

**BEFORE THE STATE OF NEW JERSEY  
OFFICE OF ADMINISTRATIVE LAW  
BOARD OF PUBLIC UTILITIES**

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

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**TESTIMONY OF DAVID E. PETERSON  
ON BEHALF OF THE  
NEW JERSEY DIVISION OF THE RATEPAYER ADVOCATE**

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## TABLE OF CONTENTS

I. INTRODUCTION.....	1
II. SUMMARY.....	3
III. IMPACT ON NEW JERSEY RATES.....	5
IV. IMPACT ON EMPLOYEES.....	21
V. EXELON BSC.....	25
APPENDIX A- Curriculum Vitae	

1 **I. INTRODUCTION**

2 **Q. PLEASE STATE YOUR NAME, OCCUPATION AND BUSINESS**  
3 **ADDRESS.**

4 A. My name is David E. Peterson. I am a Senior Consultant employed by  
5 Chesapeake Regulatory Consultants, Inc. ("CRC"). Our business address is 1698  
6 Saefern Way, Annapolis, Maryland 21401-6529. I maintain an office in Dunkirk,  
7 Maryland.

8

9 **Q. WHAT IS YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE**  
10 **IN THE PUBLIC UTILITY FIELD?**

11 A. I graduated with a Bachelor of Science degree in Economics from South Dakota  
12 State University in May of 1977. In 1983, I received a Master's degree in  
13 Business Administration from the University of South Dakota. My graduate  
14 program included accounting and public utility courses at the University of  
15 Maryland.

16

17 In September 1977, I joined the Staff of the Fixed Utilities Division of the South  
18 Dakota Public Utilities Commission as a rate analyst. My responsibilities at the  
19 South Dakota Commission included analyzing and testifying on ratemaking  
20 matters arising in rate proceedings involving electric, gas and telephone utilities.

21

22 Since leaving the South Dakota Commission in 1980, I have continued  
23 performing cost of service and revenue requirement analyses as a consultant. In  
24 December 1980, I joined the public utility consulting firm of Hess & Lim, Inc. I  
25 remained with that firm until August 1991, when I joined CRC. Over the years, I  
26 have analyzed filings by electric, natural gas, propane, telephone, water,  
27 wastewater, and steam utilities in connection with utility rate and certificate  
28 proceedings before federal and state regulatory commissions.

1 **Q. HAVE YOU PREVIOUSLY PRESENTED TESTIMONY IN PUBLIC**  
2 **UTILITY RATE PROCEEDINGS?**

3 A. Yes. I have presented testimony in 96 other proceedings before the state  
4 regulatory commissions in Alabama, Arkansas, Colorado, Connecticut, Delaware,  
5 Indiana, Kansas, Maine, Maryland, Montana, Nevada, New Jersey, New Mexico,  
6 New York, Pennsylvania, South Dakota, West Virginia, and Wyoming, and  
7 before the Federal Energy Regulatory Commission (“FERC”).

8

9 Collectively, my testimonies have addressed the following topics: the appropriate  
10 test year, rate base, revenues, expenses, depreciation, taxes, capital structure,  
11 capital costs, rate of return, cost allocation, rate design, life-cycle analyses,  
12 affiliate transactions, mergers, acquisitions, and cost-tracking procedures.

13

14 **Q. HAVE YOU PREVIOUSLY PRESENTED TESTIMONY IN UTILITY**  
15 **MERGER PROCEEDINGS?**

16 A. Yes, I have. I presented testimony to the Colorado Public Utilities Commission in  
17 Docket No. 95A-531EG on behalf of the Colorado Office of Consumer Counsel  
18 relating to the merger application of Public Service Company of Colorado and  
19 Southwestern Public Service Company. In August 1997, I presented testimony to  
20 the New Jersey Board of Public Utilities (“Board”) in BPU Docket No.  
21 EM97020103 on behalf of the Division of the Ratepayer Advocate (“Ratepayer  
22 Advocate”) relating to the acquisition of Atlantic Energy, Inc. and Atlantic City  
23 Electric Company by Delmarva Power and Light Company.

24

25 In April 2001, I presented testimony to the Board in BPU Docket No.  
26 EM00110870 on behalf of the Ratepayer Advocate relating to the acquisition of  
27 GPU, Inc. (and Jersey Central Power and Light Company) by FirstEnergy Corp.  
28 of Akron, Ohio. In September 2001, I presented testimony to the Board in Docket

1 No. EM01050308 involving the acquisition of Conectiv (and Atlantic City  
2 Electric Company) by Pepco Holdings, Inc. Lastly, I presented testimony in  
3 November 2001 to the Maryland Public Service Commission in Case No. 8898 on  
4 behalf of the Maryland Office of People’s Counsel in a proceeding involving the  
5 acquisition of Utilities, Inc., by the Dutch utility, nv Nuon.

6  
7  
8 **II. SUMMARY**

9 **Q. ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?**

10 A. I am appearing in this proceeding on behalf the Ratepayer Advocate.

11  
12 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS**  
13 **PROCEEDING?**

14 A. I have been advised by counsel that under New Jersey’s change in ownership and  
15 control statute, N.J.S.A. 48:2-51.1, the Board is required to:

16  
17 “...evaluate the impact of the acquisition on competition, on the  
18 rates of ratepayers affected by the acquisition of control, on the  
19 employees of the affected public utility or utilities, and on the  
20 provision of safe and adequate utility service at just and reasonable  
21 rates.”  
22

23 I was asked by the Ratepayer Advocate to review and evaluate the elements of  
24 Public Service Electric and Gas Company’s (“PSE&G”) and Exelon  
25 Corporation’s (“Exelon”) (collectively referred to hereafter as “Joint Petitioners”)  
26 Joint Petition concerning the impact of the merger on New Jersey rates and on  
27 PSE&G’s employees. I was also asked to evaluate the Joint Petitioners’ request  
28 for approval of a General Service Agreement (“GSA”) between PSE&G and  
29 Exelon Business Services Company (“Exelon BSC”), an affiliate service  
30 company, and a Mutual Services Agreement (“MSA”) to govern transactions  
31 between PSE&G and other Exelon affiliates, other than Exelon BSC.

1 **Q. WHAT DID YOU REVIEW IN PREPARATION FOR YOUR**  
2 **TESTIMONY?**

3 A. I carefully reviewed the February 4, 2005 Joint Petition, the Agreement and Plan  
4 of Merger (“Merger Agreement”) dated December 20, 2004, and the testimonies  
5 and exhibits of the Joint Petitioners. In addition, I reviewed Exelon’s May 27,  
6 2005 Amended Securities and Exchange Commission (“SEC”) Form S-4  
7 Registration Statement under the Securities Act of 1933, which included a Joint  
8 Proxy Statement/Prospectus, certain PSE&G, PSEG and Exelon financial and  
9 operating reports, and the Joint Petitioners’ responses to requests for additional  
10 information submitted by the Ratepayer Advocate, the Board Staff and by other  
11 intervenors in the case. In addition, I participated in several discovery  
12 conferences involving the Joint Petitioners’ witnesses relating to the issues that I  
13 address in my testimony.

14  
15 **Q. PLEASE SUMMARIZE YOUR FINDINGS.**

16 A. The Board must determine the proposed transaction can be accomplished without  
17 an adverse impact in the areas specified in the statute, that the transaction results  
18 in net positive benefits to New Jersey ratepayers and the State, and that,  
19 ultimately, the merger is in the public interest. Concerning the merger’s impact  
20 on New Jersey ratepayers and PSE&G employees, I found that the proposed  
21 transaction does not provide net positive benefits to New Jersey ratepayers. Nor  
22 does it adequately protect New Jersey ratepayers and PSE&G employees against  
23 adverse consequences that will flow from the merger if it is approved as proposed.  
24 Moreover, the proposed General Service Agreement and the Mutual Services  
25 Agreement, in their present form, do not adequately protect ratepayer interests.  
26 Therefore, the Joint Petition should not be approved in its present form.  
27 Ratepayer Advocate witness Nancy Brockway’s testimony provides a more  
28 comprehensive summary of the Ratepayer Advocate’s consultants’ findings in  
29 this proceeding and the Ratepayer Advocate’s ultimate recommendations. The  
30 bases for my findings and recommendations are set forth in the following  
31 testimony.

1 **III. IMPACT ON NEW JERSEY RATES**

2 **Q. WHAT IS YOUR UNDERSTANDING OF THE JOINT PETITIONERS’**  
3 **POSITION REGARDING THE RATE IMPACT THAT WILL RESULT**  
4 **FROM THE PROPOSED MERGER?**

5 A. Even though the merging companies project gross savings (i.e., before  
6 consideration of costs to achieve) of \$400 million in the first year following the  
7 merger and \$500 million in the second year post-merger and thereafter,<sup>1</sup> the Joint  
8 Petitioners are not proposing any rate changes for PSE&G at this time. Instead,  
9 all cost savings that result from the merger will inure to the benefit of Exelon and  
10 its stockholders until such time as the savings can be reflected in PSE&G’s retail  
11 rates in its next base rate proceeding.<sup>2</sup> In this way, Exelon witness John W. Rowe  
12 claims the savings “...will help offset the rise in cost of providing reliable  
13 regulated electric and gas distribution service and, thus, will, over time, result in  
14 lower rates than would otherwise be the case.”<sup>3</sup>

15  
16 **Q. DO YOU AGREE WITH THIS POSITION?**

17 A. No, I do not. Maintaining present rates, as the Joint Petitioners propose, produces  
18 an adverse consequence for PSE&G’s customers resulting from the merger.

19  
20 Mr. Rowe’s acknowledgment that synergy savings will be used to offset future  
21 cost increases to hold down New Jersey retail rates is also tacit acknowledgment  
22 that New Jersey ratepayers are entitled to 100 percent of PSE&G’s allocable  
23 portion of net merger savings. In the normal course of ratemaking, rates are set  
24 equal to a utility’s service costs. To the extent a utility’s costs increase or  
25 decrease, such changes are reflected in rates in the rate setting process. In this  
26 regard, I agree with Mr. Rowe that PSE&G ratepayers are entitled to, and should  
27 receive, the full benefit of all utility cost reductions, including those arising from

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<sup>1</sup> Exelon SEC Form S-4/A, filed May 27, 2005, page 59.

<sup>2</sup> Subsequent to the Joint Petitioners’ application in this docket, PSE&G filed with the Board a rate increase application for its gas distribution business unit. PSE&G’s pending gas rate filing does not include any recognition of anticipated synergy savings for New Jersey ratepayers.

<sup>3</sup> Direct Testimony of John W. Rowe, page 12.

1 the merger. Thus, there seems to be no disagreement between Mr. Rowe and me  
2 as to whether ratepayers are ultimately entitled to PSE&G's entire allocable share  
3 of merger savings. The heart of my disagreement with Mr. Rowe's position,  
4 however, is the timing of the recognition of merger savings in PSE&G's retail  
5 rates. Mr. Rowe would retain all of the savings for the benefit of Exelon and its  
6 stockholders until PSE&G files its next base rate case. Yet, he makes no case for  
7 preserving this undeserved windfall for his stockholders. In my opinion,  
8 PSE&G's share of expected annual merger savings should be reflected in retail  
9 rates upon closing of the merger so that New Jersey ratepayers begin to enjoy the  
10 benefits of the merger as they occur.

11  
12 **Q. HOW DOES THE FAILURE TO REFLECT MERGER SAVINGS IN**  
13 **PSE&G'S RETAIL RATES CONTEMPORANEOUSLY WITH THE**  
14 **MERGER CLOSING CREATE AN UNDESERVED WINDFALL FOR**  
15 **EXELON'S STOCKHOLDERS?**

16 A. PSE&G's revenue requirements, and ultimately its retail rates, are driven by the  
17 costs it incurs to serve New Jersey customers. If, as a result of the merger,  
18 PSE&G's underlying costs decline because of synergy savings, its present rates  
19 will no longer reflect its costs to serve and PSE&G will have effectively increased  
20 its authorized return allowance by permitting Exelon's stockholders to retain the  
21 benefits of PSE&G's cost reductions. This is an untenable result, especially so  
22 when one considers the Joint Petitioners' claim that one of the benefits of the  
23 merger is an economically stronger company with improved access to capital  
24 markets. That is, PSE&G will not need to increase its authorized rate of return,  
25 either directly or indirectly, because of the merger. PSE&G's owners are already  
26 adequately compensated by the Board's authorized rate of return allowance. It is  
27 unnecessary and unreasonable for Exelon to retain PSE&G's share of the merger  
28 savings for the exclusive benefit of Exelon's investors until such time that  
29 PSE&G files its next base rate case. PSE&G's present rates must be reduced to  
30 reflect merger savings contemporaneously with the merger closing if PSE&G is to



1 retain cost-based rates and avoid an adverse impact on New Jersey retail  
2 ratepayers.

3  
4 **Q. WHAT LEVEL OF MERGER SAVINGS DO THE JOINT PETITIONERS**  
5 **PROJECT?**

6 A. In documents filed with the SEC, Exelon has stated that it expects to achieve \$400  
7 million in gross savings in the first year post-merger; increasing to \$500 million  
8 by the end of the second year.<sup>4</sup> The majority of the savings, however, are  
9 anticipated to fall within Exelon's and PSEG's unregulated business activities; not  
10 within their regulated utilities (i.e., ComEd, PECO, and PSE&G). In fact, out of  
11 the total \$400 million expected savings in the first year post-merger, the Joint  
12 Petitioners project that savings within the regulated companies will be only \$85.7  
13 million, or approximately 21 percent of the total.<sup>5</sup> For the second year post-  
14 merger, Exelon projects \$132.1 million in merger savings for its regulated  
15 companies. This represents approximately 26 percent of total expected gross  
16 merger savings for that year.

17  
18 The Joint Petitioners show that PSE&G's share of expected savings is a much  
19 smaller portion of these totals. Exelon's witness on merger savings, William D.  
20 Arndt, estimated that PSE&G's share of gross merger savings will be \$32.7  
21 million in the first year following the merger increasing to \$53.2 million in year  
22 two.<sup>6</sup>

23  
24 **Q. WERE THE JOINT PETITIONERS' MERGER SAVINGS**  
25 **CALCULATIONS PERFORMED IN THE SAME MANNER THAT THE**  
26 **BOARD HAS REQUIRED IN OTHER NEW JERSEY MERGER**  
27 **PROCEEDING?**

28 A. No, they were not. Mr. Arndt's synergy analysis was calculated for only the first  
29 four years post-merger, which was assumed to be the years 2006 through 2009.

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<sup>4</sup> Exelon's SEC Form S-4/A, filed May 27, 2005, page 59.

<sup>5</sup> Direct Testimony of William D. Arndt, Exhibit WDA -2.

<sup>6</sup> Response to RAR-SQ-34, Section O, page 012.

1 In a previous merger involving a New Jersey utility, the Board required a synergy  
2 study showing expected savings and costs over the first ten years post-merger,  
3 rather than just four years, as Mr. Arndt has shown in his analysis.<sup>7</sup>  
4

5 **Q. WHY DID MR. ARNDT INCLUDE ONLY FOUR YEARS IN HIS**  
6 **ANALYSIS?**

7 A. Mr. Arndt stated that a four-year analysis was chosen to reflect the time necessary  
8 to achieve expected synergies and to incur the costs to achieve those synergies.<sup>8</sup>  
9 In other words, Exelon expects to have incurred all of the costs necessary to  
10 accomplish the merger, save for the continuing depreciation expense on new  
11 capital investments, and will have implemented all of the cost cutting measures  
12 within the first four years post-merger.  
13

14 **Q. DO YOU AGREE THAT A FOUR-YEAR ANALYSIS IS TO BE**  
15 **PREFERRED OVER A TEN-YEAR ANALYSIS IN THIS PROCEEDING?**

16 A. No, I do not. Clearly, the anticipated savings from the merger are long-term in  
17 nature and will extend well beyond the four years included in Mr. Arndt's  
18 synergies analysis. The same is not true, however, for the bulk of the costs  
19 incurred to accomplish the merger. As Mr. Arndt pointed out, the overwhelming  
20 majority of the costs to achieve will be incurred during the first four years. Thus,  
21 it is necessary to expand the synergies analysis well beyond four years in order to  
22 provide an accurate portrayal of the extent of Exelon's net, on-going savings after  
23 the costs to achieve have been incurred. The Board's practice of using a ten-year  
24 synergy analysis in merger proceedings serves this purpose well.  
25

26 **Q. HAS A TEN-YEAR SYNERGY ANALYSIS BEEN PREPARED FOR THIS**  
27 **PROCEEDING?**

28 A. Yes, it has. Several parties requested the Joint Petitioners to provide a ten-year  
29 synergies analysis showing gross savings, costs to achieve and net savings to

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<sup>7</sup> Atlantic City Electric Company and Conectiv, Inc., for Approval of a Change in Ownership and Control, BPU Docket No. EM97020103, December 30, 1997.

<sup>8</sup> Response to RAR-RR-42.

1 regulated operations over the first ten years post-merger. I have included as  
2 Exhibit DP-1 attached to my testimony Exelon's analysis that was provided in  
3 response to these requests.<sup>9</sup> This schedule shows gross savings of \$1,775,052,000  
4 over the first ten years post-merger for the three regulated utilities and net savings  
5 of \$1,249,699,000 over the same ten-year period. From this, Mr. Arndt calculated  
6 that PSE&G's share of net savings over the first ten years post-merger will be  
7 approximately \$503.8 million.<sup>10</sup>  
8

9 **Q. HAVE YOU REVIEWED MR. ARNDT'S DETAILED SYNERGIES**  
10 **CALCULATIONS?**

11 A. Yes, I have. Mr. Arndt's synergies study is summarized in the five exhibits that  
12 are attached to his Direct Testimony in this proceeding. Support for these  
13 summary schedules is contained in his workpapers, which were provided in  
14 response to a Ratepayer Advocate data request.<sup>11</sup> As explained later in this  
15 testimony, Mr. Arndt's synergies study relies on a myriad of assumptions  
16 regarding post-merger operations that are unverifiable and cannot be proven  
17 reliable at this time.  
18

19 In the narrative that accompanied his quantitative analyses, Mr. Arndt explains  
20 that small working groups from the major business units and functional areas  
21 from both Exelon and PSEG were formed to identify synergy opportunities, to  
22 estimate synergy savings, and to estimate costs-to-achieve. Synergies were then  
23 identified and estimated by comparing baseline (i.e., pre-merger) financial and  
24 operations data to anticipated post-merger operations. Mr. Arndt's analysis  
25 examined savings opportunities within the regulated companies in the following  
26 major functional areas:  
27

- 28 ■ Corporate and Shared Services Staffing
- 29 ■ Corporate & Administrative Programs

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<sup>9</sup> Response to RAR-RR-43.

<sup>10</sup> Response to RAR-RR-91, page 4.

<sup>11</sup> Response to RAR-SQ-34.

- 1                   ▪ Information Technology (“IT”)
- 2                   ▪ Utility Support Staffing
- 3                   ▪ Utility Non-Labor Savings
- 4

5   **Q.     WHAT SYNERGIES WERE SHOWN FOR THE JOINT PETITIONERS’**  
6   **REGULATED OPERATING COMPANIES?**

7   A.     A summary of expected synergies for the three regulated operating companies for  
8     the first four years post-merger is provided in Exhibit WDA-2 attached to Mr.  
9     Arndt’s Direct Testimony. The line labeled “Total Gross Regulated Savings”  
10    shows that Exelon believes the regulated operating companies can achieve  
11    \$534,706,000 in synergies in the first four years post-merger. By looking at the  
12    individual savings categories presented on this schedule, we can see that  
13    \$291,637,000 or approximately 54 percent of the expected synergies result from  
14    eliminating overlapping and redundant positions. Another \$101,158,000 is  
15    expected to be saved (before consideration of costs to achieve) within the  
16    regulated utilities’ materials and supplies procurement, contract services, and bad  
17    debt expense functions. Still another \$77.6 million is expected to be saved (again  
18    before consideration of costs to achieve) within the IT function. Finally, \$64.3  
19    million of expected savings in corporate and administrative programs functions is  
20    expected to be allocated to Exelon’s regulated utilities.

21

22   **Q.     ARE MR. ARNDT’S SAVINGS ESTIMATES VERIFIABLE?**

23   A.     No, they are not. Even though Exelon gained considerable merger experience  
24     from its 2000 merger between Unicom and PECO, that merger, unfortunately,  
25     cannot provide any assurance that Mr. Arndt’s synergies and costs estimates in  
26     this proceeding are reasonable. This is because actual synergies achieved and  
27     merger-related costs incurred in connection with the 2000 merger were not  
28     tracked.<sup>12</sup> Thus, we cannot compare Exelon’s synergies study procedures against  
29     achieved results.

30

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<sup>12</sup> Response to S-ENE-SYN-15.

1 Moreover, Mr. Arndt's study assumes that over one-half of the projected gross  
2 synergies are from positions within the companies that will be consolidated and  
3 eliminated following the merger. These workforce reduction estimates were  
4 formed by Mr. Arndt's working groups whose purpose was to identify synergy  
5 opportunities. The working groups performed no formal workforce requirement  
6 studies, however. Nor has Exelon undertaken any formal study of its post-merger  
7 workforce requirements.<sup>13</sup> Because over one-half of the expected synergies are  
8 from assumed personnel reductions, over which Exelon has considerable control,  
9 Exelon has it within its power to meet and even to significantly exceed the level  
10 of synergies shown in Mr. Arndt's study by the employment policies it adopts  
11 post-merger, which have not been shared with the parties in this proceeding.  
12 Thus, neither the parties nor the Board have any way to verify these and the other  
13 synergies projections included in Mr. Arndt's analysis prior to the closing of the  
14 merger.

15  
16 **Q. ARE THERE OTHER SAVING OPPORTUNITIES THAT WERE NOT**  
17 **INCLUDED IN MR. ARNDT'S ANALYSIS?**

18 **A.** Yes, there are. On page 7 of his Direct Testimony, Mr. Rowe identifies increased  
19 financial strength and flexibility and commitment to high quality service - sharing  
20 of best practices as among the benefits that result from the merger. These benefits  
21 could translate into significant cost savings for PSE&G; yet no corresponding  
22 savings estimates are included in Mr. Arndt's study. For example, in response to  
23 an intervenor data request, Exelon acknowledged that PSE&G's participation in  
24 Exelon's Utility Money Pool could result in a 5 – 10 basis point saving on  
25 PSE&G's short-term debt costs.<sup>14</sup> Mr. Kahal also mentions in his testimony  
26 benefits claimed by the Joint Petitioners that could reduce PSE&G's common  
27 equity cost. Neither of these types of savings, however, are included in Mr.  
28 Arndt's study. Nor are any savings from increased efficiencies and economies

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<sup>13</sup> Response to RAR-RR-27(B).

<sup>14</sup> Response to NJLEUC/RESA-PSEG-14/15.

1 included in Mr. Arndt's study; yet such savings are touted as a benefit of the  
2 merger.<sup>15</sup>

3  
4 Thus, Mr. Arndt's study is a conservative estimate of savings that can result from  
5 the merger. In fact, knowing that his savings estimates are unverifiable and that  
6 the Board has required other merging utilities to share a substantial portion of  
7 estimated merger savings with New Jersey ratepayers in prior merger proceedings  
8 provided Mr. Arndt with a strong incentive to estimate PSE&G's merger savings  
9 in this proceeding conservatively.

10  
11 **Q. HAVE YOU REVIEWED MR. ARNDT'S ESTIMATES OF COSTS**  
12 **NECESSARY TO ACCOMPLISH THIS MERGER ("COSTS TO**  
13 **ACHIEVE")?**

14 A. Yes. The Joint Petitioners' estimates of merger-related costs, as allocated to the  
15 regulated operating companies, are summarized in Mr. Arndt's Exhibit WDA-5  
16 attached to his Direct Testimony, and are further detailed in the workpapers he  
17 provided in response to Ratepayer Advocate Data Request RAR-SQ-34. Mr.  
18 Arndt's summary schedule shows that the Joint Petitioners have allocated  
19 \$357,748,000 of merger-related costs to the regulated companies during the first  
20 four years post-merger. In Section O, page 012, of Mr. Arndt's workpapers we  
21 see that \$138,450,000, or approximately 39 percent of the total costs to achieve as  
22 allocated to the three regulated utilities, were further allocated to PSE&G.

23  
24 **Q. EARLIER IN YOUR TESTIMONY YOU STATED THAT MERGER**  
25 **SAVINGS SHOULD BE RECOGNIZED IN RATES IMMEDIATELY**  
26 **UPON MERGER CLOSING. SHOULD COSTS TO ACHIEVE ALSO BE**  
27 **REFLECTED IN PSE&G'S RATES AT THAT TIME?**

28 A. Yes. While the Joint Petitioners are not asking to recover PSE&G's costs to  
29 achieve in rates at this time, it would not be appropriate to recognize merger  
30 savings without also recognizing certain costs to achieve. I do not agree,

---

<sup>15</sup> Response to S-ENE-SYN-14.

1           however, that all of PSE&G’s share of claimed merger-related costs should be  
2           recoverable in New Jersey retail rates. Nor would it be appropriate to recover  
3           costs to achieve over only the next four years.

4  
5       **Q.     WHAT MERGER-RELATED COSTS SHOULD NOT BE REFLECTED IN**  
6       **PSE&G’S RATES?**

7       **A.**    In prior New Jersey merger proceedings, the Board determined that it was not  
8           appropriate for utilities to recover merger “transaction” costs from ratepayers.  
9           The Board has a long-standing policy requiring shareholders to “shoulder the  
10          burden of merger transaction costs so that none are passed on to ratepayers.”<sup>16</sup>  
11          The Board explained it this way in the Conectiv/Pepco merger:

12  
13                           “The position that shareholders absorb merger transaction costs  
14                           represents part of the Board’s commitment to balancing  
15                           interests since it is the shareholders who receive the benefit of  
16                           any increased share value from the merger and who also share  
17                           in the merger savings.”<sup>17</sup>

18  
19          These same concerns are relevant in this case. Since the merger was announced  
20          on December 20, 2004, PSEG’s stockholders have received the benefit of a 31  
21          percent increase in the Company’s stock price.<sup>18</sup> As for sharing merger savings  
22          with investors, expected costs to achieve exceed expected merger savings for the  
23          regulated entities in year one post-merger. Thus, Exelon expects to retain all of  
24          the savings achieved in year one, and will continue to do so until the next PSE&G  
25          base rate proceeding. Therefore, it is appropriate in this case for Exelon  
26          stockholders to “shoulder the burden of merger transaction costs,” as the Board  
27          has required in previous mergers.

28  

---

<sup>16</sup> Atlantic City Electric Company, Conectiv Communications, Inc., and New RC, Inc., for Approval Under N.J.S.A. 48:2-51.1 and N.J.S.A. 48:3-10 of a Change in Ownership and Control, BPU Docket No. EM01050308, June 19, 2002, page 24.

<sup>17</sup> Ibid.

<sup>18</sup> On December 17, 2004, the last day of trading before the merger was announced, PSEG’s stock closed at \$47.27 per share. On November 18, 2005, PSEG’s stock closed at \$61.92 per share.

1 Mr. Arndt's study includes \$52.6 million for transactions costs to secure the  
2 approvals of the boards of directors and of the stockholders of the two companies  
3 through independent valuations, market analyses and fairness opinions to protect  
4 stockholder interests. These types of costs are incurred for the benefit of  
5 stockholders, not New Jersey ratepayers. As such, they should be excluded from  
6 any rate allowance for costs to achieve in New Jersey. Eliminating transaction  
7 costs from recoverable costs to achieve reduces my recommended rate allowance  
8 for PSE&G's costs to achieve by \$8,046,000.<sup>19</sup>

9  
10 I also object to any ratemaking recognition for "golden parachute" severance  
11 payments to corporate executives who lose their position as a result of the merger.  
12 Mr. Arndt's study includes \$70.7 million in severance payments for the 35 senior  
13 level positions that are assumed to be eliminated.<sup>20</sup> This represents a severance  
14 payment of approximately \$2.02 million per executive. This compares with an  
15 average severance payment of approximately \$74,000 per employee for the other  
16 non-executive positions that are assumed in Mr. Arndt's study to be eliminated as  
17 a result of the merger. Thus, the executive severance payments are considerably  
18 larger than severance benefits being made available to the non-executive  
19 employees who will lose their jobs as a result of the merger. Since it is the  
20 executives who are largely the driving force in this merger, those executives  
21 should not be allowed to promote their self interests at the expense of ratepayers  
22 by including golden parachute costs in the recoverable allowance for costs to  
23 achieve.<sup>21</sup> I recommend the \$10.181 million in golden parachute costs that have

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<sup>19</sup> Response to RAR-SQ-34, Section O, page 042.

<sup>20</sup> Response to RAR-SQ-34, Section M, page M5. Mr. Arndt's synergies study assumes 15 executive positions eliminated from Exelon and 20 executive positions eliminated from PSEG.

<sup>21</sup> It is worthwhile noting that the Joint Petitioners were required to advise stockholders in their SEC Form S-4 filing that "PSEG executive officers and directors may have interests in the merger that are different from, or in addition to, PSEG shareholders' interests. Those interests include, among other things, the accelerated vesting of PSEG equity-based awards, increased severance benefits under specified circumstances and the appointment of six of the PSEG directors to the Exelon board of directors. As a result, the directors and officers of PSEG may be more likely to recommend the approval of the merger agreement than if they did not have these interests." (Form S-4/A, Filed May 27, 2005, page 10.)



1           been allocated to PSE&G in Mr. Arndt's synergies study should be excluded from  
2           the rate allowance for costs to achieve.

3  
4           I have a similar objection to recognizing in rates any costs incurred to retain  
5           certain corporate and administrative employees following the merger. Mr.  
6           Arndt's synergies study includes \$9.6 million in retention payments or \$96,000  
7           for each of the 100 employees to whom it expects to provide retention payments.  
8           Of this total, \$1.492 million is allocated to PSE&G. Once again, it was the  
9           executives' decision to propose the merger and to create a situation where it is  
10          financially lucrative for certain employees to depart the company. Thus, this is a  
11          situation of Exelon's own creation. Ratepayers should not be responsible for  
12          reimbursing Exelon for retention benefits paid to corporate and administrative  
13          employees who now have an incentive to leave the company because of the  
14          merger.

15  
16          I also object to including the costs of signage changes that have been allocated to  
17          PSE&G. We are told that PSE&G's corporate identity as a New Jersey regulated  
18          public utility will remain intact and that the merger will be transparent to  
19          PSE&G's customers. Thus, PSE&G's image should remain prominently on all  
20          signs, stationery, communications, etc. in New Jersey in connection with  
21          communications with New Jersey ratepayers. Any inclusion of Exelon's  
22          corporate logo on PSE&G's signage, stationery and communications can only  
23          serve to promote Exelon's corporate branding and will most likely lead to  
24          confusion by New Jersey ratepayers. Since ratepayers are not the beneficiaries of  
25          the proposed changes in signage and stationery, such costs should not be included  
26          in PSE&G's rate allowance for costs to achieve. This change reduces Mr. Arndt's  
27          claimed cost to achieve for PSE&G by approximately \$700,000.

1    **Q.    IN A PREVIOUS RESPONSE YOU STATED THAT PSE&G SHOULD**  
2    **NOT BE PERMITTED TO RECOVER ITS COSTS TO ACHIEVE OVER**  
3    **THE NEXT FOUR YEARS, AS INCURRED.  WHAT IS YOUR BASIS**  
4    **FOR THIS STATEMENT?**

5    A.   Typically in ratemaking, costs are associated with service benefits.  This is why  
6    normal, recurring costs are accounted for in a single year, while the costs  
7    associated with a long-term asset (e.g., depreciation expense) are spread out over  
8    the service life of the asset.  In this sense, the costs associated with a service are  
9    properly matched with the service itself.  The same reasoning is appropriately  
10   applied to merger savings.  Exelon expects that the savings achieved by the  
11   merger will continue indefinitely.  The beneficiaries of those savings should be  
12   responsible for paying for the legitimately incurred costs to achieve those savings.  
13   Such an analysis would argue for a very long amortization period for PSE&G's  
14   costs to achieve.  But, even though the benefits will continue indefinitely, it would  
15   not be appropriate for PSE&G to hold its share of the costs to achieve on its books  
16   indefinitely.  Therefore, I recommend that PSE&G's costs to achieve, as adjusted  
17   for ratemaking purposes as I have recommended, should be amortized through  
18   rates over ten years.  This period of time precisely matches the period of time that  
19   the Board has required other New Jersey utilities to analyze in connection with  
20   mergers.  It also provides a reasonable match between the recognition of savings  
21   and the costs incurred to achieve those savings.

22  
23   **Q.    WILL PSE&G RECORD A GOODWILL PREMIUM ON ITS BOOKS IN**  
24   **THE MERGER TRANSACTION?**

25   A.   Yes.  Exelon's SEC Form S-4/A filed on May 27, 2005 states that application of  
26   the purchase method of accounting will result in approximately \$8.1 billion of  
27   additional goodwill being added to the combined companies' books.<sup>22</sup>  Of the  
28   total goodwill premium, the Joint Petitioners estimate that PSE&G will be  
29   allocated approximately \$4.036 billion, as further broken down as follows:

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<sup>22</sup> Exelon's SEC Form S-4/A, filed May 27, 2005, page 22.  Exelon's books already reflect approximately \$5.3 billion of goodwill arising from the merger between Unicom and PECO in 2000.

	(\$Million)	
1		
2	Pension and post-retirement	\$1,119
3	Deferred tax liabilities	(446)
4	Excess of purchase price over book value	<u>3,363</u>
5		
6	Total adjustment to goodwill	<u>\$4,036</u> <sup>23</sup>
7		

8 Ratepayer Advocate witness Robert Henkes addresses in his testimony the  
9 pension-related goodwill asset. My comments that follow address the \$3.363  
10 billion goodwill premium.

11

12 **Q. SPECIFICALLY, WHAT DOES PSE&G'S GOODWILL PREMIUM**  
13 **REPRESENT?**

14 A. Before I describe the goodwill premium further I want to make clear that it does  
15 **not** represent an out-of-pocket expense associated with the merger. Under the  
16 purchase accounting method required by Generally Accepted Accounting  
17 Principles, a goodwill premium arises when the purchase price exceeds the fair  
18 value of the assets and liabilities to be acquired. The purchase accounting method  
19 is a fair value business combination because the assets and liabilities of the  
20 acquired company are recorded at their market values at merger closing. Any  
21 excess of the acquisition price over the fair value of the net assets acquired is  
22 recorded as goodwill.

23

24 Under conventional accounting procedures, assets and liabilities must precisely  
25 balance each other. The asset side of the balance sheet represents the physical  
26 and monetary assets of the corporation. The liability side of the balance sheet  
27 represents the way in which those assets are capitalized (funded). These two sides  
28 of the balance sheet correspond approximately to the rate base and capital

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<sup>23</sup> Exhibit JP-1I, page 3.

1 structure in ratemaking. The assets (or rate base) represent a quantification of the  
2 physical (net plant) and monetary (working capital) assets of the corporation. The  
3 liabilities (or capital structure) represent the way those assets are funded and  
4 capitalized. A goodwill premium arises when there is an increase in the liability  
5 side of the balance sheet that is not matched by any corresponding increase in the  
6 physical or monetary assets of the corporation. Simply put, the goodwill premium  
7 is a bookkeeping entry necessary to create the “balance” in the balance sheet, but  
8 does not represent any increase in the physical or monetary assets of the  
9 corporation.

10  
11 If an acquisition had resulted in an increase in the physical or monetary assets,  
12 then the increase in those assets would create the bookkeeping balance necessary  
13 to offset the increase in liabilities. In this instance, there would be no need for an  
14 accounting entry to record a goodwill premium.

15  
16 **Q. SHOULD PSE&G’S RATES REFLECT AN AMORTIZATION OF THE**  
17 **GOODWILL PREMIUM?**

18 **A.** No. Since the rate base is intended to represent the value of the physical and  
19 monetary assets of the corporation, and since a goodwill premium, by its very  
20 nature, implies the absence of any increase in the monetary and physical assets of  
21 the corporation, there must be a strong presumption against including goodwill in  
22 rate base or allowing the recovery of goodwill through amortization. In fact,  
23 purchase accounting rules also do not permit amortization of goodwill premium  
24 absent a showing of financial impairment of the intangible asset.

25  
26 The goodwill premium that will be recorded on PSE&G’s books does not  
27 represent any new facility or equipment that will be devoted to public service. It

1 is simply an accounting mechanism that reconciles the assets and liabilities  
2 acquired in the merger with the purchase price. Because it does not represent  
3 acquired facilities being devoted to public service, it is unreasonable to charge  
4 ratepayers for the goodwill premium. Bonbright addressed this issue in his usual  
5 penetrating manner in the following passage of his treatise on public utility  
6 ratemaking:

7 “...But this [goodwill] does not represent a contribution of capital  
8 to the public service. Instead, it represents a mere purchase by the  
9 present company of whatever legal interests in the properties were  
10 possessed by the vendor. Even under an original-cost standard of  
11 rate control, investors are not compensated for buying utility  
12 enterprises from their previous owners any more than they are  
13 compensated for the prices at which they may have bought public  
14 utility securities on the stock market. Instead they are  
15 compensated for devoting capital to the public service.”<sup>24</sup>

16  
17 The prohibition of recovering a goodwill premium from ratepayers derives from  
18 the fact that the premium normally does not represent capital devoted to public  
19 service. Rather, goodwill represents capital devoted to a transfer of financial  
20 interests from one group of shareholders to another. Goodwill in this instance  
21 does not represent capital devoted to public service matched by a corresponding  
22 investment in new physical or monetary assets. The customer interest does not  
23 participate in the transaction and does not receive any *per se* benefit from it, any  
24 more than it does from the daily transactions of a company’s common stock.  
25 What Professor Bonbright tells us is that ratepayers should be no more  
26 responsible for paying for the goodwill premium than they are for compensating  
27 investors for the day-to-day fluctuations in the market price of Exelon’s common  
28 stock. The proposed transaction between Exelon and PSEG is different from  
29 daily stock market transactions only in form, not in substance, in this regard. The  
30 merger savings that are due PSE&G’s ratepayers should not be reduced by  
31 amortization of the goodwill premium in rates.

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<sup>24</sup> Principles of Public Utility Rates, Bonbright, Daniels and Kamerschen, Second Edition, Public Utilities Reports, Inc. 1988, page 240.

1    **Q.    GIVEN YOUR RECOMMENDATIONS ON MERGER SAVINGS, COSTS**  
2    **TO ACHIEVE, THE APPROPRIATE AMORTIZATION PERIOD, AND**  
3    **THE GOODWILL PREMIUM, WHAT RATE ADJUSTMENT FOR**  
4    **PSE&G SHOULD BE IMPLEMENTED AT MERGER CLOSING?**

5    A.    Exhibit DP-2 details the development of the rate adjustment that I recommend for  
6    PSE&G upon the consummation of the merger.  This schedule reflects the  
7    adjustments to Mr. Arndt’s claimed merger-related costs that I referred to earlier.  
8    Specifically, on my schedule I eliminated all transaction, executive severance,  
9    relocation, retention, and signage change costs.  This schedule also reflects \$11  
10   million in annual synergy savings relating to a reduction in PSE&G’s cost of  
11   equity capital resulting from the merger, as explained in the testimony of  
12   Ratepayer Advocate witness Matthew Kahal.  Further, my schedule reflects a ten-  
13   year amortization of the remaining costs to achieve, in order to better match cost  
14   recovery with anticipated merger-related benefits.  Rather than showing a \$27.4  
15   million net cost for PSE&G in the first year post-merger as Mr. Arndt’s ten-year  
16   analysis shows,<sup>25</sup> I calculate on Exhibit DP-2 a \$27.1 million net benefit for  
17   PSE&G in 2006.  For 2007, my analysis shows a \$46.7 million net benefit for  
18   PSE&G.  The net benefit increases to \$87.2 million by 2015 in my analysis.  
19   Normally, the Board establishes rates that we hope will be effective for more than  
20   one year.  That is, we do not usually anticipate annual rate filings.<sup>26</sup>  Therefore, I  
21   recommend that PSE&G’s rates be reduced by an amount that reflects anticipated  
22   net savings over the first three years post-merger.  If a simple annual average net  
23   savings over the first three years post-merger were used, PSE&G’s rates would be  
24   reduced by \$42,694,000.  Mr. Henkes explains in his testimony how the net  
25   savings should be allocated between PSE&G’s electric and gas business units.

26

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<sup>25</sup> Response to RAR-RR-91, page 4.

<sup>26</sup> Subsequent to filing the Joint Petition in this docket, PSE&G filed with the Board a rate application for its gas distribution business unit.  The rate increase filing, however, did not reflect anticipated synergies savings.

1 **IV. IMPACT ON EMPLOYEES**

2 **Q. THE SECOND AREA OF YOUR RESPONSIBILITY IN THIS**  
3 **PROCEEDING IS THE IMPACT ON PSE&G EMPLOYEES. WHAT**  
4 **PLANS HAVE THE JOINT PETITIONERS ANNOUNCED IN THAT**  
5 **REGARD?**

6 A. Their announced plans concerning the post-merger workforce are very vague. As  
7 I previously stated, approximately 54 percent of the anticipated merger savings  
8 for regulated operations arise from assumed reductions in workforce requirements  
9 post-merger. Exelon announced publicly that it expects to eliminate 1,400 to  
10 1,500 positions across all companies, both regulated and non-regulated, by  
11 eliminating redundant positions.<sup>27</sup> The precise positions and locations of these  
12 reductions have not been revealed, but are not expected to exceed 950 in New  
13 Jersey, 250 in Pennsylvania and 300 in Illinois.<sup>28</sup> The only personnel reductions  
14 that are reflected in Mr. Arndt's synergies analysis are within the corporate,  
15 shared services, and utility support centers. Mr. Arndt's study reflects 528  
16 personnel reductions out of 2,848 corporate and shared services positions.<sup>29</sup>  
17 When asked the location of these reductions, Exelon responded: "The location of  
18 these reductions and the location of the new positions in the merged company is  
19 not known at this time and will not be known until after the merger is  
20 consummated."<sup>30</sup> Mr. Arndt's study also identifies 390 utility support position  
21 reductions.<sup>31</sup> Similarly, these reductions have not been identified by location at  
22 this time.

23  
24 **Q. HAVE THE JOINT PETITIONERS PERFORMED A DETAILED**  
25 **ANALYSIS OF ITS POST-MERGER WORKFORCE REQUIREMENTS?**

26 A. No. Formal workforce requirement studies have not been performed for post-  
27 merger operations.<sup>32</sup> Nor is Exelon willing to commit to the post-merger

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<sup>27</sup> Response to RAR-RR-50.

<sup>28</sup> Ibid.

<sup>29</sup> Response to RAR-SQ-34, Section A, page 80.

<sup>30</sup> Response to RAR-RR-50. See also response to RAR-RR-31.

<sup>31</sup> Response to RAR-RR-30.

<sup>32</sup> Response to RAR-RR-27.

1 workforce that is reflected in Mr. Arndt's study.<sup>33</sup> Moreover, even though no  
2 field level personnel reductions were included in Mr. Arndt's synergies study, that  
3 does not mean that Exelon will not eliminate field and operations level employees  
4 prior to or following the merger. Exelon has failed to provide assurances that  
5 field level positions will not be eliminated following the merger.<sup>34</sup>  
6

7 The majority of corporate headquarters operations will likely remain in Chicago  
8 following the merger. Thus, I suspect that many PSEG corporate and shared  
9 services employees will not be willing, able, or even asked to move to Chicago.  
10 PSEG corporate and shared services employees will likely experience more than a  
11 ratable share of elimination of redundant positions. About the only assurances that  
12 Exelon has offered at this time relative to employees are commitments to honor  
13 collective bargaining agreements, pension agreements and retirement  
14 obligations.<sup>35</sup> Without an identification of the specific positions that will be  
15 eliminated and their locations, however, Exelon is not able to demonstrate that  
16 New Jersey employees will not be adversely affected by the merger let alone  
17 receive any positive benefits.  
18

19 **Q. DID THE JOINT PETITIONERS PRESENT AN IMPACT STATEMENT**  
20 **ON STATE AND LOCAL ECONOMIES THAT COULD RESULT FROM**  
21 **THE LOSS OF 950 JOBS IN NEW JERSEY?**

22 A. No, they have not.  
23

24 **Q. WHAT DO YOU RECOMMEND?**

25 A. Over one-half of the expected gross merger savings in the regulated companies is  
26 expected to be achieved by eliminating duplicate and redundant positions. Such  
27 savings reduce PSE&G's cost to serve and should be reflected as a reduction in  
28 PSE&G's New Jersey retail rates. The Ratepayer Advocate is concerned that  
29 reductions in the New Jersey workforce be implemented fairly and that departing

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<sup>33</sup> Ibid.

<sup>34</sup> Response to RAR-SQ-20.

<sup>35</sup> Response to S-EME-EMP-4 and Joint Petition, page 21.



1 employees be given reasonable severance packages. Moreover, Exelon  
2 employees must not be given job preference simply because of their present  
3 location.

4  
5 PSE&G field level workers should also be protected. The Joint Petitioners  
6 repeatedly state they do not anticipate reductions in field level positions.  
7 Moreover, no synergy savings were included in Mr. Arndt's analysis for  
8 reductions in field level positions. Yet, the Joint Petitioners are reluctant to  
9 provide any guarantees that there will not be cut-backs in field level positions  
10 following the merger. Since the Joint Petitioners clearly state that this merger is  
11 not intended to affect field level positions, I recommend that the Board require the  
12 Joint Petitioners to commit to a 36-month moratorium on any reductions in field  
13 level positions other than for normal turnover. This commitment is necessary to  
14 ensure that field level positions are not eliminated so as to jeopardize service  
15 reliability for the purpose of meeting corporate synergy and earnings projections.

16  
17 **Q. WILL PSE&G'S INTERESTS BE REPRESENTED ON EXELON'S**  
18 **BOARD OF DIRECTORS FOLLOWING THE MERGER?**

19 **A.** Yes, but not to the same extent that it presently is represented on PSEG's Board  
20 of Directors. Exelon's current Board of Directors consists of 13 members.  
21 PSEG's Board of Directors has nine members presently. Following the merger,  
22 Exelon's Board of Directors will be expanded to 18 members. Six of the seats on  
23 Exelon's new Board are available to PSEG's legacy directors. The other twelve  
24 seats will belong to Exelon. In terms of individual directors presently sitting on  
25 their respective Boards, Exelon will lose one director and PSEG will lose three.

26  
27 Exelon's present shareholders represent approximately 68 percent of the merged  
28 companies' combined shareholders. PSEG shareholders represent approximately  
29 32 percent of combined shareholders, and PSEG legacy directors will constitute  
30 33 percent membership on the Board of Directors, at least initially. Thus, PSEG  
31 shareholders will have proportionate representation on Exelon's new Board of

1 Directors. This is not necessarily good news for PSE&G and its New Jersey  
2 customers, however.

3

4 **Q. WHY NOT?**

5 A. Even though PSEG's representation on Exelon's new Board is proportional to the  
6 present number of shareholders that PSEG brings to the merger, PSEG legacy  
7 shareholders will be in the minority. Thus, there is no assurance that PSE&G's  
8 needs will receive an adequate and responsive audience with Exelon's Board of  
9 Directors.

10

11 Moreover, Exelon's merger proposal to seat six PSEG legacy directors on its new  
12 Board is only for the first three years post-merger. That is, under the proposed  
13 by-laws for the merged company, Exelon can replace all of the legacy PSEG  
14 directors at the end of the three-year transition period. Thus, there is no assurance  
15 that PSEG and PSE&G will have any representation on Exelon's new Board of  
16 Directors beyond year three post-merger.

17

18 **Q. WHAT DO YOU RECOMMEND?**

19 A. The problem of adequate representation of PSEG/PSE&G's concerns on Exelon's  
20 Board of Directors will never be fully satisfied because PSEG directors will  
21 always be in the minority. To assure that PSEG/PSE&G's voice will still retain at  
22 least token representation beyond the immediate three-year transition period,  
23 however, I recommend that at least half (i.e., three) PSEG legacy directors be  
24 appointed to Exelon's Board of Directors for an initial six-year term, rather than a  
25 three-year term as proposed by Exelon. This will give PSE&G and its customers  
26 at least some comfort that there are at least a few Board members that are aware  
27 of New Jersey concerns.

28

1 **V. EXELON BSC**

2 **Q. DOES PSEG PRESENTLY HAVE AN AFFILIATE SERVICE**  
3 **COMPANY?**

4 A. Yes. PSEG formed a new company in 2000, called PSEG Services Corporation  
5 (“PSEG SC”), to provide centralized corporate, administrative and technical  
6 services to PSE&G and other PSEG affiliates. PSE&G petitioned the Board for  
7 approval of a service agreement between PSEG SC and PSE&G. The Board  
8 approved the agreement in BPU Docket No. EM00040253.

9  
10 **Q. WHAT ARE THE JOINT PETITIONERS’ PLANS WITH RESPECT TO**  
11 **PSEG SC POST-MERGER?**

12 A. Presently, Exelon BSC provides centralized executive management, corporate  
13 governance, administrative, technical, and other services to ComEd, PECO, and  
14 Exelon’s non-regulated subsidiaries. Following the merger, PSEG SC will  
15 combine all of its activities with Exelon BSC and sell all of its assets to Exelon  
16 BSC. PSEG SC will then cease operations. Exelon BSC, which will be a first-  
17 tier subsidiary of Exelon following the merger, will remain as Exelon’s sole  
18 service company.

19  
20 **Q. WHAT ARE THE JOINT PETITIONERS REQUESTING WITH**  
21 **RESPECT TO PSEG SC AND EXELON BSC?**

22 A. The Joint Petitioners request Board approval of a GSA between Exelon BSC and  
23 PSE&G. The GSA is intended to govern all transactions between Exelon BSC  
24 and PSE&G. The GSA sets forth the types of services to be provided by Exelon  
25 BSC to client companies, and will describe the methods to be used for allocating  
26 joint and common costs among Exelon’s affiliates for the shared services  
27 provided by Exelon BSC. PSE&G will also enter into a second agreement called  
28 the MSA to govern transactions between itself and the other two Exelon operating  
29 companies. The Joint Petitioners seek Board approval of both the GSA and the  
30 MSA pursuant to N.J.S.A. 48:3-7.1.<sup>36</sup>

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<sup>36</sup> Joint Petition, page 12.

1 **Q. WHAT DOES N.J.S.A. 48:3-7.1 PROVIDE?**

2 A. I am advised by counsel that this statute is the governing authority for contracts  
3 between public utilities and their affiliates if expenditures for services rendered  
4 under the contract exceed \$25,000. I am told that the statute provides that the  
5 Board must approve of affiliate contracts unless it determines that (a) the contract  
6 violates New Jersey or federal law; (b) prices or compensation fixed in the  
7 contract exceed the fair price or fair compensation; or (c) the contract is contrary  
8 to the public interest.

9  
10 **Q. HAVE YOU PARTICIPATED IN ANY SIMILAR REVIEWS OF**  
11 **AGREEMENTS BETWEEN UTILITIES AND AFFILIATE SERVICE**  
12 **COMPANIES IN PREVIOUS PROCEEDINGS BEFORE THE BOARD?**

13 A. Yes, I have. I assisted the Ratepayer Advocate in reviewing and analyzing Public  
14 Service Electric and Gas Company's service agreement with PSEG SC in BPU  
15 Docket No. EM00040253 and Jersey Central Power and Light Company's  
16 ("Jersey Central") service agreement with GPU Service Company in BPU Docket  
17 No. EE98050267. I have also reviewed Jersey Central's service agreement with  
18 FirstEnergy Service Company in BPU Docket No. EM0210077. Therefore, I am  
19 familiar with the types of issues that can arise in New Jersey when evaluating  
20 service company contracts.

21  
22 **Q. WHY SHOULD THE BOARD BE CONCERNED WITH PSE&G'S**  
23 **PROPOSED GSA?**

24 A. In 2004, PSEG SC billed PSE&G approximately \$207.6 million for services it  
25 provided to the operating utility.<sup>37</sup> Thus, service company charges, even before  
26 the merger, constitute a significant element of PSE&G's annual expenses and,  
27 ultimately, its revenue requirement. Because PSEG SC and PSE&G are affiliated  
28 corporate entities, transactions between PSE&G and PSEG SC are not truly at  
29 "arm's length". Therefore, it is important that the Board protect ratepayers from  
30 abuses of self-dealing and unreasonable preferential treatments through an

---

<sup>37</sup> Response to Local 601-II-20.

1 affiliate relationship by carefully scrutinizing contracts under which mutual  
2 services are charged to PSE&G.

3  
4 **Q. HAVE THE JOINT PETITIONERS PROPOSED A GSA TO GOVERN**  
5 **TRANSACTIONS BETWEEN PSE&G AND EXELON BSC FOLLOWING**  
6 **THE MERGER?**

7 A. No, they have not. What the Joint Petitioners have provided thus far is only a  
8 copy of Exelon BSC's GSA with Exelon's present affiliates, i.e., prior to the  
9 proposed merger.<sup>38</sup>

10  
11 **Q. WILL THIS SAME GSA BE USED FOR EXELON BSC'S**  
12 **TRANSACTIONS WITH PSE&G FOLLOWING THE MERGER?**

13 A. No, not necessarily. The Joint Petitioners have informed the SEC that post-  
14 merger, Exelon BSC intends to add the former PSEG companies as client  
15 companies under its existing GSA, at least initially.<sup>39</sup> However, the Joint  
16 Petitioners have repeatedly told the parties in this proceeding that the future  
17 services to be provided by Exelon BSC post-merger have not yet been  
18 determined.<sup>40</sup> Moreover, the Joint Petitioners have told the parties that they have  
19 not yet determined what allocation methods and factors will be used to allocate  
20 Exelon BSC's costs among participating affiliates post-merger.<sup>41</sup> Thus, because  
21 the services to be provided post-merger have not been identified, nor have the  
22 methods to be used to allocate Exelon BSC's costs post-merger been identified,  
23 the Joint Petitioners have placed the Ratepayer Advocate and the other parties, as  
24 well as Your Honor and the Board, in the untenable position of not having a  
25 viable GSA to review in this proceeding.

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<sup>38</sup> Joint Petition, Exhibit JP-1E.

<sup>39</sup> See Response to S-ENE-SA-1.

<sup>40</sup> Response to RAR-RR-66. See also responses to S-ENE-SA-8, 14, and 21.

<sup>41</sup> Response to RAR-RR-69 (Additional) and RAR-RR-84. See also responses to S-ENE-SA-21 and 27.

1 **Q. WHAT DO YOU RECOMMEND?**

2 A. Many of the expected merger synergies arise in centralized activities that will be  
3 provided by Exelon BSC. Thus, a viable GSA to review in this proceeding is a  
4 vital and integral component of the review of the Joint Petitioners' overall merger  
5 proposals. That being the case, the merger approval should not granted by the  
6 Board unless and until the Board has before it a proper and complete GSA to  
7 review that will be reflective of Exelon BSC's operations post-merger.

8

9 **Q. HAVE YOU REVIEWED EXELON BSC'S EXISTING GSA, WHICH WAS**  
10 **PROVIDED IN EXHIBIT JP-1E?**

11 A. Yes, I have. Aside from the fact that the existing GSA does not reflect Exelon's  
12 post-merger operations because it has not yet been determined what services  
13 Exelon BSC will provide or how Exelon BSC will allocate costs to client  
14 companies post-merger, there are significant problems with the present GSA.

15

16 Generally speaking, the existing GSA does not reflect what the Board has  
17 required other New Jersey utility agreements with service companies to contain.  
18 Exelon's existing GSA was written to comply with SEC rules and regulations, not  
19 the practices of the Board. For example, the existing GSA allows Exelon BSC  
20 too much discretion in the method(s) used to allocate common and joint costs to  
21 client companies. Attached to the GSA as "Service Agreement Schedule 2" is a  
22 listing of broad service categories to be provided under the agreement, detailed  
23 categories of service under each broad category, and "expected allocation ratios"  
24 for each broad category. The term "expected allocation ratios" is troubling in that  
25 it suggests that Exelon BSC can pick and choose among all the allocation ratios  
26 that are listed for each broad category to be applied to the more specific category  
27 of service. The allocation basis for each specific service category, even if it is  
28 merely a "composite" formula such as the Modified Massachusetts Formula,  
29 should be specified within the agreement and not be left to the discretion of the  
30 service company. That is, the GSA should contain a more clearly defined matrix  
31 of specific services provided and associated allocation method(s) for each specific

1 service category. Further, in the prior proceedings involving approval of service  
2 company agreements, the Board has considered it important that there be  
3 incentives within the agreement for the service company to increase the relative  
4 level of directly billed charges, as opposed to allocated charges, and to limit the  
5 use of discretionary and often arbitrary allocation methods to apportion costs  
6 among participating companies. There is no commitment or incentive in the  
7 existing GSA, however, to increase the percentage of directly billed costs relative  
8 to those that are allocated.

9  
10 The existing GSA would also allow certain types of costs to pass through the  
11 agreement that would not be allowed for PSE&G ratemaking purposes if the  
12 services were provided by PSE&G rather than the service company. For example,  
13 on assets acquired for PSE&G but owned by Exelon BSC, the existing GSA could  
14 permit Exelon to depreciate the asset faster and charge a higher rate of return than  
15 PSE&G would be permitted by the Board if that asset were owned directly by  
16 PSE&G.

17  
18 **Q. HOW SHOULD HIS HONOR AND THE BOARD PROCEED?**

19 A. Because operations of the service company are integral to the synergies the Joint  
20 Petitioners anticipate, the Board should not approve the merger unless and until  
21 an acceptable GSA is approved by the Board. As it now stands, the Joint  
22 Petitioners cannot tell what services Exelon BSC will provide or how Exelon BSC  
23 will charge client companies for the services it will render post-merger. Thus,  
24 there is no basis for Board approval of the GSA. The Board should, therefore,  
25 direct the Joint Petitioners to present to the parties a detailed operating plan for  
26 Exelon BSC post-merger, along with Exelon BSC's detailed proposal for billing  
27 client companies for the services it will provide post-merger. A revised GSA  
28 reflecting those services and allocation methods should be included in that  
29 presentation. The same problems exist in the proposed MSA. Therefore, the  
30 MSA should be held to the same requirements.

1 **Q. IS THERE ANYTHING ELSE THAT THE BOARD SHOULD REQUIRE**  
2 **OF THE JOINT PETITIONERS PRIOR TO GRANTING APPROVAL OF**  
3 **A GSA?**

4 **A.** Yes. Any erosion of the Board’s regulatory authority over PSE&G and the rates  
5 that it charges New Jersey ratepayers should be considered an adverse  
6 consequence of the merger and contrary to the public interest.

7  
8 To avoid any adverse consequences, I recommend the following pre-conditions to  
9 merger approval relating to the service company also be adopted by Your Honor  
10 and the Board and required of the Joint Petitioners:

11  
12 1) Exelon BSC costs shall be directly charged whenever practicable and  
13 possible and affirmative steps shall be taken to increase direct billings  
14 relative to current billings. PSE&G shall report about direct and  
15 indirect charges by function quarterly and respond to questions  
16 concerning such reports. In its next base rate proceeding, PSE&G  
17 shall file testimony addressing Exelon BSC charges and the bases for  
18 such charges, as well as the modifications to procedures and systems  
19 that are being made to increase direct billings.

20  
21 2) No later than the end of the second calendar quarter of each year  
22 (“Reporting Year”), PSE&G shall provide the Board, Board Staff and  
23 the Ratepayer Advocate with the following reports:

24  
25 a. The equivalent of the SEC Form U-13-60 Report that describes  
26 Exelon BSC direct billings versus allocated costs for each  
27 operating utility company in the Exelon system. In addition,  
28 Exelon BSC shall provide a further breakdown for PSE&G,  
29 which identifies the total amounts charged, separately stating  
30 direct and indirect charges to PSE&G for each service function.

31  
32 b. The cost allocation percentages and supporting work papers for  
33 the Reporting Year based on the estimated plan factors for the  
34 Reporting Year. Such report shall compare these estimated  
35 plan factors and cost allocation percentages for the Reporting  
36 Year to those actual allocation factors and percentages used in  
37 the previous year and highlight all modifications and  
38 specifically identify those that occurred during the course of



1                   the year due to significant events based on the prior year's  
2                   actual results of Exelon BSC's charges for each allocation  
3                   factor for each Exelon affiliate. PSE&G shall explain any  
4                   change to allocation factors to PSE&G that are more than five  
5                   percentage points. PSE&G shall also make available on  
6                   request any prior months' variance reports regarding Exelon  
7                   BSC's billings to PSE&G.  
8

9                   3) PSE&G shall also provide copies to Board Staff and the Ratepayer  
10                  Advocate of the portions of any internal or external audit reports  
11                  (including any currently pending) performed by or for Exelon BSC,  
12                  pertaining directly or indirectly to Exelon's determinations of direct  
13                  billings and cost allocations to its affiliates, but only after the audit is  
14                  complete and the report is final. Such material shall be provided no  
15                  later than 30 days after the final report is completed. If after review of  
16                  such material, Board Staff or the Ratepayer Advocate determines that  
17                  review of the remainder of such audit report is warranted, PSE&G  
18                  shall make the complete report available for review in PSE&G's  
19                  Newark office or at the Board.  
20

21                  4) PSE&G and Exelon BSC shall promptly notify the Board, Board Staff  
22                  and the Ratepayer Advocate when it has received notice that the SEC,  
23                  the FERC, or the state regulatory commissions in Illinois or  
24                  Pennsylvania are preparing to perform an audit of Exelon BSC.  
25                  Exelon BSC shall provide copies of the portions of all audits  
26                  highlighting the findings and recommendations and ordered changes to  
27                  the GSA pertaining directly or indirectly to Exelon BSC's  
28                  determinations of direct billings and cost allocations to its affiliates, as  
29                  well as any sections addressing PSE&G. If after review of such  
30                  material, Board Staff or the Ratepayer Advocate determines that  
31                  review of the remainder of such audit report is warranted, PSE&G  
32                  shall make the complete report available for review in PSE&G's  
33                  Newark office or at the Board.  
34

35                  5) PSE&G shall promptly notify the Board, Board Staff and the  
36                  Ratepayer Advocate when it has received notice that the SEC, the  
37                  FERC, or the state regulatory commissions in Illinois or Pennsylvania  
38                  is rendering a specific decision affecting Exelon BSC, including any  
39                  generic rulemakings.  
40

- 1                   6) For assets that Exelon BSC acquires for use by PSE&G, the same  
2                   capitalization/expense policies shall apply to those assets that are  
3                   applicable under the Board's standards for assets acquired directly by  
4                   PSE&G.  
5  
6                   7) For depreciable assets that Exelon BSC acquires for use by PSE&G,  
7                   the depreciation expense charged to PSE&G by Exelon BSC shall  
8                   reflect the same depreciable lives and methods required by the Board  
9                   for similar assets acquired directly by PSE&G. In no event shall  
10                  depreciable lives on plant acquired for PSE&G by Exelon BSC be  
11                  shorter than those approved by the Board for similar property acquired  
12                  directly by PSE&G.  
13  
14                  8) For assets that Exelon BSC acquires for use by PSE&G, the rate of  
15                  return shall be based on PSE&G's authorized rate of return, unless  
16                  Exelon BSC is able to finance the asset at a lower cost than PSE&G.  
17                  In such cases, the lower cost financing will be reflected in Exelon  
18                  BSC's billings to PSE&G, and the resulting benefit will be passed on  
19                  to ratepayers.  
20  
21                  9) Board Staff and the Ratepayer Advocate shall be assured reasonable  
22                  and convenient access to the books and records of Exelon BSC and  
23                  other Exelon companies that transact business with PSE&G, and  
24                  supporting documentation thereof, but only to the extent relevant to  
25                  transactions with PSE&G.  
26  
27                  10) The Board and the Ratepayer Advocate will be sent copies of any and  
28                  all "60-day" letters, and supporting documentation, sent by Exelon  
29                  BSC to the SEC concerning a proposed change in the GSA.  
30  
31                  11) PSE&G shall continue to submit to the Board's jurisdiction on issues  
32                  regarding the New Jersey ratemaking treatment of Exelon BSC's costs  
33                  that are assigned or otherwise allocated to PSE&G and borne by  
34                  PSE&G customers. PSE&G shall not raise a Federal preemption  
35                  defense when challenging the appropriateness of a Board ruling on a  
36                  cost allocation issue concerning the GSA.  
37  
38                  12) PSE&G shall file petitions for approval of any modifications to the  
39                  GSA, including changes in methods or formulae used to allocate costs,  
40                  with the Board at the same time it makes a filing with the SEC or the  
41                  FERC.

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- 13) Board Staff and the Ratepayer Advocate shall have the right to review the GSA and related cost allocations in PSE&G's future base rate cases, in conjunction with future competitive service audits, in response to any changes in the Board's affiliate relations standards, and for other good cause shown.
- 14) PSE&G shall have the right to opt out of any Exelon BSC service that it determines can be procured in a more economical manner, is not of a desired quality level, or for any other valid reason, including Board Orders, after having failed to first resolve the issue with Exelon BSC, and PSE&G shall not be penalized for any such decision to opt out.
- 15) PSE&G agrees that the Board under its authority pursuant to the Electric Discount and Energy Competition Act may review the allocation of costs in sufficient detail to analyze their reasonableness, the type and scope of services that Exelon BSC provides to PSE&G and the basis for inclusion of new participants in Exelon BSC's allocation formula. PSE&G and Exelon BSC shall record costs and cost allocation procedures in sufficient detail to allow the Board to analyze, evaluate, and render a determination as to their reasonableness for ratemaking purposes.
- 16) Exelon BSC shall reflect in allocation factors new participants to the GSA in a timely manner so that new participants begin paying a fair share of Exelon BSC costs within a reasonable time after becoming participants and that existing participants' share of Exelon BSC costs are promptly adjusted accordingly after new participants become participants to the GSA. Allocation factors shall also be adjusted in a timely manner to reflect the departure of participants.

**Q. DOES THIS COMPLETE YOUR TESTIMONY AT THIS TIME?**  
**A. Yes, it does.**