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

SURREBUTTAL TESTIMONY OF MATTHEW I. KAHAL
ON BEHALF OF THE
NEW JERSEY DIVISION OF THE RATEPAYER ADVOCATE

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TABLE OF CONTENTS

PAGE

I. OVERVIEW

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Matthew I. Kahal. I am employed as an independent consultant retained in this matter by the Division of the Ratepayer Advocate (Ratepayer Advocate). My business address is 5565 Sterrett Place, Suite 310, Columbia, Maryland 21044.

Q. HAVE YOU PREVIOUSLY TESTIFIED IN THIS CASE?

A. Yes. On November 28, 2005, I submitted pre-filed direct testimony on behalf of the Ratepayer Advocate addressing issues related to capital structure and financial issues. That testimony includes a statement of my qualifications.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. On December 12, 2005, the Joint Petitioners submitted rebuttal testimony responding to the direct testimony of the Ratepayer Advocate, Board Staff and intervenor parties on certain issues. My surrebuttal testimony responds to certain aspects of the rebuttal testimony of Joint Petitioners' witnesses Rowe, Young, Houtsma and Arndt. These issues include the need for various customer protections and conditions that I believe are needed in the event that the Board concludes that the merger should be approved. In that regard, the Joint Petitioners seem to agree with some of my recommendations but dispute others.

Q. WHAT ARE THE AREAS OF AGREEMENT?

A. I believe there is at least conceptual agreement on several points, although Joint Petitioners have not necessarily made it clear that these items should be codified as merger approval conditions:

- We are in agreement on conditions for the Utility Money Pool, with one important exception, the inclusion of an unregulated generation subsidiary.

- It appears that the Joint Petitioners agree that certain financial restrictions are appropriate, but they object to these being explicit merger conditions.
- I read Joint Petitioners' testimony as stating that the capital structure PSE&G will use in future rate cases will not be rendered artificially expensive by merger accounting effects (i.e., inclusion of billions of dollars of goodwill on the balance sheet).

Q. WHAT AREAS OF DISAGREEMENT REMAIN?

A. The rebuttal testimony of these witnesses dispute several of my customer protection recommendations:

- Witness Rowe disputes my recommendation that merger approval should be conditioned on successful resolution of the current legal difficulties afflicting Exelon's largest utility, Commonwealth Edison Company (Com Ed).
- Witness Arndt disagrees that recognition should be given to cost of capital savings as part of the synergy savings.
- Witness Young opposes my recommendation for a cost of capital "hold harmless" and asserts that PSE&G customers should pay for any merger-caused cost of capital increase.
- While Mr. Young has accepted a number of protective conditions pertaining to the Utility Money Pool, he continues to insist that an unregulated affiliate, Exelon Generation, be permitted to participate as a borrower.
- Witness Houtsma testifies that merger conditions related to the Public Utility Holding Company Act (PUHCA) repeal are not needed, are not merger related, and should not be accepted.

Q. HAS JOINT PETITIONERS' REBUTTAL TESTIMONY PRESENTED ANY EVIDENCE OR ARGUMENTS THAT WOULD CAUSE YOU TO CHANGE YOUR RECOMMENDATIONS?

A. No, they have not. With one exception, my recommendations are intended as customer protections to prevent potential harms from the merger. Not surprisingly, Joint Petitioners would prefer not to be required to provide these protections. However, the rebuttal testimony provides no persuasive evidence or analysis supporting their contentions that these protections are not appropriate. In addition, they provide no evidence that these conditions would impose an unreasonable cost on Public Service Electric and Gas Company (PSE&G or the Company), or (with one exception) any cost at all.

The one exception is my recommendation that a small reduction in the cost of equity capital (0.25 percent) be recognized as part of the synergy savings. This cost savings is based on the Joint Petitioners' own testimony as well as other public pronouncements.

II. REBUTTAL ISSUES

A. Com Ed Litigation Problem

Q. WHAT IS YOUR POSITION REGARDING THE EFFECT OF THE COM ED LITIGATION ON THIS MERGER?

A. The recent predicament of Com Ed is described in my Direct Testimony and in Mr. Rowe's Rebuttal Testimony. Exelon officials have publicly acknowledged that the legal challenge that Com Ed faces concerning its post-2006 power procurement plan is extremely serious and threatens that Company's financial viability. Mr. Rowe (Rowe Rebuttal, page 13) candidly acknowledges that successful resolution of this dispute "is critically important to Com Ed, its customers and the future of competitive markets in Illinois." Since Com Ed is the largest Exelon utility, presumably resolution "is critically important" to Exelon Corporation as well. As Mr. Rowe states, this problem is regarded as so serious that it has motivated Exelon to restructure the Com Ed Board of Directors. (Id.) However, Mr. Rowe also expressed optimism on this dispute stating, "I am extremely confident that Com Ed will ultimately prevail." (Id.)

My testimony recommends that if the Board is inclined on the merits of this case to approve the merger, the merger should not close until the threat to Com Ed's financial viability is successfully resolved (as Mr. Rowe suggests will occur). This is nothing more than a sensible precaution to avoid the possibility of PSE&G merging into a potentially financially crippled corporation.

Q. ARE YOU URGING THAT THE BOARD DELAY ISSUING ITS DECISION IN THIS CASE CONCERNING THE MERGER?

A. I am not suggesting a delay in the issuance of a Board order. It is my understanding that a Board decision could arrive in May 2006 (about six months from now), and by that time the Com Ed issue may be successfully resolved in a way that does not threaten

PSE&G post-merger, rendering this issue moot. I do not dispute Mr. Rowe's optimism. However, if this financial viability cloud persists at the time of a Board order, the Board order should prohibit the merger closing absent a demonstration by Joint Petitioners of the successful resolution that Mr. Rowe predicts. In other words, if the Board decides to approve the merger with this problem pending, I recommend, that the order not be final with respect to this issue. This condition is a sensible precaution to protect PSE&G and its customers in the event of severe financial distress. If the merger is allowed to close before a successful resolution of the ComEd litigation, the Board's approval, as a practical matter, may be irreversible.

Q. WHY DOES MR. ROWE OPPOSE YOUR RECOMMENDED CONDITION?

A. He argues (in a single sentence) that the Com Ed predicament will not affect PSE&G (post-merger) because PSE&G is a separate subsidiary from Com Ed, even though they will be sister utility companies within Exelon Energy Delivery. (Rowe Rebuttal, page 14)

Q. DOES HE SUBSTANTIATE THIS ASSERTION?

A. No, he does not. He appears to defer that task to witness Young in his response to Board Staff witness Lubow's concern regarding credit ratings. At page 14, Mr. Young observes that the bankruptcy of one utility did not adversely impact the credit ratings of its utility affiliates, i.e., the recent bankruptcy of Entergy New Orleans (ENO), implying that an affiliate bankruptcy (i.e., Com Ed) would therefore not harm PSE&G.

Q. IS THE ENO BANKRUPTCY PERSUASIVE EVIDENCE THAT A COM ED BANKRUPTCY WOULD NOT ADVERSELY IMPACT PSE&G?

A. No, it is not. Entergy Corporation is similar in certain ways to Exelon Corporation. It has five operating utility subsidiaries (ENO being one) and a large (mostly nuclear), unregulated generation subsidiary. Unlike Exelon, however, Entergy is not presently

involved in a multi-billion dollar utility acquisition. If such a merger were to be pending, I strongly suspect that it would not go forward, or at a minimum, would be delayed.

There are other key differences that Mr. Young fails to mention. Whereas Com Ed is the largest utility subsidiary of Exelon, ENO is Entergy's smallest utility, accounting for only about 6 percent of the utility segment of Entergy.[1] This is an order of magnitude difference in size relative to Com Ed, which is why the effect of an ENO bankruptcy is far less than would be the effect of a Com Ed bankruptcy (if it were to occur). And while it is true that the ENO bankruptcy has not yet translated into credit downgrades for the Entergy affiliates, it may have reduced the ability of those companies to obtain credit rating improvements. Moreover, Mr. Young overlooks other potential adverse consequences of bankruptcy for the Entergy affiliates including (a) reduction in parent company financial flexibility (the parent supplied debtor-in-possession financing for the bankrupt ENO); (b) diversion of management attention from other important initiatives; and (c) complications related to purchase power agreements and related counter-party credit. The affiliate issue for bankruptcy goes far beyond credit ratings and affects many aspects of utility operations including power supply procurement. Mr. Young fails to account for these vitally important considerations.

I cannot predict that PSE&G (post-merger) would be afflicted by such problems in the event of a financially crippled or bankrupt Com Ed. But the point is that no one knows for sure what problems might arise or how serious those problems would be in the event of bankruptcy, and this is why a certain degree of caution is warranted to protect PSE&G customers in approving this merger.

Q. IS MR. ROWE'S DISMISSAL OF THIS ISSUE CONSISTENT WITH THE REST OF JOINT PETITIONERS' CASE?

[1] This is based on 2004 kWh retail sales. Source: "Entergy Statistical Report and Investor Guide 2004."

A. No, I do not believe it is. Joint Petitioners' advocacy of this merger has been based, at least in part, on the assertion that PSE&G will join a financially strong organization. On page 2 of his Rebuttal Testimony, Mr. Rowe states:

> Those [merger] benefits [for PSE&G] include additional scale and scope in energy delivery; increased financial strength and flexibility; and an opportunity to improve service while achieving meaningful cost savings. (emphasis added)

Mr. Mitchell's Direct Testimony states (page 5):

> PSE&G's [credit] rating will benefit from being associated with a parent company with stronger, more diversified cash flows and a strong commitment to solid investment-grade ratings.

I believe it is inconsistent for Joint Petitioners to proclaim that a key merger benefit for PSE&G is its membership in a financially strong and stable Exelon Corporation and later to argue that bankruptcy of a major segment of Exelon (the utility segment at that) has no relevance to PSE&G. Of course PSE&G will be impacted, but it is difficult to predict precisely how and the extent of the harm.

B. Necessity for a Cost of Capital Hold Harmless

Q. WHY ARE YOU RECOMMENDING A COST OF CAPITAL HOLD HARMLESS?

A. The Joint Petitioners' case strongly suggests that the merger should have the beneficial effect of reducing the cost of capital for PSE&G through geographic diversification, greater earnings stability and increased financial strength. While I am not specifically disputing this, my testimony notes that mergers have an uneven track record and therefore involve risk. Therefore, the potential exists for the merger to increase the cost of capital for PSE&G and consequently the allowed rate of return used for ratemaking for

PSE&G's electric and gas utility service. I believe PSE&G ratepayers should not be required to pay a merger-caused risk premium in retail rates, particularly given Joint Petitioners insistence that such an increase will not occur.

I am not proposing that PSE&G be required to submit any specific evidence in future rate cases; I am merely proposing that it not be permitted to claim an entitlement to such a premium in its requested rate of return. Moreover, any party in a rate case should be entitled to present evidence that such a cost of capital premium does or does not exist in the Company's rate of return request.

Q. DOES THE COMPANY AGREE THAT RATEPAYERS SHOULD NOT HAVE TO PAY A COST OF CAPITAL PREMIUM DUE TO THE MERGER?

A. No. Witness Young refuses to accept this principle arguing that (a) the merger will not adversely affect PSE&G's cost of capital; (b) the issue is difficult to analyze and quantify; and (c) if he is wrong and there is such a premium, shareholders are entitled to collect it from customers. (Young Rebuttal, pages 17-18)

Q. ARE MR. YOUNG'S ARGUMENTS PERSUASIVE?

A. No, not at all. The first argument (no cost of capital premium from the merger) is a factual assertion that depends on future events. If he is correct, then the hold-harmless protection should be unobjectionable to the Joint Petitioners since it will not have to be implemented. It simply will function as a customer protection or insurance policy with no cost to the Joint Petitioners.

With regard to the second argument, I agree that operation of a hold harmless is not always simple. As with any other rate of return issue in a rate case, parties should have the right to present any evidence on the existence of such a premium, and the Board will evaluate such evidence. This is how the Board (and other commissions) typically evaluate rate of return issues, i.e., based on the evidence presented. Mr. Young's

argument, that customers should be denied this protection simply because cost of capital is a complex subject, is not reasonable.

Mr. Young's third argument is that shareholders are entitled to extract this premium from PSE&G customers (while simultaneously arguing there will be no such premium) due to the various merger benefits that Joint Petitioners have claimed in this case. Joint Petitioners' insistence that they are entitled to this premium goes to the heart of the issue. Notably, Mr. Young places no limit on the magnitude of this cost penalty that PSE&G would be allowed to collect from its customers.

Q. WHY DO YOU DISPUTE THIS ASSERTED RISK PREMIUM ENTITLEMENT?

A. There are several reasons why I find this position to be unreasonable. Numerous witnesses in this case dispute Joint Petitioners' claim that the merger, as filed, will provide overall positive benefits to customers and New Jersey. I understand that the Board requires such a demonstration. Given the nature of this dispute over net benefits, it is completely inappropriate for the Joint Petitioners to claim entitlement to a higher rate of return (paid for by customers) due to the merger. Second, Joint Petitioners' witnesses insist the merger will not cause such a premium for PSE&G and strongly suggest a cost of capital reduction can be expected. Joint Petitioners either stand behind their case or they do not. It is improper to advocate merger approval based on a cost of capital improvement (or, at a minimum, no change) while at the same time insisting on the right to impose a costly risk premium on captive customers.

C. <u>Synergy Savings</u>

Q. MR. ARNDT URGES REJECTION OF YOUR 25 BASIS POINTS COST OF EQUITY REDUCTION. WHY DOES HE OPPOSE THIS?

A. He argues that I have presented no evidence quantifying a cost of equity reduction of 25 basis points. He therefore claims the 25 basis points to be arbitrary. He further argues that my testimony on this point is inconsistent because I also testify that a cost of capital increase is possible. (Arndt Rebuttal, pages 34-35)

Q. ARE YOU BEING INCONSISTENT?

A. No. My position is that no one can be sure how the merger will impact the PSE&G cost of capital, but certainly there is the possibility it could cause a risk premium. I am not necessarily predicting this will happen, but I cannot rule it out.

The Joint Petitioners have repeatedly suggested that a cost of capital reduction is a key merger benefit, although without using those exact words. This has been emphasized repeatedly in public statements, as well as in presentations by financial advisers, as one of the four or five most salient attributes of the merger. Joint Petitioners, however, have been unwilling to quantify this benefit in this case or recognize this as an explicit part of the synergy savings. My inclusion of a very modest return on equity reduction in the synergy savings is an appropriate way for Joint Petitioners to share this asserted cost of capital reduction with ratepayers and "stand behind" their claim of benefits.

Q. CAN YOU PROVIDE AN EXAMPLE OF HOW JOINT PETITIONERS IMPLY THAT THE MERGER WILL PROVIDE A COST OF EQUITY REDUCTION?

A. Yes. The most obvious example is Witness Rowe's Direct Testimony (page 6) where he states:

> For retail utility operations, the [merger] means a larger geographic "footprint" and, as a result, a more diverse customer base.
>
> The greater scale, scope and diversification of the combined company's operations should provide more stable cash flows and greater earnings predictability, which in turn, should strengthen the financial profile of PSE&G.

Mr. Ferland provides additional support claiming the merger will provide avoidance of "a high dependence on the economic performance of a single state…" as well as the "Regulatory concentration of the delivery business within the regulatory jurisdiction of a single state." (Ferland Rebuttal, page 3-4)

To a cost of capital analyst, witnesses Rowe's and Ferland's descriptions of the merger is unmistakable. Greater customer and geographic diversity, financial strengthening and improved earnings predictability can only mean a reduced cost of equity. The risk reduction benefit to PSE&G of greater geographic and business diversification is further amplified by witnesses Ferland and O'Flynn in their August 15, 2005 testimony. Joint Applicants either stand by these risk reduction assertions or they should withdraw them. If they continue to support these statements, then at least a small cost of capital reduction is an advertised benefit of the merger and should be recognized as such.

Q. HOW DO YOU RESPOND TO MR. ARNDT'S ASSERTION THAT YOUR 25 BASIS POINTS IS ARBITRARY?

A. I selected 25 basis points (0.25 percent) as being a small but meaningful reduction in the cost of equity. One certainly could argue that my 25 basis points is too small. I believe a meaningful (i.e., non-trivial) reduction should be identified given the emphasis that Joint Petitioners have given to this issue. Clearly, they believe this to be a significant and important merger benefit and have so stated. If Joint Petitioners have an alternative quantification or estimate, they should provide their proposed figure, but they have failed to do so. By criticizing my estimate without offering an alternative, Mr. Arndt effectively argues for a "zero savings" by default, while other witnesses for Joint Petitioners claim this as a merger benefit, but one to be retained for shareholders.

D. Utility Money Pool

Q. JOINT PETITIONERS' WITNESS YOUNG HAS ACCEPTED SOME OF YOUR PROPOSED CONDITIONS FOR THE UTILITY MONEY POOL. DO ANY DISAGREEMENTS REMAIN?

A. Yes, one disagreement remains. Witness Young continues to argue that Exelon Generation should be allowed to participate in the Utility Money Pool even though it clearly is not a utility. He argues for its inclusion, which will mix together regulated and unregulated portions of Exelon, because doing so "increases the potential liquidity of the money pool with little risk." In other words, he argues that it would create a larger potential pool of funds available for PSE&G.

Q. DOES THIS ARGUMENT HAVE MERIT?

A. I do not find this argument convincing. The data that I have reviewed indicate that Exelon Generation is far more likely to be a net borrower from, than lender to, the Pool, thereby restricting PSE&G's access to loanable funds from this source. However, an alternative recommendation that would be acceptable would be to permit Exelon Generation to participate in the Money Pool but only as a lender (similar to Exelon Corporation's participation).

Q. MR. YOUNG DISPUTES YOUR CONTENTION THAT THE MONEY POOL COULD INCREASE THE COSTLINESS OF PSE&G'S CAPITAL STRUCTURE. IS HE CORRECT?

A. No, he is not. The Utility Money Pool proposal provides a mechanism for transferring PSE&G's surplus cash flow (not needed for its own investments) to unregulated Exelon Generation. Subject to PSE&G properly meeting its own utility obligations, I would not object to such a funding transfer as long as it is done through dividend payments to the parent (or other equity-type transfers) rather than through a loan. A loan remains on the

books of PSE&G as an asset, and in a pending rate case would increase the cost of capital through an artificially thickened equity ratio. If PSE&G instead transfers funds to Exelon Generation through a dividend (i.e., through the holding company), that transfer comes out of PSE&G's equity balance, thereby reducing the cost of capital. Clearly, shareholders and ratepayers are not indifferent between these two methods of using PSE&G to fund Exelon Generation.

Mr. Young refers to this as "manipulating the money pool" and denies Exelon would do this. I have made no assertion of manipulation. Rather, I am simply pointing out that as a factual matter, money pool versus dividend cash transfers have differing effects on customer rates and shareholder profits. This is an important reason to avoid including Exelon Generation in the Utility Money Pool (at least as a borrower).

Q. AT PAGE 5, MR. YOUNG ASSERTS THAT YOUR CONCERN REGARDING PSE&G'S EQUITY RATIO IS INCONSISTENT WITH THE LUBOW ET. AL. PANEL SPONSORED BOARD STAFF. WHAT IS THE BASIS FOR HIS STATEMENT?

A. Mr. Young understands that the Lubow panel is recommending the infusion of $350 million of equity into the PSE&G capital structure, with the funds coming from generation divestiture proceeds. Mr. Young appears to oppose this recommendation because he believes it "subsidizes the utility affiliate." (Young Rebuttal, page 17)

I take no position on whether PSE&G and its retail customers should receive divestiture proceeds nor whether this would constitute an undue "subsidy." I do agree, however, that there has been no showing that PSE&G is operating with a capital structure with too little common equity (i.e., a debt ratio that is too high). PSE&G is presently operating with a common equity ratio of about 47 percent and a debt ratio of about 52 percent. Given the Company's Standard & Poor's (S&P) Business Position rating of "3,"

the 52 percent debt ratio is comfortably within the S&P debt ratio benchmark range of 50 to 55 percent for a single A credit rating. I see no need to utilize $350 million to increase PSE&G's already adequate equity ratio. Doing so would run the risk of harming ratepayers by unnecessarily increasing the Company's pre-tax cost of capital.

E. PUHCA Protections

Q. WHAT PUHCA PROTECTIONS HAVE YOU RECOMMENDED IN THIS CASE?

A. On page 38 of my Direct Testimony, I recommend four conditions that I believe are needed in light of PUHCA repeal in combination with PSE&G joining (through merger) a much larger and more diverse holding company corporation. Absent the recent repeal, Exelon and its subsidiaries would be subject to the PUHCA protections. These four conditions are:

- Maintain a common equity ratio of at least 30 percent for Exelon, the ultimate parent, to help ensure its financial strength and access to capital.
- Restrict PSE&G from making loans to affiliates (or purchasing securities), other than through the Utility Money Pool.
- Limit PSE&G dividend payments to earnings and retained earnings.
- PSE&G should not guarantee debt securities or pledge its assets as collateral for affiliates.

Q. DO JOINT PETITIONERS DISPUTE THESE RECOMMENDATIONS?

A. It appears that they object in principle to addressing any PUHCA-related issues on the grounds that (a) they are (or will be) covered by other regulatory authorities, including a FERC rulemaking, and (b) they are not issues specifically related to this merger. In particular, witness Houtsma argues that PSE&G, as a subsidiary of a single state holding

company, has not been subject to PUHCA, and hence, the merger is not causing a loss of existing PUHCA protections for PSE&G.

Despite these disagreements on principle, it appears that there may be some area of agreement on appropriate policies. For example, at page 13 of his Rebuttal Testimony, Mr. Young states that to avoid financial risks, Exelon adopts as a policy:

> "Prohibiting regulated affiliates from guaranteeing the debt of other affiliates, pledging mortgaged assets as security for repayment of the loans of an affiliate, or making long-term loans to affiliates;"

This policy appears to be substantially similar to two of my four recommended PUHCA conditions. The problem is that these are only Exelon policies, and, absent translating policies into merger conditions, there is no assurance that the Board would be able to require PSE&G to adhere to those policies.

Q. DO JOINT PETITIONERS DISPUTE THE OTHER TWO CONDITIONS?

A. Yes, it appears so. Witness Houtsma opposes having any requirement or standard at all for the Exelon capital structure. As best I can tell, her only argument is that FERC does not presently require a minimum equity ratio (although a 30 percent minimum does serve as a notification threshold figure). (Houtsma Rebuttal, pages 15-16) In essence, her argument is that the Board should defer to FERC on this issue and not set a standard or condition.

I disagree with her deference to FERC regulation on this matter. If PSE&G is to be financially integrated through this merger into the Exelon system, then New Jersey has a legitimate interest in ensuring that Exelon is appropriately capitalized. I see nothing in the Joint Petitioners' rebuttal filing demonstrating that (a) 30 percent is an unreasonable minimum; or (b) adherence to minimum capitalization standards is inappropriate. Joint Petitioners have failed to identify a reasonable alternative other than "defer to FERC."

Q. DOES MS. HOUTSMA OPPOSE YOUR PROPOSED CONDITION ON PSE&G DIVIDEND PAYMENTS?

A. It appears so, although the present proposal that PSE&G has submitted to the FERC may be similar to my recommendation. She notes that under purchase accounting for the merger, the retained earnings account on the balance sheet will be eliminated. Consequently, "PSE&G has requested authority from FERC to pay dividends from capital accounts only up to the level of retained earnings of PSE&G as of the date of the merger." (Houtsma Rebuttal, pages 16-17) While she recommends deferring to FERC on this issue, this proposal appears to be substantively similar to my recommendation. That is, it would serve to place a limitation on the total amount of PSE&G's dividend payments equivalent to the level of retained earnings at merger closing. Notwithstanding the requested FERC approval, I believe this should be an explicit merger condition.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes, it does.