PSE&G's reliability will not be harmed. *JPIB at 54*. In any event, even this claim lacks merit.

When ComEd and PECO merged, both companies had much worse reliability records than PSE&G currently enjoys. *RA-11 at 33-34, 42-43*. Most importantly, even accounting for the recent reliability improvements at ComEd and PECO, both utilities' reliability performance continues to trail the current performance of PSE&G. *Id.* Clearly some of Exelon's current "best practices" in the reliability area may not benefit PSE&G's post-merger reliability, and in fact may harm it.

Finally, the Joint Petitioners brag that "Exelon has met all of its commitments associated with the 2000 merger with PECO in the areas of reliability, customer service, and safety…." *JPIB at 54*. The Ratepayer Advocate is unclear as to why this matters in the present case. First, there is no evidence in the record as to the difficulty for PECO in meeting the commitments it agreed to undertake in that merger. Further, the achievement is of negligible importance considering that the Joint Petitioners offer no discernible commitments to maintain PSE&G's strong service quality record as a condition of this proposed merger. They unconditionally reject the Ratepayer Advocate's Maintenance Plan, which simply attempts to commit the Joint Petitioners to the representations they are making to Your Honor and the Board.

To the extent that the Joint Petitioners allege that the ComEd/PECO merger is the "best evidence" of post-merger reliability trends for PSE&G, this argument is a red herring and should be rejected.

f. The Joint Petitioners' Claim that Exelon's Customer Service Performance is Superior to PSE&G's Performance Is Misleading.

In their Initial Brief, the Joint Petitioners claim that "the Exelon Utilities' customer service performance is generally superior to PSE&G's." *Id. at 61*. The

Ratepayer Advocate asserts that this statement is misleading. While it is true that Exelon exceeds PSE&G in certain customer service metrics, such as average answer speed, this is not true of all metrics. As discussed in the Ratepayer Advocate's Initial Brief, Ms. Brockway undisputedly testified that PSE&G's performance in percentage of service appointments met exceeds both PECO and ComEd. *RPAIB at 44*. Also, PECO's number of complaints per 1000 customers to regulatory agencies has been as much as 5 times that of PSE&G. *Id.*

In addition, these metrics say nothing about the subjective aspects of superior customer service, such as the quality of assistance provided to customers. There are many important aspects of utility customer service that cannot be quantified. As Ms. Brockway testified, these subjective aspects include quality of response to customer concerns, familiarity with local geography, outreach programs, and culture. *RA-1 at 22*. It is important to note that Exelon intends to "align" call center operations between Chicago and the Philadelphia/New Jersey area to take advantage of the different time zones. Under this plan, a PSE&G customer calling a customer service center may end up speaking with a representative in Chicago. The Chicago representatives may lack knowledge of New Jersey specific issues, such as geography, local assistance programs, etc. There is sound reason to reject Exelon's assertion that "this merger will produce measurable improvements in PSE&G's customer service performance." *JPIB at 61*. In fact, in light of the proposed call center alignment and accompanying staff reductions, the opposite may be true. The quality of assistance provided to customers, in particular, may decline.

The Ratepayer Advocate also urges Your Honor and the Board to disregard the Joint Petitioners' misleading reliance on a 2005 J.D. Power survey which ranked PECO's and ComEd's customer satisfaction higher than PSE&G's customer satisfaction. *Id. at 53*. As previously stated, ComEd and PECO have historically experienced reliability problems; ComEd's reliability, in particular, became so egregious in the 1990's that it led to a public outcry. ComEd's and PECO's reliability have seen improvement in recent years. PSE&G, by comparison, not only currently has superior reliability to either Exelon utility, but has historically experienced this high quality service. ComEd's and PECO's customer satisfaction scores very well may be attributable to the fact that they were such poor performers, that their customers were thrilled when they experienced some level of improvement.

Moreover, the J.D. Power survey states that the study's results "are based on customer responses from more than 26,700 telephone interviews conducted from April 7, 2005 through June 5, 2005…." *JP-107*. By April 2005, the public was well aware of PSE&G's intention to merge with Exelon. Perhaps PSE&G ratepayers sent a message through this survey that they are not pleased with this proposed merger.

g. Despite Numerous Irrelevant, Flawed, and Misleading Arguments, The Joint Petitioners Have Been Unable to Discredit Any Aspect of the Ratepayer Advocate's Maintenance Plan, Which Should Be Adopted By Your Honor and The Board If the Merger Is Approved.

The Joint Petitioners criticize the Ratepayer Advocate's Maintenance Plan from many angles. Your Honor and the Board should dismiss the Joint Petitioners' criticisms for the reasons outlined below.

1. Your Honor and the Board Should Disregard the Joint Petitioners' Argument That the Proposed Maintenance Plan Would Place an "Unprecedented Burden" On Them.

The Joint Petitioners dramatically argue that "Ms. Brockway ignores the actual financial implications of her [proposed Maintenance Plan], which could place an unprecedented burden and financial risk on the utility." *JPIB at 70*. They make the misleading allegation that "Ms. Brockway has done no analysis of what expense would be required to improve PSE&G's SAIFI/CAIDI performance to the levels she espouses." *Id*. (emphasis added). The Ratepayer Advocate notes that our proposed Maintenance Plan does not ask PSE&G to improve its reliability, but rather asks PSE&G to maintain its current First Quartile performance. To the extent the Joint Petitioners allege otherwise, they apparently are confused. Also, although the Joint Petitioners complain that the Maintenance Plan will financially burden them, they fail to explain the nature of this alleged burden. It is difficult to imagine why the Joint Petitioners would experience the "unprecedented burden" they allege, given that the Maintenance Plan only asks them to maintain their current performance. It is also significant that Joint Petitioners do not offer even to maintain their current levels of reliability.

The Joint Petitioners' argument also contradicts their own contentions that the merger will "benefit" PSE&G's gas service and "will not harm" PSE&G's electric service. *JPIB at 54, 57*. Indeed, the Joint Petitioners represent that "[t]he benefits of the proposed merger to customers are substantial and indisputable and will be realized in the form of even better service at lower rates." *JPIB at 29* (emphasis added). The Ratepayer Advocate's Maintenance Plan simply accepts the Joint Petitioners' claims and asks them to commit to their representations. In fact, the Maintenance Plan does not even require

PSE&G to produce better service, as the Joint Petitioners allege will result from the merger, but only to maintain their current service levels. The Joint Petitioners contradict themselves by representing to Your Honor and the Board that improved service quality at lower rates will occur as a result of this merger, then complaining that the Maintenance Plan financially burdens them. The Ratepayer Advocate questions how the Joint Petitioners can allege they will <u>improve</u> service quality through cheaper methods, yet claim they will be financially burdened when asked to commit to a plan that only requires them to <u>maintain</u> current levels. The Joint Petitioners' argument is clearly disingenuous.

2. The Joint Petitioners' Comparison of the Maintenance Plan to Previous Board Actions is Wholly Irrelevant, and the Assertion That Any Penalties Imposed Under the Maintenance Plan Are Automatic is Erroneous.

Attempting to discredit Ms. Brockway and the Ratepayer Advocate's Maintenance Plan, the Joint Petitioners allege that Ms. Brockway "has no idea how the automatic penalty she proposes for failure to maintain first quartile performance … compares to the only other reliability penalty that has been imposed by the Board, that is, the penalty imposed on First Energy in the form of a 25 basis point reduction in JCP&L's equity allowance." *JPIB at 70*. This contention is erroneous and irrelevant.

As stated in the Ratepayer Advocate's Initial Brief, despite the Joint Petitioners' repeated mischaracterizations, the penalty mechanism proposed under our Maintenance Plan is not "automatic." As always, the Board could take into account special conditions out of PSE&G's control in determining the amount of a penalty to impose. *RA-1 at 47*. Penalty amounts will always be within the Board's discretion.

Moreover, the Joint Petitioners' argument, that the Maintenance Plan's penalty mechanism somehow does not "compare" to the Board's 2004 decision to reduce

JCP&L's return on equity, is completely irrelevant. It is within the Board's discretion to adopt the Maintenance Plan regardless of the FirstEnergy case. The Ratepayer Advocate reminds the Joint Petitioners that the Board has not previously entertained a proposed gas and electric utility merger of such a grand scale as this merger. Indeed, this merger, if approved, would create the largest utility in the United States. Based on the Joint Petitioners' reasoning, the Board should not approve their proposed merger because it does not "compare" to any other merger previously approved by the Board.

3. A Service Quality Working Group is Not an Adequate Substitute for the Ratepayer Advocate's Maintenance Plan, and The Joint Petitioners' Argument That PSE&G Should Be Entitled to Incentives For Good Performance is Inappropriate in the Context of This Proceeding.

The Joint Petitioners try to belittle the importance of the Ratepayer Advocate's Maintenance Plan by alleging Ms. Brockway "ignore[s] the fact that PSE&G has been working with the BPU and the Ratepayer Advocate in a collaborative working group to set interim performance and service quality standards for the industry." *JPIB at 72*. The Joint Petitioners also state that "PSE&G supports a formal rulemaking that would develop performance standards…including potential incentives for excellent performance and penalties for substandard performance." *Id*. The Ratepayer Advocate urges Your Honor and the Board to reject this proposed alternative to the Maintenance Plan.

The working group referred to by the Joint Petitioners is not an appropriate substitute for the Ratepayer Advocate's Maintenance Plan. As Ms. Brockway testified, the working group's objectives differ from the Maintenance Plan's objectives. *RA-11 at 30-31*. The objective of the Maintenance Plan is to commit the Joint Petitioners to their representations regarding PSE&G's post-merger service quality. The working group's

goal, meanwhile, is to recommend minimum reliability standards for all New Jersey utilities. *Id. at 30*. If Your Honor and the Board recommend merger approval, the Joint Petitioners should be held to their representations. The Maintenance Plan provides a means for accomplishing this. As for the working group, it is speculative to anticipate when it will produce a consensus work product, if ever, and should not be perceived as an adequate substitute for the Maintenance Plan.

Moreover, there is nothing inappropriate about a service quality plan that lacks incentives for PSE&G, as PSE&G already has an obligation to provide superior service to its customers. Our State Supreme Court has found that "[u]nlike other corporations…utilities are subject to a special obligation to serve the public interest. In particular, the primary obligation of a utility is to provide safe, adequate, and proper service at fair and reasonable rates." *I/M/O Alleged Violations of Law By Valley Rd. Sewerage Co.*, 154 *N.J.* 224, 240 (1998). The Board is requiring positive benefits to flow to PSE&G ratepayers and the State of New Jersey as a condition of this proposed merger. The Joint Petitioners' eagerness to secure incentives for themselves stands in sharp and telling contrast to their vehement objection to the Ratepayer Advocate's proposed Maintenance Plan, which seeks only to assure that PSE&G's current service quality and reliability are not degraded by the merger. We urge Your Honor and the Board to reject this proposed alternative and to adopt the Ratepayer Advocate's Maintenance Plan.

B. Since They Failed to Cross-Examine the Ratepayer Advocate's Gas Supply Witness in the Hearings And Failed to Address the Ratepayer Advocate's Proposed Modifications in Their Initial Brief, One Must Conclude that Joint Petitioners Endorse the Ratepayer Advocate's Recommendations Regarding Gas Procurement.

Throughout these proceedings Joint Petitioners have failed to address how PSE&G's gas operations will be structured if the proposed merger is approved. In their Petition, discovery and testimony, Joint Petitioner did not provide definite plans regarding any proposed structural changes, and in their Initial Brief they ignored the subject entirely.

Since the Company cannot, or will not, provide such information, the Ratepayer Advocate recommends that, if Your Honor and the Board approve the merger, that the Company's gas procurement program be modified in a Board Order in such a way as to protect PSE&G's ratepayers as discussed in the Ratepayer Advocate's Initial Brief.

Joint Petitioners asserted in their Petition that PSE&G would continue to receive its total firm gas supply requirements from its unregulated PSEG affiliate, PSEG Power's Energy Resources & Trade ("ER&T") or a successor company. *RPAIB at 49*. However, the potential change in ownership and the need to recoup acquisition costs could potentially cause problems that negatively affect PSE&G'S ratepayers, which the Joint Petitioners have refused to address. *Id*.

As discussed in more detail in our Initial Brief, in 2002 the Board approved a transfer of PSE&G's gas supply and capacity contracts from the utility to ER&T. *Id*. Pursuant to the terms of the Requirements Contract ("the Contract"), ER&T was to provide to PSE&G its total gas requirements of its BGSS customers. *Id*.

Ratepayer Advocate witness Richard LeLash testified that "a change in ownership and future operational changes may affect provisions of the existing Contract, and will not ensure on-going supply under commensurate terms and conditions." *RPAIB at 50, citing RA-4 at 6*. If the merger were to be approved, ER&T or a successor entity under

Exelon's ownership and control could contend that its prospective obligation to PSE&G is limited to the specific terms and conditions of the amended Contract. Moreover, "the Requirements Contract is neither clear nor comprehensive on procurement matters, and there is a need to fully define and obtain commitments concerning the Board's prospective authority over procurement and the Requirements Contract provisions." *Id., citing RA-4 at 31.*

The Ratepayer Advocate's Initial Brief addresses the shortcomings of the Contract and provides recommendations that the Ratepayer Advocate believes are essential to protect PSE&G's ratepayers from a change in ownership and operational control. The most important Contract issues are as follows:

Capacity Margin Sharing

The Contract is silent concerning the post-transfer mechanics of margin-sharing on capacity transactions. *Id.* Unless the mechanics are spelled out clearly, the margin issue could be subject to dispute under Exelon's ownership of ER&T. *Id. at 51, citing RA-4 at 28.* As Mr. LeLash testified, in order to protect ratepayers, "what is needed [in a post-merger world] is a clear specification of which ER&T transactions will generate margins or credits, how such margins or credits will be determined and the mechanism for allocation of the margins or credits among various customers that receive and pay for the associated gas supply." *Id., citing RA-4 at 29.*

Level of Capacity Resources

Under the Contract, ER&T may unilaterally "amend, extend, replace or supersede" any existing gas contracts in order to meet its full requirements obligation to PSE&G. *Id., citing RA-4 at 23*. Moreover, the Board has no explicit authority over

changes to the portfolio. *Id*. ER&T presumably could maintain excess capacity in its portfolio for sale in the secondary market. The surplus capacity, although paid for by PSE&G's ratepayers, would not benefit those ratepayers since ER&T would retain all margins obtained from such sales. *Id.* As Mr. LeLash stated in his testimony, "PSEG has a potential conflict of interest in matters related to the matching of demand and supply for ER&T's gas supply and capacity portfolio." *Id. at 52, citing RA-4 at 26.*

Board Oversight of Capacity

When it approved the contract transfer**, t**he Board acknowledged that, after this approval, it would not have the ability to investigate ER&T's gas procurement practices, nor to alter any contractual or pricing terms between PSE&G and ER&T. *Id. at 52, Contract Order at 10.* After 2007, the Contract will become an annual agreement. With annual notice, ER&T could declare itself no longer responsible for PSE&G's full requirements, requiring the utility to purchase gas from a third party supplier at potentially higher prices, to be passed through to ratepayers. *Id.*

Other Contract Issues

The Board should also address the following other Contract issues:

1) Curtailment of non-firm customers.

2) Reference to all relevant legal requirements regarding affiliate standards.

3) Force Majeure.

4) Capacity release provisions for Initial Firm Transportation Capacity Release Program

5) Permanent Capacity Release/Assignment Program for the Benefit of Third

6) Party Suppliers. *Id at 53.*

Recommended Modifications and Regulatory Protections

As a condition of any merger approval, the Ratepayer Advocate reiterates that the Board should require the following:

- The Contract should be modified to include a provision requiring Board approval for any material modification of the level or cost of gas capacity required by PSE&G. Such material modifications should include contract termination, capacity enhancements or substitutions and any changes to the nature or scope of operations of ER&T or its successor. *RA-4 at 35.*
- The Contract should specify all transactions related to the PSE&G capacity, the determination of margins and credits, and the allocation of such margins to gas ratepayers, and it should incorporate all relevant margin provisions as set forth in applicable prior Board Orders. *Id.*
- There should be a commitment for the continuation of the current BGSS service and its pricing provisions and a requirement that residential customers have the right to receive cost-based gas supply that is subject to annual reconciliation. The commitment also should prohibit PSE&G from adopting any monthly indexed price procedure for its residential BGSS-RSG service. *Id.*
- The Contract should specify that only PSE&G should have the authority to control service interruptions, and that Force Majeure provisions should only allow weather-related claims if the average daily mean temperature is below the level incorporated into the Company's latest design day requirements determination. *Id. at 36.*

- All TPS transportation or storage capacity release provisions currently in effect should be terminated. Subsequently, PSE&G could propose prospective release programs subject to Board approval. *Id*.
- Although the Board "reviews gas supply and capacity costs in PSE&G's annual BGSS filing," (*JP-21 at 9*), the extent of the Board's authority over ER&T's or any successor's performance or related costs is not known. The Joint Petitioners may claim that all ER&T responsibilities and charges have been set forth in the Contract, and the Board may be powerless to obtain any necessary modifications. For this reason, it is essential that all terms and conditions of the Contract between PSE&G and ER&T be made explicit.
- Finally, Joint Petitioners have stated that they plan to relocate ER&T to Pennsylvania. The Board should require that ER&T's successor's gas management operations or trading should continue to be based in Newark unless otherwise expressly authorized by the Board. *RA-4 at 36.*

The Ratepayer Advocate's position and recommendations regarding gas procurement and gas operations are unrebutted. If Your Honor and the Board decide to approve the proposed merger between Exelon and PSE&G, Your Honor and the Board should adopt the Ratepayer Advocate's recommendations relating thereto.

C. Low-Income Issues

The Joint Petitioners' Initial Brief includes an argument that the Ratepayer Advocate's concern about the continued availability of PSE&G's walk-in customer service centers is unwarranted. *JPIB at 68-69.* The reasons for the Ratepayer Advocate's concern are discussed in detail in the Ratepayer Advocate's Initial Brief and will not be

repeated here. *RPAIB at 60-63; 65; 79-71.* The Ratepayer Advocate does, however, wish to comment on the Joint Petitioners' misleading citation of the record on this issue.

Joint Petitioners' Initial Brief, at page 68, contains the following description of the testimony of their witness M. Bridget Reidy:

> In addition, while ComEd maintains far fewer of its own walk-in customer centers than PSE&G, Ms. Reidy explained that there are contractor-operated payment centers in Illinois and Pennsylvania at "probably 600 different locations," which is significantly more than the number of customer centers in PSE&G's service territory.

T599:L18-T600:L4 (1/9/06); T605:L21-25 (1/9/06).

This is a blatantly misleading comparison. Ms. Reidy was comparing Exelon's 600 contractor-operated payment centers to the number of PSE&G full-service, Company operated customer service centers. Ms. Reidy acknowledged that a proper comparison would have to include PSE&G's contractor-operated payment centers:

> Q. So assuming that PSE&G does have some contractor-operated centers, you would have to compare the ComEd and PECO 600 figure to the total walk-in and contractor-operated centers?
> A. That's correct.

T606:L11-15 (1/9/06). When Ms. Reidy was asked about PSE&G's contractor-operated payment centers she gave the following responses:

> Q. Now, PSE&G also has some -- some contractor-operated payment centers. Is that correct?
> A. I'm not -- I can't give you the answer to that question. I'm not aware.
> Q. You don't know?
> A. I don't know how many they have, no.
> Q. Okay. So --
> A. I'm not aware how many they use.

T606:L1-10 (1/9/06). Thus, the Joint Petitioners' Initial Brief made use of a comparison which their own witness acknowledged was an improper comparison. Further, the Joint

Petitioners' purported comparison does not take account of the fact that PSE&G's company-operated centers offer many services that are not available at contractor-operated payment locations. *RPAIB at 60-61.*

In their response to a transcript request for this information, the Joint Petitioners acknowledged that PSE&G has "over 200" contractor-operated payment centers. *TR-606 (Appendix).* The following more detailed information was reported in the prefiled testimony of Staff witness Michael Rafferty:

> PSE&G: 15 full-service Company-operated centers, one temporary Company-operated center (Elizabeth), and 233 contractor-operated payment center
>
> ComEd: No full-service Company-operated centers, and139 contractor-operated payment centers
>
> PECO: One full-service Company-operated center, and 382 contractor-operated payment centers.

S-3 at 21-22. Thus, it appears that (1) PECO has more contractor-operated payment centers than PSE&G, but only a single full-service center compared to PSE&G's 15 full-service centers and the temporary center in Elizabeth, while (2) ComEd has fewer contractor-operated payment centers and no full-service centers. The Board should consider the above comparisons, rather than the misleading comparison suggested in the Joint Petitioners' Initial Brief.

The Ratepayer Advocate notes also that the Joint Petitioners' Initial Brief includes a clear indication of the risks to PSE&G's full-service walk-in centers if the merger is approved. At page 68-69 of their Initial Brief, the Joint Petitioners state that "the closure of many Exelon customer service centers in Illinois has occurred due to reduced need as a result of implementation of CIMS," (*i.e.,* Exelon's Customer Information Management

System) and specifically acknowledge that “[i]f PSE&G successfully adopts the Exelon CIMS and sees a resultant drop in walk-in center usage (as was experienced at ComEd), the closure of unnecessary walk-in centers may be an issue for the company and the Board to consider in the future.” Thus, the Joint Petitioners’ own statements confirm the need for the Board to include in any Order approving the proposed merger explicit conditions that will assure the continued operation of the current walk-in centers, with their current functions and current staffing. *See RPAIB at 70-71.*

VI. IMPACT OF THE MERGER ON THE RATES OF AFFECTED CUSTOMERS

A. Impact of the Merger on Distribution Rates

As stated in the Joint Petitioners' Initial Brief, Exelon's Chief Executive Officer John Rowe offered for the first time at the January 4, 2006 evidentiary hearing "to commit to refund $120 million to PSE&G's customers through rate credits, commencing within 30 days of closing the merger." T79:L14-18 (1/4/06)*; JPIB at 73.* The total $120 million rate credit would continue for either three or four years at which time it would then stop. The Joint Petitioners saw fit to wait eleven months after filing their original merger petition to make this offer and to do so only after all the other parties had finished prefiling their testimony. The offer was also made only after the Joint Petitioners agreed to pay a $120 million rate credit in the merger proceedings before the Pennsylvania Public Utility Commission. While this rate credit may be a welcome opening offer, it is fraught with uncertainty.

Mr. Rowe did not specify whether three years or four years should be the actual credit period. The difference would obviously be $10 million per year in the annual rate credit. Mr. Rose testified that the details of the rate credit could be worked out in negotiation among the parties and that Exelon would not foreclose the idea of a rate credit larger than $120 million. T101:L7-16 (1/4/06) As stated in its Initial Brief, the Ratepayer Advocate has made its own proposal for a rate credit that is larger than the one proposed by the Joint Petitioners and which is not necessarily tied specifically to a three or four year length.

The annual rate credit related to merger synergy savings would be $42,694,000 and would continue each year for at least the first three years post-merger and continuing thereafter until PSE&G's next base rate case. While the Ratepayer Advocate witness Nancy Brockway testified that after the third year, the rate credit would go away, she testified that it would only go away "[a]s a credit" and that the merger synergies savings as such would then be reflected in the revenue requirement in that next base rate case. T3248:L15 to T3249:L12 (3/31/06). Ms. Brockway also testified that the Ratepayer Advocate's rate credit should be passed through to customers irrespective of any rate case that might be filed between the merger closing and the end of the three years. T3250:L20-24 (3/31/06).

If Your Honor and the Board decide to approve the merger, the Ratepayer Advocate respectfully requests adoption of our rate recommendations including the rate reduction calculated by our witness David E. Peterson along with the other rate reduction proposals recommended by our other witnesses. In this section of our Reply Brief, the Ratepayer Advocate will address the reasons why our rate reduction proposal is superior to that of the Joint Petitioners.

The Joint Petitioners have argued that their proposal for a rate credit of $120 million over three or four years is more supportable than Mr. Peterson's recommended rate reduction because their offer comes directly from the synergy study of Mr. Arndt. *JPIB at 73, 77.* However, when Mr. Arndt was asked at the evidentiary hearing about the allegation that the rate credit offer comes directly from his synergy study, he denied the accuracy of that allegation:

> Q. I don't mean to ask you about any legal advice that Mr. Rowe got and I'm not going to ask you about that, but were

> you consulted at all on the calculations or the derivation of the 120 million dollars before last Wednesday [January 4, 2006 evidentiary hearing]?
>
> A. Not before last Wednesday.
>
> Q. And so the calculation that you're making today, the roughly 160 million times 75 percent, that's an example of how the study could be used to reach 120 million dollars?
>
> A. That is an example of how it could be used.
>
> Q. But it's not -- but you're not saying, though -- excuse me. You're not saying, though, that that's how the Joint Petitioners derived their offer from last Wednesday?
>
> A. I'm not aware exactly of how the 120 million was developed but I am aware of how we met and utilized the study, given all the context of discovery, rebuttals, surrebuttals and all the discussions to utilize the study to demonstrate how it could be used in that context to resolve a lot of the issues in discussion associated with my synergy study.

T851:L5 to T852:L3 (1/11/06) (emphasis added).

Thus, it is clear that the $120 million rate credit offer was not originally generated from the synergy study directly, but that Mr. Arndt only testified that, if one is looking for some way to calculate $120 million, it is possible to back into the number by using certain pages of his study. It is not the same as the Joint Petitioners' statement that their rate credit offer is an attempt to provide ratepayers with an essentially cost-free rate credit of synergy savings. It is also clear that the Ratepayer Advocate's rate reduction calculated by Mr. Peterson is the only rate reduction figure that has a clear genesis and is the preferable recommendation for Your Honor and the Board to adopt if the merger proposal is approved.

Concerning the synergy study, the Joint Petitioners would have Your Honor and the Board believe that just because they worked hard on the synergy study and because they assigned many people to work on it, that this is sufficient reason to assume that the synergy study is verifiable. *JPIB at 78-80 and 97-98.* This is another area in which the Joint Petitioners rely on the quantity of effort rather than the quality of it. Clearly, more than hard work is required in order to make a synergy study reliable. While the amount of effort the Joint Petitioners put into the synergy study may be commendable, the results are not, as is conclusively shown in our Initial Brief.

The Joint Petitioners once again take the opportunity to misrepresent the testimony of Ratepayer Advocate witness Mr. Peterson by implying that Mr. Peterson agrees fully with the synergy study presented by the Joint Petitioners' witness Mr. Arndt. *JPIB at 4 and 93.* The Joint Petitioners also would have Your Honor and the Board believe that Mr. Peterson's use of the synergy study is tantamount to his approval of the study in all its aspects. *JPIB at 4.* They attempted to get Mr. Peterson to say this at the evidentiary hearing, but he resisted this effort to misrepresent his testimony and confirmed his differences with the manner in which the study was conducted:

> Q. So you used Mr. Arndt's study as the basis for your calculation and recommendation, is that correct?
>
> A. That was the starting point, yes. I didn't use those in totality, I made several adjustments to those numbers. But that was the starting point, yes.
>
> Q. So you accepted all of his saving numbers. Is that correct?
>
> A. I didn't-- well, no. We've accepted them and added to them.
>
> Q. You accepted all the savings numbers?

> A. All the gross savings, but we added to them, the amount on line two.

T981:L24 to T982:L13 (1/11/06).

The Joint Petitioners have also purposefully omitted any discussion of the more than $21 million in corrections that Mr. Peterson made to eliminate improper costs to achieve from the synergy study. *RA-10, Schedule DP-2, lines 5-9.* It is clear from the reliable testimony in the record that the Joint Petitioners have overstated their case when they imply that Mr. Peterson has simply adopted Mr. Arndt's study. The Ratepayer Advocate respectfully recommends that Your Honor and the Board adopt the adjustments made by Mr. Peterson if the merger petition is to be approved.

The Joint Petitioners also attempt to obscure the record by mistakenly claiming that Mr. Peterson's adjustments to the Joint Petitioners' synergy study are flawed and that Mr. Peterson actually proposes smaller rate benefits than those proposed by the Joint Petitioners. *JPIB at 4 and 94.* For instance, the Joint Petitioners mistakenly claim that the $11 million rate reduction due to a lower cost of capital post-merger should be denied because Mr. Peterson acknowledged that there is no Board precedent for this. *JPIB at 95.* This is another misrepresentation by the Joint Petitioners.

A complete review of the transcript cited by the Joint Petitioners proves that Mr. Peterson did not testify that there is no Board precedent for such a rate reduction in a merger. He actually testified that he did not recall whether, in the merger orders the Joint Petitioners mentioned there, the Board had adopted such a rate reduction or not; especially, since two of the cases involved stipulations approved by the Board, although the third case included testimony on such a rate reduction that was not quantified:

> Q. You indicated you testified at other merger proceedings, is that correct?
>
> A. Yes.
>
> Q. And I think on page two and three you list some of them that are in the State of New Jersey, that were in the State of New Jersey, correct?
>
> A. Yes.
>
> Q. Did the Board adopt any cost of capital reductions as merger savings in those proceedings?
>
> A. I believe in at least two of the three mentioned there the Board accepted a stipulation and I don't know that there were a cost of capital savings mentioned in that it was a stipulation between the Joint Petitioners and other parties, in the one litigated case Atlantic City Electric and Connective [sic], I don't believe there was a cost of capital savings in that.
>
> Q. Was there any testimony presented by any party about cost of capital savings in those proceedings?
>
> A. I may have testified in the Atlantic City Electric-Connective [sic] case, that there should be.
>
> Q. Did you quantify it?
>
> A. No.

T982:L21 to T983:L22 (1/11/06).

While the three merger orders mentioned above may not contain a specific quantification of a lower cost of capital rate reduction, that is far from reaching the conclusion that the three merger orders stand for the proposition that the Board policy is opposed to such a rate reduction. However, the Joint Petitioners improperly attempt to twist the import of those orders and Mr. Peterson's testimony to that effect. The Joint Petitioners' attempts to mischaracterize the record are not worthy of consideration by

Your Honor and the Board and should be rejected. Furthermore, even assuming that the above orders did not include a cost of capital rate reduction, the Joint Petitioners themselves rely on the fact that Board orders in stipulated cases are not precedential. *JPIB at 100-102.*

The Joint Petitioners also mischaracterize Mr. Peterson's testimony concerning the inclusion of transmission savings in his synergy savings calculation. They incorrectly claim that Mr. Peterson acknowledged these items should be removed. *JPIB at* 95. As was conclusively demonstrated in the Ratepayer Advocate Initial Brief, Mr. Peterson was asked by the Joint Petitioners' counsel to assume that transmission costs and savings should be removed, but they did not provide any evidence to substantiate that assumption. *RPAIB at 86-87.* Mr. Peterson testified that if the Joint Petitioners are correct that there are no transmission costs or revenues in PSE&G's delivery rates, then this portion of the synergy savings should be removed. T986:L6 to T987:L9 (1/11/06). As stated in its Initial Brief, the Ratepayer Advocate would agree to that removal if the Joint Petitioners can demonstrate conclusively that their assumption concerning the delivery rates is correct. Until that proof is provided, Your Honor and the Board should disregard this mischaracterization of the testimony.

The Joint Petitioners complain that Mr. Peterson's synergy savings rate reduction includes 100% of the savings and that the Board has previously only passed through to customers 75% of such savings. *JPIB at 95-97.* This argument completely misses the point that the Joint Petitioners have admitted that the regulated utility synergy savings are a very small fraction of the total benefits that the merged company shareholders will

receive if the merger is permitted to close. *JPIB at 99; JP-29 at 20.* As admitted in the Joint Petitioners' Initial Brief:

> It is also important to emphasize that, because of the nature of Exelon's and PSEG's operations, there are greater opportunities for consolidation (and cost savings) in the unregulated businesses. As Mr. Arndt explained in his rebuttal testimony:
>
>> The consolidation potential of the regulated utilities (PECO, ComEd, and PSE&G) is relatively limited compared to that of the non-regulated businesses due to the distinct service territories of the utility business and the labor-intensive nature of the field work. Moreover, all three utilities will remain separate corporate entities with separate headquarters located in three different states, with local administrative and management personnel. In addition, the field forces at each utility will be unaffected by the merger. By contrast, the non-regulated businesses have much more significant integration potential because the managements of the generation fleet can be combined and the trading and marketing businesses can be consolidated.

In this situation, it is entirely fair and reasonable to allocate 100% of the relatively modest synergy savings to customers. The Joint Petitioners' argument that, without the 25% of synergy savings going to shareholders, the company would not pursue merger-related cost savings at all, is unpersuasive when compared to the fact that the lion's share of total merger savings will go to those same shareholders. Accordingly, the Ratepayer Advocate reiterates its position that Mr. Peterson's analysis for rate credits and synergy savings should be adopted by Your Honor and the Board, if this merger is approved.

VII. IMPACT OF THE MERGER ON PUBLIC UTILITY EMPLOYEES

In its Initial Brief, the Ratepayer Advocate outlined its remaining concerns on the proposed merger's direct negative effects on employees. *RPAIB at 89.* Despite the fact that the Joint Petitioners readily admit that the merger will reduce employee positions by 950 in the State of New Jersey, they also continue to cling to the untenable position that "there is no serious claim that the proposed merger will negatively impact the employees of PSE&G." There should be no disagreement with the fact that loss of employment is clearly a negative impact, but the Joint Petitioners steadfastly claim the opposite. This is once again another example of their refusal to accept clear facts and their determination to incorrectly summarize the state of the record. It is also another example of their attempt to base the merger approval on conclusory statements not supported by the weight of the evidence. While the Joint Petitioners have been willing to place their commitment to union personnel in a written agreement, they have been unwilling to do so with most of their other promises to ratepayers and the State of New Jersey. It is this failure to make specific concrete, reliable commitments to these promises that make the Ratepayer Advocate and most of the other parties in this matter unwilling to rely on those unsupported promises in order to support the proposed merger.

The Joint Petitioners claim that the number of involuntary job losses will be "extremely small", so as to be de minimis. *JPIB at 30, 127.* The 187 jobs lost at the utility may be small to a company as large as the merged company would be, but it is undeniably an "adverse impact" that the Board has decided should be an impermissible result of the proposed merger. As stated in its Order on Standard of Review, the Board has already decided that "the Joint Petitioners must show and the Board must be satisfied

that positive benefits will flow to customers and to the State as a result of the proposed change in control, and, at a minimum, that there are no adverse impacts on <u>any of the criteria delineated in N.J.S.A. 48:2-51.1.</u>" *I/M/O the Joint Petition of Public Service Electric and Gas Company and Exelon Corporation for Approval of a Change in Control of Public Service and Gas Company and Related Authorizations,* BPU Dkt. No. EM05020106, Order on Standard of Review, (November 9, 2005), pp. 15, 25 (emphasis added). Losing 187 jobs at the utility as part of a larger loss of 950 jobs in the State of New Jersey is clearly an "adverse impact" on one of the statutory criteria mentioned above. This fact alone should mean that the merger as proposed cannot meet the Board's positive benefits standard of review and should be rejected.

The Joint Petitioners also attempt to bolster their argument concerning the effects on employees by relying on the enhancements to the severance packages that will be offered to employees who will be laid off. *JPIB at 132*. It is a dismal misapprehension of the term "positive benefits" when the Joint Petitioners allege that it is better to have no job and a severance package than it is to keep your current job. The Joint Petitioners apparently believe that offering these severance benefits post-merger will make them more competitive "among utility companies in the New York-New Jersey-Pennsylvania region" and that somehow this is also a positive benefit of the merger. *Id.* Suffice it to say that it seems unlikely that prospective job seekers will prefer to apply for work at the merged company simply because they will get an enhanced severance package when they are laid off.

VIII. IMPACT OF THE MERGER ON COMPETITION

A. Introduction

As set forth below, the Joint Petitioners have presented nothing in their Initial Brief which diminishes the conclusion that, as proposed, the merger at issue will not provide positive benefits to New Jersey ratepayers by its impact on competition. The Joint Petitioners' market power argument is based *inter alia* on the application of an incorrect standard of review, a misplaced reliance on the flawed analyses of their witness, and incorrect and unsupported interpretations of the analyses prepared by the Market Monitoring Unit ("MMU") of the PJM Interconnection, LLC ("PJM").

1. Market Power Standard of Review

The general tenor of the Joint Petitioners' position on market power issues seems to disregard the Board's pronouncements on the applicable standard of review and the Board's clearly stated concerns about the proposed merger's impact on competition and the need for "structurally competitive markets."[15] In its Order on Standard of Review, the Board explicitly recognized the potential impact of the proposed merger on competition:

> …New Jersey's retail electric customers are dependent upon competitive electric supplies acquired through the Board-authorized Basic Generation Service auction, bilateral agreements between customers and suppliers, or through PJM-operated energy and capacity markets. Structurally competitive markets are the necessary predicate for fair market prices paid by New Jersey electric customers, now and into the future. The development and maintenance of structurally competitive markets requires vigilance through market monitoring and the implementation of definitive mitigation measures where the potential or actual exercise of market power is evidenced. Under the subject petition, the acquisition of PSEG by

[15] November 9, 2005 Order at 20.

> Exelon would explicitly reduce the number of significant competitors in New Jersey wholesale markets by one as the Exelon and PSEG generation subsidiaries join to become a new, combined generation entity. Further, absent mitigation or other measures, the currently substantial market shares of each company in the relevant markets raises not merely the potential but rather the certainty of significantly higher market concentration and the potential future exercise of market power. The Joint Petitioners themselves recognize the problem of market power inherent in the proposed acquisition, viz. the Joint Petitioners' accompanying proposal for market power mitigation. Exhibit JP-6, Direct Testimony of Rodney Frame. Thus, as noted by the Ratepayer Advocate, the proposed merger has the potential to adversely affect not only the customers of the utility directly involved, PSE&G, but also all users of electricity in the State. RPA Reply Brief at 6.[16]

Accordingly, the Board ruled that it would apply the "positive benefits" standard of review in the instant case, in contrast to the no harm standard oft cited by the Joint Petitioners.[17] *See RPAIB at 93-96.*

In contrast to the Board's positive benefits standard, the Joint Petitioners continue to cite the wrong standard of review to be applied here, as summarized in their Initial Brief: "[t]he key question for the Board on the issue of market power is whether the merger, after Petitioners' mitigation commitment is implemented, will adversely impact competition." *JPIB at 138.* The Joint Petitioners incorrectly present the applicable standard as a no harm standard, notwithstanding the fact that the Board explicitly rejected that standard of review.[18] The potential adverse effect of the proposed merger on market power was explicitly recognized by the Board. The testimony of the Ratepayer

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16 November 9, 2005 Order at 20-21.
17 November 9, 2005 Order at 25.
18 November 9, 2005 Order at 25.

Advocate's witnesses and other witnesses in this proceeding demonstrates that the Board's market power concerns were well-founded.[19]

The Joint Petitioners' references to a no harm standard, though incorrect, are understandable since the record developed in the instant proceeding clearly shows that positive benefits will not flow to New Jersey ratepayers from the proposed merger's impact on competition. The Joint Petitioners' dogged adherence to a no harm standard goes so far as the Joint Petitioners asking Your Honor and the Board to rely on decisions of the FERC and PAPUC approving the merger.[20] *See JPIB at 139-142*, *161-164*, *and 168-170*.

The Ratepayer Advocate respectfully submits that any reliance on the FERC and PAPUC rulings in the instant case is misplaced, in light of the Board's ruling on the applicable positive benefits standard of review under New Jersey law. Significantly, both the FERC and PAPUC decisions referenced by the Joint Petitioners rely on standards of review that are less stringent than the Board's positive benefits standard. Also, in each case, the scope of their respective review was also much different than the case at bar. Furthermore, the FERC standard for merger approval has been effective for several years. If the Board had wanted to adopt the FERC standard for its own merger review cases, the

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[19] With respect to electric market power, on November 14, 2005 the Ratepayer Advocate submitted the testimony of Messrs. Bruce Biewald, Robert Fagan, and David Schlissel of Synapse Energy Economics, Inc. ("Synapse"), *RA-5* (Redacted) and *RA-6* (Confidential). On December 27, 2005, the Ratepayer Advocate submitted the surrebuttal testimony of Messrs. Biewald, Fagan, and Schlissel of Synapse, *RA-16* (Redacted) and *RA-17* (Confidential). On March 17, 2006, the Ratepayer Advocate submitted the supplemental testimony of Messrs. Robert Fagan and David Schlissel of Synapse, *RA-62*. Please note that references herein to the redacted testimony also refer to the corresponding confidential testimony.

[20] *See Exelon Corporation, et al.*, *Order Authorizing Merger Under Section 203 of The Federal Power Act* (July 1, 2005), FEC Dkt. No. EC05-43-000, 112 FERC 61,1011 (2005) ("FERC Merger Order") [*S-462*]; *Exelon Corporation, et al.*, *Order Denying Rehearing, Accepting Compliance Filing and Granting Certification* (December 21, 2005), FEC Dkt. No. EC05-43-000, 113 FERC 61,299 (2005) ("FERC Order Denying Rehearing"); and *Joint Application of PECO Energy Company and Public Service Electric and Gas Company for Approval of the Merger of Public Service Enterprise Group, Inc. with and into Exelon Corporation*, Docket No. A-110550F0160, Opinion and Order (PA PUC Feb. 1, 2006) ("PAPUC Merger Order") [*JPIB Appendix, Vol. 2, item 17*].

Board could obviously have done so previously, but has declined to adopt that standard. Therefore, the Joint Petitioners' reliance on the FERC orders concerning this merger is inapposite and irrelevant. In addition, the Board has recently adopted a merger standard regulation in which it could have used the FERC standard for its own, but once again declined to do so. In fact, the Board reaffirmed its decision to use the positive benefits standard not only for this merger, but for future merger proposals as well.[21] This should prove once and for all that the Joint Petitioners' reliance on the FERC standard of review has no place in this matter.

The Joint Petitioners proffer the FERC orders approving the proposed merger in support of their position in the instant case. *See JPIB at 139-143*, *161-164*. Notably, as set forth in the Ratepayer Advocate's Initial Brief, the FERC used a standard of review less stringent than the positive benefits standard adopted by the Board. *See RPAIB at 93-96*. In its order approving the proposed merger, the FERC cited the no adverse impact standard as the basis for its findings regarding competition, rates, and regulation. Therein, the FERC succinctly summarized its standard of review: "…we [FERC] approve the proposed merger as consistent with the public interest and find that it <u>will not adversely affect</u> competition, rates, or regulation."[22] Notably, under the FERC's Merger Guidelines, rather than requiring positive benefits for competition, the FERC may find that a proposed merger has no adverse impact on competition even when the proposed merger results in a Herfindahl-Hirschman Index ("HHI") <u>increase</u>, if the increase falls within prescribed limits.[23] *See RA-5 at 19, 21*; *RPAIB at 93-96*.

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21 *See N.J.A.C. 14:1-5.14;* 38 *N.J.R.* 1854.

22 FERC Merger Order at 4 [emphasis added].

23 *See Inquiry Concerning the Commission's Merger Policy Under the Federal Power Act: Policy Statement*, Order No. 592 (December 18, 1996), FERC Dkt. No. RM96-6-000, 61 Fed. Reg. 68595, 68607

Furthermore, the FERC matter was decided in a proceeding where other parties were deprived of the benefit of discovery and evidentiary hearings. Numerous parties, including the Ratepayer Advocate, petitioned the FERC to hold evidentiary hearings before rendering a decision on the proposed merger. The FERC rejected the many requests for evidentiary hearings.[24] Moreover, in its review, the FERC did not address retail market power issues, relied solely on market power analyses based on HHI analyses without the benefit of simulation analyses such as Synapse's ELMO model, and relied to a very significant extent on the prospect of post-merger filings and reviews. *See RA-5 at 17-28.* Furthermore, the FERC record did not include the PJM MMU's analyses and the extensive testimony and analyses presented by Synapse and other witnesses in the instant case. Hence, the Joint Petitioners' claim that the proposed merger was "comprehensively analyzed by the FERC" should be rejected. *See JPIB at 139.* Thus, in its own way -- using the FERC merger guidelines and on the basis of a limited record, without the benefit of discovery and evidentiary hearings -- the FERC reached its decision following the no adverse impact standard rather than the positive benefits standard adopted by the Board. Not surprisingly, the FERC decision approving the proposed merger is now the subject of an appeal joined by numerous parties, including the Board and the Ratepayer Advocate, before the D.C. Circuit Court of Appeals.[25] Certainly, with all due respect to the FERC, the FERC's ruling on the proposed merger cannot be relied upon for guidance

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(1996). ("FERC Merger Policy Statement"). Please note that the FERC Merger Policy Statement is supplied in PPL's Initial Brief Appendix, as item 10.

[24] *See* FERC Order Denying Rehearing at 4-6.

[25] *See PPL Electric Utilities Corporation, et al. v. Federal Energy Regulatory Commission and Exelon Corporation, et al.*, Unites States Court of Appeals for the District of Columbia Circuit, Case Nos. 06-1009, 06-1022, 06-1067, 06-1073, 06-1074, 06-1075 (consolidated).

on market power issues in the instant proceeding where the applicable standard is the positive benefits standard.

The PAPUC ruling likewise offers no guidance with respect to market power issues. Significantly, the PAPUC applied a standard of review in its consideration of market power issues which differs from the Board's positive benefits standard.[26] The PAPUC adopted the HHI-based market power methodology applied by the FERC in its orders addressing the proposed merger.[27] And the PAPUC did not have the benefit of the extensive record developed in the instant case, such as the PJM MMU analyses. Furthermore, contrary to the assertions of the Joint Petitioners, the parties in the instant case did not "raise the same issues and filed virtually the identical testimony" as that filed in the PAPUC case. *JPIB at 140.* The PAPUC did not have the benefit of a record with the extensive analyses performed by PJM MMU, Synapse, and other witnesses in the instant case. Furthermore, in approving the proposed merger, the PAPUC considered a stipulation of settlement among some parties and not a fully-litigated case on all issues with all parties.[28] In sum, with all due respect to the PAPUC, its ruling on the proposed merger cannot be relied upon for guidance on market power issues in the instant case.

Finally, there is the matter of a witness not presented by the Joint Petitioners in the case at bar. Although the Joint Petitioners cite the testimony of Joint Petitioners witness Dr. William Hieronymous before the FERC and PAPUC, Dr. Hieronymous was not presented as a Joint Petitioners' witness in the case at bar and, therefore, was not

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[26] PAPUC Merger Order at 7-9 and 29-35.
[27] PAPUC Merger Order at 35.
[28] PAPUC Merger Order at 4-5.

subject to discovery and cross-examination, nor did he submit written testimony.[29] *See JPIB at 146*. Accordingly, the Joint Petitioners' references to the conclusions of Dr. Hieronymous in support of their position should, accordingly, be given no weight.

In sum, the standard of review applicable in the instant case is the positive benefits standard, set forth in the Board's November 9, 2005 Order on Stanadard of Review. The Joint Petitioners' application of the no adverse impact standard is clearly erroneous, and any conclusions resulting from the application of the no adverse impact standard should be rejected.

B. Horizontal Market Power Issues

1. Electric Horizontal Market Power

a. HHI Analyses

In this section the Joint Petitioners' arguments with respect to the HHI analyses presented in the instant proceeding are addressed. First, issues relating to the HHI analyses of Joint Petitioners' witness Mr. Rodney Frame are addressed, followed by issues relating to the analyses prepared by the PJM Market Monitoring Unit ("PJM MMU"). Next, the Joint Petitioners' arguments with respect to the issues of on-peak/off-peak data and the allocation of transmission import capacity are addressed.

1. Joint Petitioners Witness Mr. Rodney Frame's HHI Analyses

[29] Although the Joint Petitioners initially submitted the testimony of Dr. Hieronymous in the instant case, as a result of Dr. Hieronymous' role in the New Jersey BGS auction the Joint Petitioners withdrew his testimony and submitted that of Mr. Frame. *See SIB at 4,note 3*.

The Joint Petitioners claim that the HHI analyses performed by their witness, Mr. Rodney Frame, demonstrate that the proposed merger "will not harm competition." *See JPIB at 147.* However, the Joint Petitioners' claims regarding the results of Mr. Frame's analyses ignore the substantial flaws[30] in those analyses that were identified by Synapse and set forth in detail in the Ratepayer Advocate's Initial Brief. *See RPAIB at 99-105*; *RA-5 at 31-5*; *RA-16 at 9-15*. Synapse found that the Joint Petitioners' market power analyses were fraught with errors and limited to a few unrealistic mitigation scenarios. *See RA-5 at 31-51*; *RA-16 at 9-15*.

First, Mr. Frame relied on the FERC Merger Guidelines to assess whether the proposed merger's impact on competition was acceptable. Clearly, the FERC Merger Guidelines do not embody the Board's positive benefits standard, as shown above. *See RPAIB at 93-96*.

Second, even assuming *arguendo* that FERC Merger Guidelines have probative value in the instant proceeding as a benchmark to assess the proposed merger's effect on competition, Mr. Frame's conclusions regarding compliance with the FERC's Merger guidelines are based on flawed analyses and unrealistic mitigation scenarios. Synapse identified several flaws in Mr. Frame's analysis, namely the treatment of transmission and plant outages, planned nuclear unit uprates, and the likely destination markets for capacity outside PJM East. *RA-5 at 29-51*. Furthermore, Mr. Frame's analysis was limited to a very small range of mitigation scenarios and, in the absence of pertinent restrictions on purchasers, it is unlikely that the mitigation scenarios presented by Mr. Frame would ever materialize. *See RA-5 at 74-76*, *Table 9; RA-62 at 6-10*.

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30 *See RA-5 at 7-10, 31-32*.

Synapse found, on the other hand, that just four straightforward corrections to Mr. Frame's assumptions concerning transmission allocation into PJM East, nuclear outage rates, and nuclear operating performance, result in the proposed merger failing the FERC Merger Guideline's screen in 23 of 30 load periods across three sets of Mr. Frame's mitigation scenarios (mitigation scenarios 1, 2, and 3) for the PJM East market.[31] Using realistic mitigation scenario assumptions (Synapse mitigation scenarios 4, 5, and 6) - where the Joint Petitioners' divested capacity is purchased by entities already owning capacity in PJM - results in the proposed merger failing even the FERC Merger Guideline screens in 30 of 30 load periods across three sets of alternative mitigation scenarios in PJM East.[32]

In sum, when Synapse corrected material flaws in Mr. Frame's analyses and analyzed a range of realistic mitigation scenarios, HHI changes in excess of even the less stringent FERC Merger Guidelines result, thereby failing the Board's more stringent positive benefits test. Hence, Mr. Frame's analyses do not conclusively demonstrate that the proposed merger "will not harm competition," nor do his analyses show that the proposed merger will pass the Board's positive benefits test. *JPIB at 147*.

2. PJM MMU's HHI Analyses

Simply put, the Joint Petitioners incorrectly represent the results of the analyses prepared by the PJM MMU. First, the PJM MMU's analyses do not show that the Joint Petitioners' proposed mitigation "can effectively ameliorate any competitive impact in

[31] *RA-5 at 77-79, Tables 10 and 11, Exhibit BFS-6, page 2.*
[32] *RA-5 at 77-79, Tables 10 and 11, Exhibit BFS-6, page 2.*

each market that was analyzed." *JPIB at 139*. Instead, the results of the PJM MMU analyses show that it is vital for the Board to know the buyers of the divested capacity and energy and the specific units to be divested before it approves the proposed merger. In fact, the PJM MMU clearly states that without identifying the units and the purchasers, one cannot determine if market power has been mitigated. *See S-5 at 4-5*; *S-5(a) at 1*; and *S-5(b)at 3-5.* Furthermore, absent restrictions on purchasers, a wide range of reasonable scenarios must be examined. *See RA-62 at 7-10.*

As Synapse noted in its testimony, the scenarios that the Joint Petitioners asked the PJM MMU to examine represented only a very small subset of the extremely large number of permutations of parties that might be buyers of the divested fossil capacity and nuclear energy and the amounts of such divested fossil capacity and nuclear energy that each potential buyer might purchase. *RA-62 at 8*. Moreover, there is no guarantee that the various sets of buyers for the divested fossil capacity and nuclear energy that the Joint Petitioners asked the PJM MMU to study actually would be the purchasers of the divested capacity and energy. *RA-62 at 7*. Therefore, it is essential that the impact of the merger on competition must be examined using a much broader range of possible buyer scenarios than the Joint Petitioners have proposed or asked the PJM MMU to examine. For this reason, the Ratepayer Advocate asked the PJM MMU to analyze a number of alternative, and very plausible, scenarios that assumed that the divested capacity will be purchased by buyers who already have a significant market shares in PJM. *See RA-62 at 7-10, 18-19*.

Second, the PJM MMU results do not show "that if reasonable assumptions are made about who will buy Petitioners' divestiture, the merger passes all of the MMU's

competitive screens." *JPIB at 141*. The PJM MMU says nothing about the "reasonableness" of the various purchaser assumptions, as the Joint Petitioners imply. *JPIB at 141*. The PJM MMU simply presents results of its analyses of the various mitigation scenarios. Furthermore, there are no "MMU competitive screens." *JPIB at 141.* In contrast to the Board's positive benefits test, the PJM MMU applied the less stringent FERC Merger Guidelines in its analyses. The conclusions drawn from the analyses by the PJM MMU relied on the FERC Merger Guidelines - which allow defined increases in pre- to post-merger HHI's - for determining compliance, rather than the Board's positive benefits standard. *See S-5(c) at 3*; *RA-62 at 6*. If the positive benefits test were applied to the PJM Aggregate Hourly Energy Market scenarios analyzed by the PJM MMU, none of the scenarios would have complied since all of the scenarios analyzed have changes in the minimum and average HHIs that are greater than zero. *RA-62 at 5, RPAIB at 114, Attach. B.*.

Furthermore, the results of PJM MMU's analyses do not show "unambiguously" that the Joint Petitioners' proposed divestiture will satisfy competitive screens. *JPIB at 150*. Contrary to the assertions of the Joint Petitioners, the findings of the earlier (pre-April 2006) analyses prepared and presented by the PJM MMU and Synapse, using the May 1 through July 31, 2005 data, show that the proposed merger will fail the Board's positive benefits standard in the aggregate PJM Hourly Energy Market in all hours in all of the many scenarios proposed by the Joint Petitioners, the Ratepayer Advocate, and Board Staff. *See JPIB at 148-150*; *RPAIB at 106-115; RA-62 at 20-24; S-584* and *-585*.

Synapse was able to re-run the earlier (pre-April 2006) PJM MMU analyses[33] and, after correcting several identified errors, found the proposed merger will fail the less stringent FERC Merger Guidelines in the aggregate PJM Hourly Energy Market in many individual hours in all of the scenarios proposed by the Joint Petitioners, the Ratepayer Advocate, and the Board Staff. *RA-62 at 20-24.* Synapse found that the proposed merger failed the Board's positive benefits test in 100 percent of the hours examined in the each of the Joint Petitioners' requested scenarios, since in each of these hours, the pre-merger to post-divestiture HHI increase was greater than zero. *RA-62 at 17*, Table S-1. Similarly, Synapse found that the divestiture scenarios examined would violate even the less stringent FERC guidelines in many individual hours. *See RA-62 at 17-23*. Synapse found that each set of Ratepayer Advocate mitigation scenarios would fail the Board's positive benefits test in 100 percent of the hours, and fail even the less stringent FERC Merger Guidelines in many hours. *RA-62 at 20-23*. Synapse also evaluated divestiture scenarios posited by Board Staff and, after making the two corrections, found that all of the Board Staff scenarios examined by Synapse fail the Board's positive benefits standard in 100 percent of the hours and also fail the FERC Merger Guidelines in many hours. *See R-62 at 23-24*, Table S-6.

Notably, the PJM MMU aggregate energy market analyses of the Joint Petitioners' scenarios conservatively assume that virtual divestiture is an effective mitigation tool. Synapse also found that if virtual divestiture was assumed to be not

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[33] *See* "Exelon/PSEG Merger Analysis" (May 24, 2005), *S-5,* and "Exelon/PSEG Merger Analysis Supplemental Report" (June 16, 2005), *S-5(a).* "Exelon/PSEG Merger Analysis Part Two (October 14, 2005), *S-5(b)* and *S-5(c)*. Also, additional PJM reports were produced on January 25, 2006 (*S-560*); February 1, 2006 (*S-561*); February 2, 2006 (*S-562*); February 9, 2006 (*S-563*); February 17, 2006 (*S-564*); and March 1, 2006 (*S-565*). At the hearing on March 24, 2006, the PJM MMU's Dr. Joseph Bowring presented the results of additional analyses that had been undertaken by the PJM MMU in response to errors that had been identified by Synapse. *S-584* and *S-585*.

effective and, thereby, not considered in the evaluation of the Ratepayer Advocate's divestiture scenarios, all of the divestiture scenarios would fail both the Board's positive benefits standards and the FERC Merger Guidelines. *RA-62 at 23*.

Additionally, the flaws identified by Synapse in each of the earlier (pre-April 2006) PJM MMU analyses caused the PJM MMU analyses to understate the potential impact of the proposed merger on competition and the ability of the merged company to exercise market power in the PJM energy markets. *RA-62 at 2-4*. Hence, the analysis results were conservative in that flaws in the underlying analyses understated the extent of market concentration.

Notwithstanding the fact that the earlier analyses performed by the PJM MMU were flawed in a number of ways, the results of those studies confirm Synapse's conclusions regarding the potentially significant adverse impacts of the proposed merger. The ultimate results of the earlier PJM MMU analyses confirm Synapse's conclusion that the proposed merger will violate the Board's positive benefits standard in all hours and, notably, will also violate the less stringent FERC Merger Guidelines in many individual hours.

Likewise, the more recent PJM MMU analyses, contrary to the Joint Petitioners' assertion, do not "confirm that Petitioners' proposed mitigation can adequately address any market power concerns raised by the Merger."[34] *JPIB at 157*. The Joint Petitioners' incorrect conclusion regarding the April PJM MMU reports demands a rebuttal, as does

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[34] The PJM MMU issued two new reports in response to Board Staff's transcript request of March 24, 2006. *See* TR-2820 (3/24/06). The first PJM MMU report produced pursuant to the transcript request was dated April 19, 2006 ("April 19, 2006 PJM MMU Report "), *S-592*, and the second report was dated April 21, 2006 ("April 21, 2006 PJM MMU Report "), *S-593*.

the Joint Petitioners' argument that the Board should not "give great weight" to the April PJM MMU reports. *JPIB at 157*.

First, contrary to the position of the Joint Petitioners, the Ratepayer Advocate respectfully submits that the April PJM MMU reports should be accorded substantial weight by Your Honor and the Board. *JPIB at 157*. In contrast to its earlier reports which used only three months of actual data, from May 1, 2005 to March 31, 2006, the April PJM MMU reports <u>used eleven months of actual data</u>, from May 1, 2005 through March 31, 2006. Thus, the latest PJM MMU analyses examined a total of 8,040 hours of data, or <u>more than 3.6 times</u> as much data as the 2,208 hours used in its earlier reports. *See S-592 at 4*, *Table 1-4*. The longer time period examined by the latest PJM MMU reports encompasses a wider range of conditions, albeit using historical data, thereby addressing, in part, the criticisms of the PJM MMU's use of a shorter time period. *See RPAIB at 109*. Furthermore, although the Joint Petitioners assert that the parties did not have the opportunity to cross-examine Dr. Joseph Bowring of PJM on the April reports, the methodology underlying the PJM MMU reports was already subject to much scrutiny in the course of the instant proceeding. *JPIB at 157*. The fact that Dr. Bowring was not cross-examined, without more, is no reason to diminish the probative worth of the April PJM MMU reports.

Clearly, the April 19, 2006 PJM MMU report does not support the Joint Petitioners' aforementioned assertion that its proposed mitigation can "adequately address any market power concerns raised by the Merger." *JPIB at 157*. That report addressed four sets of mitigation scenarios requested earlier for analysis by the Ratepayer Advocate. *See RPAIB at 115-118*. The results of the new analyses found in the April 19,

2006 PJM MMU Report show that the proposed merger fails both the Board's positive benefits standard and the FERC Merger Guidelines if the reasonable assumption is made that the divested fossil capacity and/or nuclear energy is purchased by several parties that are already large participants in PJM. *See RPAIB at 115-118*, *Table [A]; RA-62 at 7-9.*

Similarly, the PJM MMU's latest report, issued on April 21, 2006 ("April 21, 2006 PJM MMU Report"), also does not support the Joint Petitioners' contention that its proposed mitigation can "adequately address any market power concerns raised by the Merger." *JPIB at 157*. In that report, at the request of Board Staff, the PJM MMU re-examined three sets of divestiture scenarios that the Joint Petitioners had requested earlier.

The first set of scenarios ("Set One") examined in the April 21, 2006 PJM MMU Report reflects the possibility that the Joint Petitioners' proposed divestiture of nuclear energy will not be an effective mitigation measure and each of the Set One scenarios fails both the Board's positive benefits standard and the FERC Merger Guidelines in every single one of the 8,040 hours examined. *S-593*, *Tables 1-3 and 1-4; RPAIB Attach. B*, *Table [B].* The Joint Petitioners' Set Two scenarios assume that the buyers of the divested fossil capacity are assumed to be two <u>new</u> entrants (two parties that currently own <u>no</u> capacity in PJM). Even with this extreme, unrealistic assumption, each of the Joint Petitioners' Set Two scenarios fail the Board's positive benefits standard because they have pre-merger to post-merger HHI changes greater than zero in almost every hour studied and also fail the less stringent FERC Merger Guidelines because they have HHI changes greater than 100 in more than 11.85 percent of the 8,040 individual hours examined. *S-593*, *Table 2-3*; *RPAIB Attach.B.*

The Joint Petitioners' Set Three scenarios assume that the buyers of the divested nuclear energy are eleven parties specified by the Joint Petitioners. *S-593 at 4*. For the Set Three scenarios, the proposed merger fails the Board's positive benefits standard in each one of the 8,040 hours examined because they have pre- to post-merger HHI changes greater than zero and also fail the FERC Guidelines in more than 25.05 percent of the 8,040 individual hours examined. *S-593*, Table 2-7; *RPAIB Attach. B.*

Thus, contrary to the Joint Petitioners' assertions, the latest PJM MMU Reports, *S-592* and *593,* do not support the allegation that Joint Petitioners' proposed mitigation "can adequately address any market power concerns." *JPIB at 157*. The latest PJM analyses show conclusively that all of the Joint Petitioners' and Ratepayer Advocate's scenarios examined fail the Board's positive benefits standard in almost every single one of the 8,040 individual hours examined. Furthermore, each of the scenarios analyzed in the latest PJM MMU reports also fail the FERC Merger Guidelines for a substantial number of hours. *See RPAIB at 115-119*; *RPAIB Attach. B*.

3. On-Peak / Off-Peak Hours in the PJM MMU HHI Analyses

The Joint Petitioners' criticism of the PJM MMU's use of on-peak/off-peak data in its recent reports (April 19 and April 21, 2006 PJM MMU Reports) is misplaced and unsupported. Notably, the latest (April 2006) PJM MMU reports used eleven months of actual data, from May 1, 2005 to March 31, 2006, instead of the three months of data that the PJM MMU had used in each of its earlier studies. Furthermore, at the request of

Board Staff, the eleven months of data was broken down into "peak" and "off-peak" hours for the Aggregate Energy Market in the April analyses. *See S-592 at 1*; *S-593 at 1*. Of the 8,040 hours examined in the April 2006 PJM MMU reports, 3,728 hours were on "peak" and 4,312 were "off-peak." *See S-592 at 4*, Table 1-4.

The Joint Petitioners claim that the use of hour-by-hour on-peak/off-peak data in the April PJM MMU reports "slices the onion too thin" and the analyses relying in that data "cannot form the basis for determining whether a market power concern is raised." *JPIB at 158-159.* On the contrary, the use of such detailed data is critical. In fact, even the Joint Petitioners' witness Mr. Frame's Delivered Price Test explicitly looks at on-peak and off-peak periods during different seasons. As set forth in the Ratepayer Advocate's Initial Brief and testimony of its witnesses, this type of load level differentiation is exactly what the FERC Merger Guidelines specify as required in order to determine the potential for exercise of market power over a range of system conditions. *See RPAIB at 108-109*; *RA-62 at 11, 14.* In its order adopting merger filing regulations, Order 642, the FERC required applicants to identify and separately analyze products differentiated by load level:

> Because demand and supply conditions for a product can vary substantially over the year, periods corresponding to those distinct conditions must be identified by load level, and analyzed as separate products. [35]

Furthermore, the FERC recently reaffirmed the necessity of performing Delivered Price Test analyses over a range of seasons and load conditions.[36]

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[35] *Revised Filing Requirements Under Part 33 of the Commission's Regulations*, Order No. 642 (November, 15, 2000) , FERC Dkt. No. RM98-4-000, 65 Fed. Reg. 70984, at 71016 (2000), 93 FERC 61,164, at 145 ("FERC Merger Filing Requirements Order").

[36] *See* Order (April 14, 2004), FERC Dkt. No. ER96-2495-016 *et al*, 107 FERC ¶ 61,018, at 43-44.

Even Joint Petitioners' witness Mr. Frame noted the importance of analyzing different seasons and load levels "in order to reflect a variety of demand and supply conditions." *JP-6 at 22, ln. 17-19.* The Joint Petitioners cannot have it both ways. Either load level differentiation is important, as Mr. Frame states, and thus looking at off-peak and on-peak differentiation matters; or it is not. The Ratepayer Advocate respectfully submits that examining load differentiation matters.

The Joint Petitioners also state in their Initial Brief that "[u]nless there is an observable and sustainable pattern of HHI violations that can be predicted and acted upon by market participants, the fact that there are large HHI changes in certain hours does not indicate a market power problem." *JPIB at 159.* The Joint Petitioners proceed to state that this is why their analysis uses 10 specific load conditions. *JPIB at 159.* However, the Joint Petitioners' support of the use of 10 load periods and apparent concern for load differentiation is at odds with their briefing position that breaking load levels into on-peak and off-peak periods cannot form the basis for determining whether a market power concern is raised.

The Joint Petitioners further go on to state that "[t]hat there are very few problematic hours during on-peak conditions, which represent the area of greatest concern, provides the Board with comfort that market power will not be a problem." *JPIB at 159.* The Joint Petitioners are not correct when they imply that the number of "problematic" on-peak hours does not raise significant market power concerns. As stated above, the Ratepayer Advocate has identified a significant number of on-peak hours that fail the FERC Merger Guidelines and the Board's positive benefits standard. As the Joint Petitioners admit, the on-peak periods represent the area of greatest concern. The number

of on-peak hours that fail both standards should give Your Honor and the Board sufficient reason to disregard the Joint Petitioners' implication.

Furthermore, while the analysis of on-peak hours is vital, that does not diminish the importance of analyzing off-peak hours as well. On the contrary, analysis of supplier concentrations during off-peak hours is critical, which is why the FERC recognizes off-peak periods as a relevant product market.[37] Even Mr. Frame analyzes off-peak periods in his model. *See JP-6 at 32-33*. Thus, it is disingenuous to disregard the off-peak hours. Off-peak hours represent more than one-half of the total hours of the year[38] and generally exhibit higher supplier concentrations, relative to peak hours, as shown by the percentage of off-peak hours with HHI differences greater than 100 in the April 21, 2006 PJM MMU Report. *See S-593*, *Table 2-8.*

The Joint Petitioners state that the off-peak period percentage of hours with HHI differences greater than 100 are "still low" in Tables 2-4 and 2-8 of the April 21, 2006 PJM MMU Report. *JPIB at 159*. This is a distortion of the PJM MMU results, since in the unlikely scenario of purchase of virtually divested energy by new entrants, in up to almost one-quarter of the off-peak hours the HHI threshold is exceeded. *See RPAIB Attach. B at 2-5, Table [B]*. This is not "low" by any means – it represents over 900 hours during the 11 month period, which present many possibilities (in an hourly market framework) to exercise market power. In the more reasonable, yet still conservative, "multiple buyers" scenario represented by Table 2-8, in some scenarios there are over 1,900 hours that represent a potential market power exercise concern. *See RPAIB Attach. B at 2-5,Table [B].*

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[37] *See* FERC Merger Policy Statement at 63, 61 FR 68595 at 68607; FERC Filing Requirements Order at 52 and 145, 65 FR 70984 at 70995 and 71016.

[38] *See S-592 at 4*, Table 1-4.

Finally, the Joint Petitioners state that "it is well established that market power concerns are lessened during off-peak hours, both because it is not feasible to withhold the baseload generation that is on-line during off-peak hours, and because there is a significant amount of generation available to respond to price increases that might occur during off-peak hours." *JPIB at 159-160*. Significantly, the record shows that no such circumstances have been established for the off-peak periods in question in this proceeding. Thus, the Joint Petitioners' contention is unsupported and should be rejected.

In sum, the Joint Petitioners' criticism of the PJM MMU's April reports, based on their use of off-peak and on-peak data, is without support and should be rejected.

4. Allocation of Transmission Imports

As noted in *RA-62*, the Biewald-Fagan-Schlissel Surrebuttal testimony at 23: 3-25, the matter of FERC's preference for economic or pro-rata allocation of transmission capacity across interfaces is not as simplistic as the Joint Petitioners state in their Initial Brief at page 176. FERC states that the method used must be supported, and contrary to Joint Petitioners' claims, it is not supported in their testimony. *See RA-62 at 21:14 – 22:5*. In particular, PJM uses economic allocation exclusively through the use of financial transmission rights ("FTRs"), and in the case of PJM the economic allocation process is conceptually superior to the pro-rata allocation method. *RA-62 at 22:6-23:2; RA-21 at 21-25, 35-36.*

The Joint Petitioners state that the Ratepayer Advocate method of using economic allocation of transmission capacity into PJM East is "insupportable." *JPIB at 176.* However, the allocation of transmission amounts presented in *RA-5* in Exhibits BFS-4 and BFS-5 are fully supported as set forth in that testimony.

b. Capacity Markets

The Joint Petitioners aptly state in their Initial Brief, "[t]he future capacity paradigm for PJM is unknown at this time." *JPIB at 155*. The Ratepayer Advocate concurs that the impact of the proposed merger on the capacity market is uncertain at this time, pending the resolution of the PJM capacity proposal before the FERC.[39] *See RPAIB at 121-122*.

However, the Ratepayer Advocate submits that some points raised by the Joint Petitioners in their Initial Brief require correction. There is some uncertainty with respect to the Joint Petitioners' commitment to bid all their "net long" capacity into PJM's daily capacity market at a price of zero. The Joint Petitioners state that "Dr. Bowring testified that the capacity bid mitigation that Petitioners proposed would eliminate market power concerns in both the current capacity market and in locational capacity markets." *JPIB at 153* [*emphasis added*]. However, Dr. Bowring did not state explicitly that the Joint Petitioners' proposal would "eliminate" market power concerns.

Three references within the transcript section cited by the Joint Petitioners illustrate that Dr. Bowring qualified his opinion concerning capacity bid mitigation and

[39] The FERC's recent Order on PJM's capacity market ("RPM") proposal leaves many issues unresolved including market monitoring and mitigation for the new RPM system. The FERC indicates that it will "require the parties to address the issue of mitigation in the paper hearing, including whether mitigation is in fact necessary." *See PJM Interconnection, LLC.*, FERC Docket Nos. EL05-148-000 and ER05-1410-000, 115 FERC 61,079 (April 20, 2006), at 52.

market power. First, Dr. Bowring placed a caveat on his remarks on how mitigation would affect the current capacity market, because it would depend on how any mitigation proposal was structured. T2707:L16-T2708:L3 (3/10/06), citing *S-5(c) at 44*. Second, Dr. Bowring testified that a future PJM East locational capacity market would require divestiture to a single new entrant in order to achieve the mitigation required to meet the FERC Guidelines. *See* T2710:L10-T2711:L12 (3/10/06). Finally, regarding any residual market power in a PJM East locational capacity market, Dr. Bowring testified that after the divestiture the presence of an RMR ["reliability must run"] contracting structure would address market power concerns. T2714:L12- T2715:L19 (3/10/06). Thus, Dr. Bowring's testimony hardly implies that he believes market power concerns for the capacity market would be "eliminated."

Therefore, the Ratepayer Advocate respectfully reiterates its recommendation that Your Honor and the Board should not approve the proposed merger until it has had a reasonable opportunity to review concrete proposals from the Joint Petitioners identifying the amounts and locations of capacity that would have to be divested in order to mitigate market power concerns under the Reliability Pricing Model ("RPM") proposal now before the FERC, or whatever new or revised capacity market form is ordered by the FERC. *See RPAIB at 121-122*; *RA-5 at 59*.

c. Northern New Jersey Market

The Northern New Jersey ("NNJ") geographic area is a load pocket and a highly concentrated market, according to PJM.[40] The Joint Petitioners have added nothing in their Initial Brief which quells the Ratepayer Advocate's concerns. *See RPAIB at 119-121*. The Ratepayer Advocate, therefore, respectfully reiterates its recommendation that the Board should "work with PJM to identify potential actions to actually reduce the levels of [market] concentration" in NNJ, and not approve the proposed merger if it will increase concentration in NNJ. *RA-5 at 62, ln. 17-19*.

d. Virtual Divestiture

The Joint Petitioners claim that the evidence is "unambiguous" that virtual divestiture is superior to the sale of physical power plants. *JPIB at 142.* However, that is most certainly not the case, as Dr. Bowring repeatedly stated that there are a continuum of methods to use, and that virtual divestiture is not equal to actual sale. T2490:L13-18; T2491:L12-20 (3/9/06). In addition, since the proposed virtual divestiture does not result in the sale of any capacity rights from plants providing the virtually divested energy, it is not unexpected that the MMU found that all of the Joint Petitioners' scenarios failed the PJM East local capacity market screens.[41] It is evident that the Joint Petitioners focus on behavioral mitigation because those structural failures are so damning.

The Joint Petitioners distort Dr. Bowring's testimony on virtual divestiture issues. Dr. Bowring explained that the MMU "did not model the impact of virtual divestiture on HHIs because that's not conceptually possible." T2611:L19-21 (3/10/06). He explained

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[40] *See* PJM MMU 2004 State of the Market Report at 57 (*JP-137*); PJM MMU 2003 State of the Market Report at 42; *RA-5 at 59*.

[41] *S-584, MMU Report, February 9, 2006, Table 1-5.*

that "HHIs are calculated to reflect market structure or changes in market structure… virtual divestiture doesn't change the ownership structure of the units and, therefore, does not change HHI." T2612:L21 to T2613:L3 (3/10/06). He also agreed with the statement that as he understands virtual divestiture, the seller would retain some partial control over the assets. As pointed out by Counsel for Mount Holly, that partial control could weaken the purchaser's competitiveness and thereby pose a potential problem under the DOJ guidelines. T2672:L1 to T2673:L1 (3/10/06).

Dr. Bowring stated that under the Joint Petitioners' virtual divestiture proposal, the purchaser would have control over the energy since what is being sold is a guaranteed level of energy output and would also have control over what they did with their ownership rights in the energy. T2825:L14-23 (3/24/06). He also pointed out that it would be reasonable to assume that the purchasers of virtually divested nuclear energy would change over time because the Joint Petitioners propose annual auctions. T2537:L24 to T2538:L4 (3/9/06).

Dr. Bowring described clearly that there was a spectrum of arrangements concerning ownership and operation, and he discussed Power Purchase Agreements ("PPA"), virtual divestiture, and actual physical sales in this context. T2823:L5 to T 2824:L14 (3/24/06). The PPA arrangements described by Dr. Bowring are a very different arrangement than the proposed virtual divestiture. T2820:L17to T2821:L10 (3/24/06). "In a virtual divestiture, the ongoing plant owner will make an offer of energy to the market, and the purchaser of the virtual energy will own rights to effectively a slice of system, effectively a level of megawatt hours in every hour." T2827:L8-12 (3/24/06). The Joint Petitioners' virtual divestiture proposal does not give the purchasers of the

nuclear power the same operational control over the output of the plant that the PPA arrangements would give. T2827:L8-19 (3/24/06).

Dr. Bowring described the differences between the Joint Petitioners' virtual divestiture proposal and structural divestiture:

> [T]he question of virtual divestiture versus structural is somewhat complicated, but a virtual divestiture is, first of all, relatively short-term, these three-year contracts are relatively short-term, and therefore in fact there is a benefit to be gained by exercising market power in the energy market, because while you don't receive it during the first three year term, you would receive it during the second three year term. Secondly, virtual divestiture is not the sale of the unit and, therefore, it doesn't transfer control and doesn't transfer the incentives that would be transferred if the unit were sold. That's not to say that virtual divestiture doesn't have an impact on the market. Clearly it does. But equally clearly it's not the same as selling the unit. I don't think there's any question about that.

T2873:L6-23 (3/24/06).

Finally, Dr. Bowring did not make a recommendation to the BPU whether it should accept virtual divestiture. T2877:L7-10 (3/24/06). While the Joint Petitioners request that the Board adopt this concept, there were no hearings at the FERC so the concept could not be fully examined. It is only in this fully-litigated proceeding, with the assistance of expert testimony, that the ethereal nature of virtual divestiture is exposed. Dr. Bowring made it very clear that <u>actual</u> divestiture is preferable to virtual divestiture: "Clearly structural competitive markets are to be preferred to non-structural competitive markets." T2458:L11-13 (3/9/06).

e. Synapse's ELMO Model

The Joint Petitioners claim that the ELMO model analysis [42]presented by Ratepayer Advocate witness Synapse is unreliable and fails to analyze Joint Petitioners' "actual divestiture proposal." *JPIB at 180.* They also complain about the ELMO analysis, arguing incorrectly that it "provides no support for the claim that the merger will adversely affect competition." *JPIB at 183.* They offer three reasons for these conclusions.

The Joint Petitioners' first reason for rejecting the ELMO model analysis is that Synapse did not analyze the "actual divestiture packages that the MMU examined -- despite all parties being given an opportunity to present supplemental testimony regarding these scenarios." *JPIB at 181.* While it is true that Synapse did not analyze those scenarios in ELMO, that was not necessary or appropriate because: (a) Synapse did analyze a set of realistic divestiture scenarios in ELMO; (b) the Joint Petitioners made no commitment to actually implement the "actual divestiture packages" analyzed by the MMU; and (c) those packages are no more "actual" or "realistic" than other scenarios that Synapse did analyze.

The Joint Petitioners second reason for rejecting the ELMO model analysis is that the Ratepayer Advocate witnesses supposedly "manipulated the ELMO model's assumption in order to reach a preordained conclusion." *JPIB at 181.* This conclusion is based upon "testimony" by the Joint Petitioners' attorney rather than anything stated by the Ratepayer Advocate witnesses, or any other witnesses, in this case. Mr. Roberts' statements in the transcript[43] are <u>not</u> an appropriate basis upon which to reach conclusions about the ELMO model since Mr. Roberts' credentials on computer simulation modeling

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[42] See *RA-5 at 81-89*; *RA-16 at 27-33.*

[43] *See, for example, T2105:L6-18 (1/19/06).*

of electricity markets were not established. Nor was Mr. Roberts subject to cross-examination in this case.

The Joint Petitioners' third reason for rejecting the ELMO model analysis is that "the ELMO model failed to consider many factors that affect pricing behavior in the market" and specifically "sellers' obligations to serve customers". *JPIB at 182.* While it is true that ELMO makes some simplifying assumptions, this is true of all computer models. In particular the "sellers' obligations to serve customers" was included in none of the computer model analyses offered in this case, including the analyses presented by the petitioners, by the BPU staff, by the PJM MMU, and by the PPL companies. If, in order for a computer model to be acceptable to be relied upon by the BPU in this case, the model were required to include load obligations, then the BPU would have a record with no market power analysis whatsoever to rely upon. That would require that the merger petition be denied, since there would be no reliable record to show that the merger satisfies the Board's positive benefits standard.

The Joint Petitioners point to an analysis submitted by Mr. Frame[44] to support the conclusion that "...if the ELMO model were corrected to consider the Petitioners' obligations to serve customers, it would reveal, once again, that market prices will be lower after the merger than before." *JPIB at 182-183.* Ratepayer Advocate witnesses explained in pre-filed Surrebuttal Testimony that Mr. Frame's re-analysis of the ELMO result was based on "faulty assumptions" including unrealistic consideration of the nature of contracting and ratemaking.[45] In short, Mr. Frame assumed that increases in the load serving entity's cost of serving load could not be passed through to customers. While

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44 *Ex. JP-138, p. 1.*
45 *Id. at 28 and 29.*

customers certainly wish that this were the case, unfortunately it is not. Indeed costs to average residential customers have increased an average of 12.66 percent in New Jersey as a result of the last BGS auction.[46] During the hearings, counsel for NJLEUC/RESA described the "prices derived in the [NJBPU February 2006] fixed price auction represented a 55 percent increase over the prior year." T3154:L19-21 (3/27/06).

f. BGS

The Joint Petitioners suggest that their virtual divestiture proposal will "enhance" the BGS Auction because their divestiture auction will coincide with the BGS Auction and might help to attract participants as the baseload nuclear capacity will be broken up into smaller pieces. *JPIB at 188-189.* However, when asked by Board Staff's Counsel whether there was anything to distinguish Joint Petitioners' proposed divestiture auction process, Dr. Bowring stated: "I actually don't know what the company would do otherwise but a sale, it would not be surprising that either the companies separately or together would sell a block of energy to participants in the BGS Auction." T2506:L7-15 (3/9/06). In addition, there is no requirement that the purchaser of the divested energy resell it into the BGS auction. The purchaser may choose to resell it back to the company or into another market, including the New York ISO. T2754:L19-24 (3/10/06); T3104:L10-16 (3/27/06).

As was stated in the Synapse testimony,[47] the Joint Petitioners have not presented any analysis of the impact of the proposed merger on competition in the BGS auctions

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[46] *BPU Press Release PR#05-06 Dated February 9, 2006.* See footnote 5 above..

[47] See the November 14, 2005 testimony of Schlissel and Biewald, *RA-5 at 80-81*.

beyond several pages of narrative discussion in the Additional Testimony of Mr. Frame[48] and no market power study of the BGS auctions was done.[49] Nevertheless, Your Honor and the Board should be concerned about the potential for the merged company to exercise market power, directly or indirectly, in the BGS auctions because PSEG has supplied substantial amounts of power through the BGS auctions, both as a successful bidder and as a supplier to other successful bidders.[50]

While Exelon has not supplied a significant amount of BGS power, that might change as its commitment to using its nuclear capacity in Illinois to serving loads in its Chicago service area will no longer exist after the end of 2006. At that time, Exelon will be free to bid some or all of its 10,000 MW+ of nuclear capacity into the BGS auctions.[51] While BGS customers might benefit from this additional low-cost nuclear energy, there is also the possibility that the merged company is able to exercise market power to boost BGS prices due to the availability of this additional nuclear energy, its dominance in the PJM East market, and/or its position as a supplier of natural gas to competitor power plants.

The Board needs to conduct more detailed oversight of the BGS auction process in order to permit a meaningful investigation of whether any post-merger bidder(s) will directly exercise market power in the annual BGS auctions; or whether an indirect exercise of market power will result in higher BGS prices because of supra-competitive prices paid to the merged company in the bilateral market by auction participants.

g. Nuclear

[48] See the Additional Direct Testimony of Mr. Frame in *JP-6 Additional*.

[49] Response to NJLEUC/RESA-PSEG-125, Exhibit *RA-5 at 80*.

[50] For example, see the Direct Testimony of Joint Petitioners' witness Mr. Frank Cassidy in *JP-9 at 18-26.*

[51] Schlissel and Biewald testimony dated November 14, 2005, *RA-5 at 81*, *ln. 1-5*.

The Joint Petitioners claim that virtual divestiture of the output from the nuclear plants would be preferable to actual divestiture. *JPIB at 165-167.* However, as Synapse discussed in previous testimony in this proceeding, the proposed virtual divestiture of nuclear energy is an inadequate mitigation remedy due to several critical weaknesses: under the proposed virtual divestiture, the merged company still would maintain control over operations of the units that would generate the divested energy; and under the proposed virtual divestiture, the merged company would have an incentive to exercise market power as that would indirectly increase the prices in the yearly nuclear auctions. Finally, as proposed, the virtual divestiture is not symmetrical because there would be no provision for increasing the amount of nuclear energy to be divested if the merged company constructs or acquires additional capacity.[52]

C. Vertical Market Power Issues

The Ratepayer Advocate Concurs with Board Staff and Dr. Paul Carpenter that the Merged Entity of PSE&G and Exelon Will Have the Power to Affect Gas Vertical Market Power for the PJM East Territory.

In its Initial Brief, the Ratepayer Advocate concluded that the merger of PSE&G's gas business with that of Exelon could create a gas market power problem in the PJM East territory. *RPAIB at 145.* Such a concentration of pipeline capacity under the control of a single entity might well result in a problem of vertical market power, enabling Joint Petitioners to manipulate gas prices in the New Jersey market. *Id.* Both Board Staff and PGW, in their Initial Briefs, concur with the Ratepayer Advocate. The merger of the two gas businesses should, therefore, be rejected absent significant modifications to the proposed merger plan.

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[52] Biewald-Fagan-Schlissel Direct Testimony, Exhibit *RA-5* Redacted and Exhibit *RA-6* Confidential, at page 68, line 19, to page 74, line 7.

As Board Staff has noted in its Initial Brief, vertical mergers do not directly eliminate a competitor and therefore do not increase concentration in a single product market. *SIB at 98-99.* However, they can increase the merged company's incentives to use its market position to adversely affect competition in a related segment of its business. *Id. at 99, citing FERC Order 642, issued Nov. 15, 2000, at 78.* In reviewing Joint Petitioners' incentive to control gas and electric prices resulting from their concentration of ownership of nuclear power plants, Board Staff determined that

> The merged entity will have the ability and incentive to control gas prices and withhold capacity, so that gas prices will rise and consequently increase the price for peak facilities as well as for all base units. Thus the incentive for PSEG and Exelon to control and encourage price increases clearly exists.

Id.

In their testimony Joint Petitioners relied upon their witness Dr. John Morris, who included New York and New England as part of the relevant market in his HHI analysis. *JP-22 at 29.* He redefined the relevant market in order to lower the HHI results so as to conclude that the Joint Petitioners will not have vertical market power in that market. *RPAIB at 147; SIB at 113*. Both Board Staff and PGW witness Dr. Carpenter concurred with the Ratepayer Advocate that the relevant market is the existing PJM East, which does **not** include New York and New England. *Id.; PGW-1 at 11.* Board Staff concluded that:

> The merged entity will posseses market power in the upstream market for delivered natural gas in the PJM East market. . . .The Petitioners will own substantial baseload power generation capacity post-merger even after the currently proposed divestiture. This situation will create an incentive for the merged entity to raise the price of gas. . . .

SIB at 113.

In its Initial Brief the Ratepayer Advocate concluded that under the proposed conditions of the merger, Joint Petitioners could manipulate gas supply and demand to affect the price of gas. *RPAIB at 149.* Board Staff supported this conclusion, finding that manipulation of vertical market power not only could raise gas prices, but could be extremely difficult to detect:

> It is difficult for a regulatory body to detect the exercise of market power after the fact because in any market there are many things happening at any particular point in time. For example, the Board would need direct evidence that discretionary action was taken to withdraw from storage or not to cause the resulting price increase or volatility. During an *[sic]* after the fact*[sic]* BGSS review the Board would have to determine if the price spike was due to the exercise of market power or whether it was due to some other benign factor such as changes in weather, demand, or supply. Staff believes that this causes the potential for there to be a severe impact on retail gas rates.

SIB at 114.

The Ratepayer Advocate supports the HHI evaluation performed by PGW witness Dr. Paul Carpenter and the evaluation and conclusions reached by Board Staff regarding vertical market power in the Joint Petitioners' gas market. The Ratepayer Advocate therefore recommends that Your Honor and the Board reject the proposed merger as filed. If Your Honor and the Board decide to permit the merger, the Ratepayer Advocate strongly recommends that stringent restrictions and modifications be imposed upon the Joint Petitioners in order to prevent an incentive for improper exercise of vertical market power.

IX. FINANCIAL, ACCOUNTING AND CORPORATE GOVERNANCE

The Ratepayer Advocate's position and recommendations on financial, accounting and corporate governance issues are discussed in detail at pages 151 through 195 of the Ratepayer Advocate's Initial Brief in this matter. The sections below discuss a limited number of issues raised in the Joint Petitioners' Initial Brief that require clarification.

A. Capital Structure and Cost of Capital

1. Impact of Illinois Litigation

The Ratepayer Advocate's Initial Brief, at pages 153 through 155, recommended that the proposed merger not be allowed to go forward until the Joint Petitioners can demonstrate that the ongoing challenges to ComEd's procurement plan for default generation service have been satisfactorily resolved and ComEd's viability is no longer threatened. As discussed in the Ratepayer Advocate's Initial Brief, we are not seeking a delay in the Board's decision in this matter, only that satisfactory resolution of the dispute be established as a condition for an approved merger to close. *RPAIB at 155.*

The Joint Petitioners' Initial Brief attempts to suggest that this dispute has been resolved, because the proceedings before the Illinois Commerce Commission ("ICC") and a lawsuit filed by the Illinois Attorney General and others in the Circuit Court of Cook County during the pendency of proceedings before the ICC, have been resolved in ComEd's favor. *JPIB at 11, 234.* To the contrary, while ComEd has obtained favorable decisions in the ICC and in a lawsuit that was filed in an Illinois trial court while the ICC proceedings were pending, an active dispute remains. The ICC decision is currently on appeal, and legislation to extend ComEd's current rate freeze is under consideration in

the Illinois General Assembly. *See RPAIB at 153-54.* Further, in its communications with the investment community Exelon continues to portray the appeal and the proposed legislation as significant threats to ComEd, and possibly Exelon. In a Form 10-Q filed on April 26, 2006, the same day the Joint Petitioners' Initial Brief was filed in this matter, Exelon stated as follows:

> House Bill 5766 — On February 24, 2006, House Bill 5766 was introduced in the Illinois General Assembly and was referred to the Rules Committee. This bill, if enacted into law, would result in the extension of the retail rate freeze in Illinois. As ComEd believes the proposed legislation, if enacted into law, would have serious detrimental effects on Illinois, ComEd, and consumers of electricity, ComEd and others are vigorously opposing this legislative initiative.
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> * * *
>
> Certain governmental officials and consumer advocacy groups claim that ComEd's retail rates for electricity should not be based solely on its cost to procure electricity and capacity in the wholesale market. Additionally, certain parties to ComEd's pending rate case proceeding have indicated ComEd's rates for delivering energy should be reduced or not increased. If the price at which ComEd is allowed to sell electricity beginning in 2007 is below ComEd's cost to procure and deliver electricity, or if ComEd is unable to recover its costs and investment through the Rate Case, there may be material adverse consequences to ComEd and, possibly, Exelon.

Exelon Corp. Form 10-Q (April 26, 2006) at 72, 73 (excerpt in Appendix).[53] The same SEC filing also notes that Exelon has filed an appeal objecting to the ICC's requirement for a prudence review. *Id. at 72.*

This recent SEC filing would appear to indicate that, contrary to the suggestion in the Joint Petitioners' Initial Brief, the dispute surrounding the ComEd procurement plan has not been satisfactorily resolved. As Ratepayer Advocate witness Matthew I. Kahal testified at the hearings in this matter:

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[53] Your Honor and the Board are respectfully requested to the take official notice of the referenced SEC filing.

> The one caution that I would give you is that I don't think it would be appropriate for Exelon and Commonwealth Edison to be filing documents at the S.E.C. saying that this pending matter, whether you want to call it litigation or not, but whether this pending matter threatens the viability and continued existence of Commonwealth Edison, and at the same time telling the board that there's no problem. That would strike me as being highly inconsistent.

T436:L2-11 (1/5/06). As long as Exelon's communications with the investment community continue to characterize the ongoing controversy in Illinois as a significant threat to ComEd's financial viability, the merger should not be allowed to close.

The Joint Petitioners' Initial Brief further attempts to dismiss concerns over potential ComEd financial distress by referencing Entergy New Orleans, the now bankrupt subsidiary of Entergy Corporation. *JPIB at 335.* Citing a Standard & Poor's report, they assert that this bankruptcy has not adversely impacted the utility affiliates of that company. Joint Petitioners' reliance on the Entergy New Orleans example is misplaced. First, Joint Petitioners have not shown there is no adverse impact on the affiliates, they have merely asserted it. As Mr. Kahal points out, there in fact are important adverse impacts on the affiliates. *RA-13 at 6.* Second, Entergy New Orleans is a dramatically smaller company than ComEd, and therefore, its bankruptcy would be financially far less damaging than a ComEd bankruptcy. *Id.* Third, and most important, Entergy Corporation, unlike Exelon, is not seeking to proceed with a "mega merger" while the bankruptcy of its largest utility subsidiary is at issue. *Id.*

2. Reflection of Expected Cost of Capital Reduction in Merger Savings

Joint Petitioners take issue with Ratepayer Advocate witness Mr. Kahal's proposed cost of equity synergy savings of $11 million annually. *JPIB at 104-05.* Their objection is that this recommendation is allegedly inconsistent since this witness

acknowledges that the merger could result in PSE&G's cost of equity either increasing or decreasing depending on the success achieved in meeting merger objectives. They further object because Board Staff witness Howard Lubow testified that the merger is unlikely to meaningfully change the utility's cost of capital, and in any event, such cost of equity changes should be made only in rate cases. *Id. at 105.* Notably, the Joint Petitioners' Initial Brief does not deny a cost of capital reduction, nor does it rebut Mr. Kahal's $11 million quantification. They merely assert that Mr. Kahal "did not conduct any analysis" to arrive at his result. *Id. at 104.*

Joint Petitioners' arguments miss the point. The merger may or may not reduce the cost of capital depending on Joint Petitioners' success in merger execution. The point is that Joint Petitioners have made numerous statements in testimony suggesting the merger, will in fact, reduce PSE&G's business risk (*e.g.*, through geographic diversification) and increase its financial strength through its integration into Exelon. If these benefits are realized, they unquestionably translate into a reduced cost of equity. *See RPAIB at 155-56.* Joint Petitioners should be required to stand behind their assertions of merger benefits rather than merely asserting their existence but failing to provide them to customers. Moreover, the Ratepayer Advocate recommends that this cost of equity synergy savings benefit be provided to customers only until the first post-merger rate case when PSE&G's cost of equity can be redetermined based on conditions and evidence at that time. *Id. at 156-57.*

Mr. Kahal's recommendations on these financial issues are in two parts. The Joint Petitioners have attempted to confuse the two parts and pretend that they are inconsistent, which they are not. Mr. Kahal's recommended $11 million in annual cost of

capital savings is simply a matter of translating the Joint Petitioners' prediction of financial benefits from the merger into a concrete proposal to satisfy the Board's positive benefits standard. Mr. Kahal also raised the concern of negative impacts from the proposed merger concerning a possibly more expensive capital structure post-merger. His recommendation to cap PSE&G's common equity ratio at its pre-merger level for purposes of the first base rate case that occurs after merger closing is simply a separate recommendation to address this possible risk. That recommendation is wholly consistent with his proposal to include $11 million in annual cost of capital savings in the merger savings to be passed through to ratepayers until the first post-merger base rate case occurs.

3. Ratepayer Protections Against Cost of Capital Increases

A concern raised by a number of parties is the potential distortion to capital structure and other aspects of ratemaking from the use of "push down" accounting, and in particular, adding "goodwill" to PSE&G's balance sheet. In their Initial Brief, Joint Petitioners respond that no adverse rate impact is intended and the regulatory asset treatment "will be revenue neutral for ratemaking …. The Petitioners have made this commitment." *JPIB at 215.* Joint Petitioners specifically commit to excluding "goodwill from both PSE&G's rate base and capitalization for ratemaking purposes …." *Id. at 222.*

Based on the record in this case, the Ratepayer Advocate understands that these commitments extend only to New Jersey jurisdictional or retail ratemaking, and to date Joint Petitioners have not been willing to extend this commitment to FERC jurisdictional or wholesale ratemaking. *See RPAIB at 159.* The FERC, however, sets the transmission network service rates that the PSE&G customers must pay, even if such payments are

subsumed within the BGS rates or rates charged to retail customers by competitive retail suppliers. Unless PSE&G extends its rate commitments for regulatory assets and goodwill to transmission, these commitments will fall short and are not adequately protective of customers.

4. Participation in Exelon Utility Money Pool

The Ratepayer Advocate notes that Joint Petitioners have accepted a number of our recommendations on the Utility Money Pool, leaving only one issue unresolved. Specifically, the Ratepayer Advocate objects to Joint Petitioners' proposal to include Exelon Generation as a full participant, although we have no objection to its participation on the same basis as Exelon Corporation, *i.e.,* as a lender only. The plain fact is that Exelon Generation is the unregulated merchant arm of Exelon and is <u>not</u> a utility. Our Initial Brief (and that of Board Staff) explained the disadvantages of including Exelon Generation, and that discussion need not be repeated here. *RPAIB at 161-63; SIB at 149-50.*

In its Initial Brief, Joint Petitioners defend Exelon Generation's participation arguing that the Ratepayer Advocate's and Board Staff's testimony that Exelon Generation typically is a borrower is not fully correct. *JPIB at 232.* The Ratepayer Advocate does not contest Joint Petitioners' assertion that Exelon Generation at times could be a lender, and we do not object to its participation on that basis. But for the available time period examined, Exelon Generation has been mostly a borrower from the Utility Money Pool, exposing utility customers to risk and potential capital structure distortions. *RA-9 at 3; RPAIB at 161-62.* Joint Petitioners have not dispelled these risks

or cited any convincing ratepayer benefit from permitting an unregulated generation affiliate to participate as a borrower in the Utility Money Pool.

5. Preservation of PUHCA Protections

The Ratepayer Advocate and the Board Staff have recommended certain financial practices and commitments that in part are necessitated by the recent repeal of the Public Utility Holding Company Act (PUHCA). *RPAIB at 163-64; SIB at 151-54.* The four recommendations by Ratepayer Advocate witness Mr. Kahal pertain to maintaining a minimum equity ratio for the parent company, dividend payout limits for PSE&G, and avoidance of affiliate loans or loan guarantees. *RA-9 at 38.*

Joint Petitioners' response to these four protections in their Initial Brief is to oppose all four recommendations. The opposition, however, is not substantive, but rather it is due to the context in which the recommendation has been made—as a response to the February 2006 PUHCA repeal:

> However, Mr. Kahal errs in assuming that PUHCA repeal will create a regulatory vacuum. There is simply no basis upon which to reach this conclusion. Moreover, PSE&G is already subject to, or the Petitioners have agreed to implement, three of his proposed conditions.

JPIB at 222 (emphasis added). Joint Petitioners argue that PUHCA repeal is a generic, not a merger issue and the Board already has substantial authority and is presently engaged in a rulemaking process. Their Initial Brief also refers to FERC rules that would address PUHCA repeal. *Id. at 223-24.*

While the Joint Petitioners have agreed to three of Mr. Kahal's four financial protections, in point of fact, they have made no commitment at all. They merely state their agreement and that these conditions comport with their current financial policies. *Id. at 222, 225.* But absent making these "policies" firm merger approval conditions, the

Joint Petitioners could change these policies the next day (or upon obtaining a waiver from FERC). If these conditions comport with present policy, then Joint Petitioners should accept them as merger approval conditions. Whether they are or are not specifically linked to "PUHCA repeal" becomes immaterial.

The one issue on which there is disagreement in substance is the commitment to maintain a minimum 30 percent equity ratio. *Id. at 226.* Again, Joint Petitioners make no substantive argument why 30 percent is an unreasonable standard. Instead, they argue that 30 percent is "arbitrary" and not specifically supported by credit rating metrics. They further argue that FERC does not impose this requirement (other than for reporting purposes). These two arguments are unpersuasive. The Ratepayer Advocate is not proposing 30 percent as a target equity ratio but as a minimum, to help ensure access to capital. The 30 percent is far below the level that would be justified by credit rating metrics and therefore is merely a floor value that Joint Petitioners should not oppose. Moreover, whether FERC does or does not require a capitalization floor should not guide the merger approval conditions appropriate in this case. Joint Petitioners have failed to explain why a conservatively low equity floor of 30 percent is an unreasonable minimum requirement.

X. ADDITIONAL ISSUES RAISED IN THE COURSE OF THIS PROCEEDING

The Ratepayer Advocate has addressed all issues in this Reply Brief.

XI. CONCLUSION

For the reasons stated in our Initial Brief and this Reply Brief, in the testimonies of our witnesses, and in the balance of the record, the Ratepayer Advocate respectfully urges Your Honor and the Board to reject the proposed merger. However, if Your Honor and the Board should decide to approve the proposed merger, the Ratepayer Advocate respectfully urges that the approval be conditioned only upon the recommendations of the Ratepayer Advocate.

Respectfully submitted,

SEEMA M. SINGH, ESQ.
RATEPAYER ADVOCATE

By:________________________________
Badrhn M. Ubushin
Assistant Deputy Ratepayer Advocate

TABLE OF APPENDIX

No.1 Response to transcript request *TR-606*

No. 2 Exelon Corporation Form 10-Q dated April 26, 2006 (excerpts)

RESPONSE TO TRANSCRIPT REQUEST
TR-606

RESPONSE TO TRANSCRIPT REQUESTS
REQUEST: TR-606
WITNESS(S): HOUSE
PAGE 1 OF 1
MERGER

PUBLIC SERVICE ELECTRIC AND GAS COMPANY
CONTRACTOR LOCATIONS ACCEPTING PAYMENTS

QUESTION:
Please provide the number of contractor operated payment centers for PSE&G.

ANSWER:
PSE&G has over 200 Western Union location sites. Please see the Response to RAR-LI-35 for a listing of the Western Union locations, as well as the PSE&G Customer Service Center Locations.

Exelon Corporation Form 10-Q
Dated April 26, 2006 (excerpts)

FORM 10-Q

EXELON CORP - EXC

Filed: April 26, 2006 (period: March 31, 2006)

Quarterly report which provides a continuing view of a company's financial position

5. Regulatory Issues (Exelon, ComEd, PECO and Generation)

ComEd

The legislatively–mandated transition and rate freeze period in Illinois will conclude on January 1, 2007. Associated with the end of this rate freeze, ComEd is engaged in various regulatory proceedings to establish rates for the post–2006 period, which are more fully described below.

Illinois Procurement Filing. On February 25, 2005, ComEd made a filing with the Illinois Commerce Commission (ICC) to seek regulatory approval of tariffs that would authorize ComEd to bill its customers for power costs incurred under a reverse–auction competitive bidding process (the Procurement Case). On January 24, 2006, the ICC, by a unanimous vote, approved the tariffs which are based on a reverse–auction competitive bidding process for procurement of power by ComEd for the period commencing January 1, 2007. The auction will be administered by an independent auction manager, with oversight by the ICC staff. The first auction is scheduled to take place during the fall of 2006, at which time ComEd's entire retail load will be up for bid. To mitigate the effects of changes in future prices, the load will be staggered in three–year contracts. The ICC determined that it will review the prudence of ComEd's purchase of power but that compliance with the ICC–approved process will establish a presumption of prudence. ComEd, the Attorney General of Illinois, Citizens Utility Board, Cook County, Environmental Law and Policy Center and the Building Owners Management Association have filed petitions for review of portions of the order with the Illinois Appellate Court. While ComEd is generally supportive of the order in the Procurement Case, ComEd has objected to the requirement for a procurement review.

The ICC, in its January 24, 2006 order, also ordered its staff to initiate three separate rulemakings regarding demand response programs, energy efficiency programs and renewable energy resources. ComEd intends to participate in those rulemaking proceedings.

Illinois Rate Case. On August 31, 2005, ComEd filed a rate case with the ICC, which seeks, among other things, to allocate the costs of delivering electricity and to adjust ComEd's rates for delivering electricity effective January 2, 2007 (Rate Case). Several intervenors in the Rate Case, including the ICC Staff and the Illinois Attorney General, have suggested and provided testimony that ComEd's rates for delivery services should be reduced. These proposals do not support a total rate reduction because the commodity component of ComEd's rates will be established by the reverse–auction process in accordance with the ICC order in the Procurement Case. The results of the Rate Case are not expected to be known until at least the third quarter of 2006.

Mitigation Proposal. To mitigate the impact on its residential customers of transitioning to the post rate freeze period, ComEd has offered to develop a "cap and deferral" proposal to ease the impact of the expected increase in rates on residential customers, which could require regulatory or legislative approval to implement. A cap and deferral proposal, generally speaking, would limit the procurement costs that ComEd could pass through to its customers for a specified period of time and allow ComEd to collect any unrecovered procurement costs, including an appropriate return, in later years. This proposal was submitted in the Rate Case and by agreement of the parties will be reviewed as part of a separate proceeding before the ICC.

Renewable Energy Filing. On April 4, 2006, ComEd filed with the ICC a proposal to purchase and receive recovery of costs associated with purchasing the output of a portfolio of wind resources of approximately 300 MW. The filing supports the ICC's resolution of July 19, 2005, in Docket No. 05–0437, which endorsed the governor's proposal for a voluntary initiative in which electric suppliers would obtain resources equal to 2% of electricity sold to Illinois retail customers from renewable energy resources by 2007 and gradually increasing to a target of 8% by 2013. Additionally, the filing expresses ComEd's support of the

renewable, efficiency and demand response rulemaking proceedings ordered by the ICC in the Procurement Case. ComEd will file additional renewable energy, demand response and energy efficiency components sometime in the future, pending outcomes in those rulemakings.

Rate Freeze Extension Proposal. On February 24, 2006, House Bill 5766 was introduced in the Illinois General Assembly and was referred to the Rules Committee. To date, no further action has been taken related to House Bill 5766. If passed, this bill would result in the extension of the rate freeze in Illinois until at least 2010. In order for the bill to become law, it must be approved by both the Illinois House and the Senate, and signed by the Governor. ComEd believes the proposed legislation, if enacted into law, would have serious detrimental effects on Illinois, ComEd, and consumers of electricity. ComEd believes the proposed rate freeze extension, if enacted into law, will violate Federal law and the U.S. Constitution, and ComEd is prepared to challenge the rate freeze legislation in court. Due to the serious impact this proposed legislation would have, ComEd and others are vigorously opposing this legislative initiative. If enacted, this legislation would have adverse liquidity consequences for ComEd and could require ComEd to cease applying SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation," (SFAS No. 71) which covers the accounting for the effects of rate regulation and which would require Exelon and ComEd to eliminate the financial statement effects of regulation for the portion of ComEd's business that ceases to meet the criteria. This would result in the elimination of all associated regulatory assets and liabilities that Exelon and ComEd had recorded on their Consolidated Balance Sheets through the recording of a one–time extraordinary item on their Consolidated Statements of Income and Comprehensive Income, which could be material.

Post 2006 Summary. ComEd cannot predict the results of the Rate Case before the ICC or whether the Illinois General Assembly might take action that could have a material impact on the outcome of the regulatory process. However, if the price which ComEd is ultimately allowed to bill to customers for energy beginning in 2007 is below ComEd's cost to procure and deliver electricity, ComEd expects that it will suffer adverse consequences, which could be material. Exelon and ComEd believe that these potential material adverse consequences could include, but may not be limited to, reduced earnings for Exelon and ComEd, loss of ComEd's investment grade credit ratings, limited or lost access for ComEd to credit markets to finance operations and capital investment, and loss of ComEd's capacity to enter into bilateral long–term energy procurement contracts, which may force ComEd to procure electricity at more volatile spot market prices. Moreover, to the extent ComEd is not permitted to recover its costs, ComEd's ability to maintain and improve service may be diminished and its ability to maintain reliability may be impaired. In the nearer term, these prospects could have adverse effects on ComEd's liquidity if vendors reduce credit or shorten payment terms or if ComEd's financing alternatives become more limited and significantly less flexible. Finally, if ComEd's ability to recover its costs from customers through rates is significantly impacted, all or a portion of ComEd's business could be required to cease applying SFAS No. 71.

PECO

Partial Settlement before the Pennsylvania Public Utility Commission (PAPUC). On January 27, 2006, the PAPUC approved the Merger and a partial settlement regarding PECO's electric distribution and transmission rates through 2010 and other financial commitments of PECO related to the Merger. The provisions of the PAPUC order and partial settlement are contingent upon the completion of the Merger. The PAPUC order and partial settlement require PECO to implement electric rate reductions aggregating $120 million during a four–year period and to cap its electric rates through the end of 2010. The partial settlement also provides substantial funding for alternative energy and environmental projects, economic development, and expanded outreach and assistance for low–income customers. PECO also made commitments for enhanced customer service and reliability, commitments for charitable giving and employment, and

EXELON CORPORATION AND SUBSIDIARY COMPANIES
COMMONWEALTH EDISON COMPANY AND SUBSIDIARY COMPANIES
PECO ENERGY COMPANY AND SUBSIDIARY COMPANIES
EXELON GENERATION COMPANY, LLC AND SUBSIDIARY COMPANIES

COMBINED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

a pledge to maintain its Philadelphia headquarters for a period of time. The total of these funding commitments is approximately $44 million, of which $30 million will be expensed at the time the Merger is completed. See Note 4 of Exelon's Notes to Consolidated Financial Statements within Exelon's 2005 Annual Report on Form 10–K for further discussion.

ComEd and PECO

Through and Out Rates/SECA. In November 2004, the Federal Energy Regulatory Commission (FERC) issued two orders authorizing ComEd and PECO to recover amounts for a limited time during a specified transitional period as a result of the elimination of through and out (T&O) rates for transmission service scheduled out of, or across, their respective transmission systems and ending within pre–expansion territories of PJM Interconnection, LLC (PJM) or Midwest Independent System Operators (MISO). T&O rates were terminated pursuant to FERC orders, effective December 1, 2004. The new rates, known as Seams Elimination Charge/ Cost Adjustment/ Assignment (SECA), were collected from load–serving entities within PJM and MISO over a transitional period from December 1, 2004 through March 31, 2006, subject to refund, surcharge and hearing. As load–serving entities, ComEd and PECO were also required to pay SECA rates during the transitional period based on the benefits they receive from the elimination of T&O rates of other transmission owners within PJM and MISO. Since the inception of the SECA rates in December 2004, ComEd has recorded approximately $49 million of SECA collections net of SECA charges, including $5 million in 2006, while PECO has recorded $10 million of SECA charges net of SECA collections, including $3 million in 2006. As a result of recent events related to disputes over the methodology of computing SECA amounts, during the first quarter of 2006, ComEd and PECO increased their previously–recorded reserves for amounts to be refunded. Management of each of ComEd and PECO believes that appropriate reserves have been established in the event that SECA collections are required to be refunded. As the ultimate outcome of the proceeding establishing SECA rates is uncertain, the result of this proceeding may have a significant effect on ComEd's and PECO's financial condition, results of operations and cash flows.

Generation

Market–Based Rates Filing. On April 3, 2006, FERC accepted Exelon's compliance filings regarding its triennial update of market–based rates and terminated proceedings under Section 206 of the Federal Power Act. FERC had initiated Section 206 proceedings based upon its initial understanding that Exelon had not addressed the affiliate abuse and reciprocal dealing component of FERC's market–power analysis. In the order, FERC accepted Exelon's statements that, under the regulatory structures in Illinois and Pennsylvania, most of the load is served under fixed prices, a scenario that has not changed since the previous market–based rates filing in 2000. FERC agreed that these pricing structures alleviated any concerns of affiliate abuse or reciprocal dealing. For a further discussion of this matter, see Note 4 of Exelon's Notes to Consolidated Financial Statements within Exelon's 2005 Annual Report on Form 10–K.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

(Dollars in millions except per share data, unless otherwise noted)

General

Exelon is a public utility holding company. It operates through subsidiaries in the following business segments:

- *ComEd,* whose business includes the purchase and regulated retail and wholesale sale of electricity and distribution and transmission services in northern Illinois, including the City of Chicago.
- *PECO,* whose businesses include the purchase and regulated retail sale of electricity and distribution and transmission services in southeastern Pennsylvania, including the City of Philadelphia, and the purchase and regulated retail sale of natural gas and distribution services in the Pennsylvania counties surrounding the City of Philadelphia.
- *Generation,* which consists principally of the electric generating facilities and wholesale energy marketing operations of Generation, the competitive retail sales business of Exelon Energy Company and certain other generation projects.

See Note 15 of the Combined Notes to Consolidated Financial Statements for further segment information.

Exelon's corporate operations, through its business services subsidiary, Exelon Business Services Company (BSC), provide Exelon's business segments with a variety of support services, including legal, human resources, financial, information technology, supply management and corporate governance services. ComEd and PECO also receive additional services from BSC, including planning and engineering of delivery systems, management of construction, operation and maintenance of the transmission and delivery systems, and management of other support services. Generation receives additional services from BSC for inventory and information technology support and management of other support services. These costs are allocated to the applicable business segments. Additionally, the results of Exelon's corporate operations include costs for corporate governance and interest costs and income from various investment and financing activities.

EXELON CORPORATION

Executive Overview

Financial Results. Exelon's net income was $400 million for the three months ended March 31, 2006 as compared to $521 million for the same period in 2005 and diluted earnings per average common share were $0.59 for the three months ended March 31, 2006 as compared to $0.77 for the same period in 2005. The decrease was primarily due to the following:

- unrealized mark–to–market losses on contracts not yet settled;
- unfavorable weather conditions in Exelon's service areas;
- higher operating and maintenance expenses, including expenses related to stock compensation as a result of adopting FASB Statement No. 123 (revised 2004), "Share–Based Payment" (SFAS No. 123–R) and higher non–outage operating costs and nuclear refueling expenses;
- increased depreciation and amortization expense, primarily related to competitive transition charge (CTC) amortization at PECO;
- reduced earnings from investments in synthetic fuel–producing facilities;
- a gain recorded in 2005 associated with the sale of Exelon's investment in Sithe Energies, Inc. (Sithe);
- increased interest expense associated with the debt issued in March 2005 to fund Exelon's pension contribution; and

- increased taxes other than income due to favorable real estate tax settlements at PECO and Generation in 2005.

The factors driving the overall decrease in net income above were partially offset by the following:

- higher margins on Generation's wholesale market sales;
- increased electric revenues at PECO associated with certain scheduled rate increases; and
- increased kWh deliveries, excluding the effects of weather, reflecting load growth at ComEd and PECO.

Investment Strategy. Exelon continues to follow a disciplined approach in investing to maximize earnings and cash flows from its assets and businesses, while selling those investments that do not meet its strategic goals. Highlights from the first quarter of 2006 include the following:

- Proposed Merger with Public Service Enterprise Group Incorporated (PSEG) — On December 20, 2004, Exelon entered into a merger agreement with PSEG (Merger), and shareholders of both companies approved the transaction in July 2005. As of April 25, 2006, all material regulatory actions required to complete the Merger have been completed with the exception of the approval from the New Jersey Board of Public Utilities (NJBPU) and the United States Nuclear Regulatory Commission (NRC) and the review by the United Sates Department of Justice (DOJ).

  In New Jersey, hearings for the Merger review concluded at the end of March 2006. Settlement discussions began in December and are expected to resume soon. Exelon expects to complete all regulatory reviews and close the Merger in the third quarter of 2006.

Financing Activities. During the first quarter of 2006, Exelon met its capital resource requirements primarily with internally generated cash. When necessary, Exelon obtains funds from external sources, including capital markets, and through bank borrowings. In February 2006, ComEd and Generation entered into credit facilities totaling $1 billion and $950 million, respectively. In addition, in March 2006, ComEd issued $325 million of First Mortgage Bonds. See Note 7 of the Combined Notes to the Consolidated Financial Statements for further information on the credit facilities and the bond issuance.

Regulatory and Environmental Developments. The following significant regulatory and environmental developments occurred in the first quarter of 2006. See Notes 5 and 13 of the Combined Notes to the Consolidated Financial Statements for further information.

- Illinois Procurement Filing — On January 24, 2006, the Illinois Commerce Commission (ICC) approved ComEd's procurement case, authorizing ComEd to procure power after 2006 through a reverse–auction competitive bidding process and to recover the costs from retail customers with no markup. The auction will be administered by an independent auction manager, with oversight by the ICC staff. The first auction is scheduled to take place during the fall, at which time ComEd's entire load will be up for bid. To mitigate the effects of changes in future prices, the load will be staggered in three–year contracts. ComEd, the Attorney General of Illinois, Citizens Utility Board and other parties have filed appeals for review of portions of the order with the Illinois Appellate Court. While ComEd is generally supportive of the order in the procurement case, ComEd has objected to the requirement for a prudence review.
- House Bill 5766 — On February 24, 2006, House Bill 5766 was introduced in the Illinois General Assembly and was referred to the Rules Committee. This bill, if enacted into law, would result in the extension of the retail rate freeze in Illinois. As ComEd believes the proposed legislation, if enacted into law, would have serious detrimental effects on Illinois, ComEd, and consumers of electricity, ComEd and others are vigorously opposing this legislative initiative.
- Nuclear Generating Station Groundwater — In February 2006, Exelon and Generation launched an initiative across its ten–station nuclear fleet to systematically assess systems that handle tritium and take the necessary actions to minimize the risk of inadvertent discharge of tritium to the environment. The initiative is in response to the detection of tritium in water samples taken related to leaks at the

Braidwood, Byron and Dresden nuclear generating stations in Illinois. There is no health or safety threat to existing drinking water wells or sources based on current testing results, and the drinking water tested in residential wells meets Federal safe drinking water standards. Exelon and Generation will continue to monitor these matters and are working with state and local officials to determine the appropriate remediation plans, where necessary.

Outlook for 2006 and Beyond. Exelon's future financial results will be affected by a number of factors, including the following:

- Exelon expects the Merger will result in synergies, cost savings and operating efficiencies. Although Exelon expects to achieve these anticipated benefits of the Merger, achieving them is subject to a number of uncertainties.
- Certain governmental officials and consumer advocacy groups claim that ComEd's retail rates for electricity should not be based solely on its cost to procure electricity and capacity in the wholesale market. Additionally, certain parties to ComEd's pending rate case proceeding have indicated ComEd's rates for delivering energy should be reduced or not increased. If the price at which ComEd is allowed to sell electricity beginning in 2007 is below ComEd's cost to procure and deliver electricity, or if ComEd is unable to recover its costs and investment through the Rate Case, there may be material adverse consequences to ComEd and, possibly, Exelon. However, the ICC's unanimous approval of the reverse–auction process, barring any successful appeals or change in law, should provide ComEd with stability and greater certainty that it will be able to procure energy and pass through the costs of that energy to ComEd's customers beginning in 2007 through a transparent market mechanism in the reverse–auction competitive bidding process. The results of the Rate Case are expected be known during the third quarter of 2006.
- The price of power purchased and sold in the open wholesale energy markets can vary significantly in response to market conditions. Generally, between 60% and 70% of Generation's supply currently serves ComEd and PECO customers. Consequently, Generation has historically limited its earnings exposure from the volatility of the wholesale energy market to the energy generated in excess of the ComEd and PECO requirements, as well as any other contracted longer term obligations. Following the expiration of the purchased power agreement (PPA) with ComEd at the end of 2006, approximately 70% to 80% of Generation's supply will be exposed to energy market prices, increasing the volatility of Exelon's results. While current market prices for electricity have increased significantly over the past few years due to the rise in natural gas and fuel prices in the market which has improved Generation's margins due to its significant capacity of low–cost nuclear generating facilities, Generation's ability to maintain those margins will depend on future fossil fuel prices and its ability to obtain high capacity factors at its nuclear plants. As mentioned previously, following the expiration of the PPA between ComEd and Generation, Exelon will increase the amount of power sold into the wholesale energy market. Based on recent increases in market prices, power now being sold to ComEd is likely to be sold in 2007 at higher prices than the prices previously received as part of the PPA.
- Federal and state governing bodies have begun to introduce, and in some cases approve, legislation mandating the future use of renewable and alternative fuel sources, such as wind, solar, biomass and geothermal. The extent of the use of these renewable and alternative fuel sources varies by state and could change. The future requirement to use these renewable and alternative fuel sources for some portion of ComEd's and PECO's distribution sales could result in increased fuel costs and capital expenditures.
- Exelon anticipates that it will be subject to the ongoing pressures of rising operating expenses due to increases in costs such as medical benefits and rising payroll costs due to inflation. Also, Exelon will continue to incur significant capital costs associated with its commitment to produce and deliver energy reliably to its customers. The Company is determined to operate its businesses responsibly and to appropriately manage its operating and capital costs while serving its customers and producing value for its shareholders.

• Exelon, through three wholly owned subsidiaries, has investments in synthetic fuel–producing facilities. The IRS provides tax credits for such facilities under Section 45k (formerly Section 29) of the Internal Revenue Code. Based on the 2006 and 2007 New York Mercantile Exchange, Inc. index (NYMEX) futures prices per barrel of oil at March 31, 2006, Exelon estimates there will be a phase out of tax credits of 52% and 60% in 2006 and 2007, respectively. This would decrease Exelon's net income as compared to 2005 by as much as $47 million and $53 million in 2006 and 2007, respectively. These estimates can change significantly due to the volatility in oil prices and pending legislation in Congress. See Note 10 of the Combined Notes to Consolidated Financial Statements and Liquidity and Capital Resources for further discussion.

Critical Accounting Policies and Estimates

Management of each of the Registrants makes a number of significant estimates, assumptions and judgments in the preparation of its financial statements. See "Management's Discussion and Analysis of Financial Condition and Results of Operations — Critical Accounting Policies and Estimates" in Exelon's 2005 Annual Report on Form 10–K for a discussion of the estimates and judgments necessary in the Registrants' accounting for asset retirement obligations, asset impairments, depreciable lives of property, plant and equipment, defined benefit pension and other postretirement welfare benefits, regulatory accounting, derivative instruments, contingencies, severance and revenue recognition.

Stock–based compensation cost (Exelon, ComEd, PECO and Generation)

On January 1, 2006, Exelon adopted SFAS No. 123–R, which requires that compensation cost relating to share–based payment transactions be recognized in the financial statements. That cost is measured on the fair value of the equity or liability instruments at the date of grant and amortized over the vesting period. The fair value of stock options on the date of grant is estimated using the Black–Scholes–Merton option–pricing model, which requires assumptions such as dividends yield, expected volatility, risk–free interest rate, expected life and forfeiture rate. The fair value of performance share awards granted in the first quarter of 2006 was estimated using historical data for the previous two plan years and a Monte Carlo simulation model for the current plan year, which requires assumptions regarding Exelon's total shareholder return relative to certain stock market indices and the stock beta and volatility of Exelon's common stock and all stocks represented in these indices. See Note 3 of the Combined Notes to Consolidated Financial Statements for further information. If actual results differ significantly from the estimates, the Consolidated Financial Statements could be materially affected.

New Accounting Pronouncements

See Note 3 of the Combined Notes to Consolidated Financial Statements for discussion of new accounting pronouncements.