BEFORE THE STATE OF NEW JERSEY
BOARD OF PUBLIC UTILITIES
OFFICE OF ADMINISTATIVE LAW

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

INITIAL BRIEF OF
THE DIVISION OF THE RATEPAYER ADVOCATE

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I. INTRODUCTION

A. Statement of the Case

In December 2004, Public Service Enterprise Group and Exelon Corporation announced that the two companies would file a Joint Petition with the New Jersey Board of Public Utilities requesting approval for their merger. The merger valued at $12.8 billion, if approved, would result in the largest power company in the United States. The combined companies would own generation assets capable of producing over 52,000 megawatts of power, serve over nine million customers through three utility companies, and potentially earn approximately $27 billion in annual revenues.

The companies filed the Petition in February 2005 along with the testimony of six witnesses. The Board transmitted it to the Office of Administrative Law on February 18, 2005, assigned to Administrative Law Judge Richard McGill. A pre-hearing conference was held on April 5, 2005, and a pre-hearing order was issued establishing a procedural schedule with hearings scheduled for October 2005.

In addition to the filing with the BPU, Joint Petitioners sought approval of the merger from the Federal Energy Regulatory Commission ("FERC"). They included in the FERC petition, a proposal for a "Virtual Divestiture" of assets as mitigation for the market power of the merged entities. The FERC is supposed to determine whether or not a proposed merger of utilities will have an adverse effect on competition because of resulting from the merger.

The Ratepayer Advocate, along with the New Jersey Board of Public Utilities, the Pennsylvania Public Utility Commission, and a number of intervenors filed with FERC and requested that the FERC hold hearings on the merger. On July 1, 2005, FERC determined that hearings were not necessary and approved the merger. The Ratepayer Advocate and a number of other parties filed requests for reconsideration with FERC. The requests for reconsideration were denied on December 21, 2005. The Ratepayer Advocate has appealed the FERC order.

During the pendency of the state proceedings, the New Jersey Board of Public Utilities requested submissions concerning the Standard of Review that it should use in deciding the Joint Petition. The Ratepayer Advocate submitted comments recommending the "Positive Benefits to Ratepayers Standard" rather than a "No Harm Standard". The Positive Benefits Standard was adopted by the Board on November 9, 2005.

The Ratepayer Advocate retained expert consultants to address significant issues in the case before the Board of Public Utilities including: market power, service quality, low income issues, synergy savings, accounting treatments, financial matters, gas issues, and overall policy issues. Included in the Ratepayer Advocate testimoniesy were recommendations that the merger should not be approved as filed, and, if approved by the Administrative Law Judge or the Board, it should only be approved, if the specific ratepayer savings and other recommendations were adopted. Among these recommendations were a rate freeze or rate reduction, additional synergy savings, requiring a market power mitigation plan, commitments to low income ratepayers, guarantees of service quality and reliability, additional requirements for financial protections, changes to accounting treatments and assurances of accountability to New Jersey regulators.

The initial procedural schedule that established hearings in October 2005 was extended by 60 days and, subsequently, by an additional 30 days resulting in hearings being scheduled for January 4 through January 20, 2006. The Joint Petitioners filed additional Direct Testimony in August 2005 and the Ratepayer Advocate and other parties filed Direct Testimony on November 14 and 28 2005. The Joint Petitioners filed Rebuttal Testimony in November and December

2005, and finally on December 27, 2005 the Ratepayer Advocate and other parties filed Surrebuttal Testimony.

Public Hearings were held on November 21, 2005 in Trenton and Hackensack, on November 22 in New Brunswick, on November 28, 2005 in Newark, and on November 29, 2005 in Cherry Hill. The Ratepayer Advocate attended the public hearings to obtain public responses on the proposed merger. The Ratepayer Advocate filed the Direct Testimony of seven expert witnesses in eight specific areas, and seven Surrebuttal Testimonies. Throughout the proceeding the parties have conducted extensive discovery including written interrogatories, depositions and interviews with Joint Petitioners' witnesses. Over 55 witnesses were scheduled to testify at the hearings in January. After the hearings and briefs, the record will be closed and the Administrative Law Judge will issue an Initial Decision to be transmitted to the Board of Public Utilities. The Board may then adopt, affirm or modify the Initial Decision of the Administrative Law Judge

B. Procedural History

On February 4, 2005, Public Service Electric and Gas Company ("Public Service" or "PSE&G") and Exelon Corporation ("Exelon"), on behalf of its wholly-owned subsidiary Exelon Energy Delivery Company, LLC, (together, "Joint Petitioners") filed a Joint Petition, pursuant to *N.J.S.A.* 48:2-51.1 and *N.J.S.A.* 48:3-10, seeking approval of the New Jersey Board of Public Utilities ("Board" or "BPU") for a change in control of PSE&G and related authorizations. *In the Matter of the Joint Petition of Public Service Electric and Gas Company and Exelon Corporation for Approval of a Change in Control of Public Service Electric and Gas Company and Related Authorizations, BPU Docket No. EM05020106 , OAL Docket No. PUC 1874-05*

("Merger Petition"). The merger would result in the creation of the largest public utility in the United States.

Accompanying the Petition were the pre-filed testimonies of the following witnesses:

JP-2 John Rowe - overview of merger
JP-3 Ralph Izzo - continuation of PSE&G's history of reliability and continued support of State energy policies
JP-4 J. Barry Mitchell - financial issues
JP-5 William Arndt – synergy savings
JP-6 Rodney Frame – market power
JP-7 Pamela Strobel – administrative functions

Joint Petitioners

Public Service is a combined gas and electric utility existing pursuant to *N.J.S.A.* 48:2-13 and N.J.S.A. 48:3-51 and is, therefore subject to regulation by the Board. It is a wholly-owned subsidiary of Public Service Enterprise Group Inc. ("PSEG"), a public utility holding company that has four principal wholly-owned subsidiaries: the utility PSE&G; PSEG Power LLC ("PSEG Power"), a multi-regional, wholesale energy supply company that includes generating asset operations as well as wholesale energy, fuel supply and energy trading and marketing ("ER&T"); PSEG Energy Holdings LLC ("PSEG Energy Holdings"), a global energy investment company; and PSEG Services Corporation ("PSEG Services"), which provides administrative and corporate support services to PSEG and its subsidiaries. *JP-1 at 2-3.* PSE&G serves 2 million electric customers and 1.6 million natural gas customers in its service territory, which covers approximately 2,600 square miles in New Jersey. *Id. at 8, 2.*

Exelon is a corporation organized under the laws of Pennsylvania and is a registered holding company. Through its subsidiaries, Exelon operates in three business areas: Energy Delivery, Generation and Enterprises; and provides business services to the consolidated group. *JP-1 at 3.* Exelon conducts its energy delivery business through its second-tier subsidiaries

PECO Energy Company ("PECO") and Commonwealth Edison Company ("ComEd"). *Id.* PECO is a combined electric and gas utility that supplies, transmits and distributes electric and gas service to customers in several counties in Pennsylvania. *Id.* ComEd is an electric utility that supplies, transmits, and distributes electricity in Northern Illinois and, through a wholly-owned subsidiary, provides electric transmission service in parts of Indiana. *Id. at 3-4.*

PSE&G, PECO and ComEd have all turned over operational control of their electric transmission systems to PJM Interconnection LLC ("PJM"). *Id.*

Merger Agreement

On December 24, 2004, the Joint Petitioners signed an Agreement and Plan of Merger ("Merger Agreement"), which provided that PSE&G would merge into Exelon, thereby ending the separate corporate existence of PSEG. *JP-1, Ex. JP-1C.* The new company would be renamed Exelon Electric & Gas Corporation ("EEG"). *JP-1at 5.* Pursuant to the Merger Agreement each PSE&G shareholder would receive 1.225 shares of Exelon common stock for each share of PSE&G stock, with cash paid for fractional shares of Exelon stock. *Id. at 4.* The resulting merged entity would be a combined electric and gas company serving over 7 million retail electric customers and 2 million retail gas customers in three states. *Id. at 7.* It would hold total assets of approximately $70 billion, earn $27 billion in annual revenues and earn $2.6 billion in annual net income.[1] *JP-2 at 7.*

[1] The companies also entered into a Nuclear Services Contract ("NOSC"), that commenced on January 17, 2005, under which Exelon provided personnel to manage PSE&G's nuclear operations (Hope Creek and Salem I and II). Under the agreement, Exelon supplies senior personnel to oversee daily plant operations and to implement the Exelon Nuclear Management Model. PSE&G remains license holder and retains responsibility for management oversight until the close of the merger. PSE&G has full authority to market its share of nuclear energy from the plants.

FERC

Simultaneous with filing their Joint Petition before the Board on February 4, 2005, PSE&G and Exelon filed another Petition to merge before the FERC. *FERC Dkt. No. EC05-43-000*. The Division of the Ratepayer Advocate ("Ratepayer Advocate"), the Board, and other intervenors filed a protest in reply opposing the proposed merger.[2] In an Order dated July 1, 2005, the FERC denied all requests for hearings and conditionally approved the proposed merger. The Ratepayer Advocate, the New Jersey Board and other intervenors sought rehearing, which was denied in a FERC Order dated December 21, 2005. On February 16, 2006, the Ratepayer Advocate appealed the FERC's July 1 and December 21 decisions to the U.S. Court of Appeals for the D.C. Circuit, as did the Board and other intervenors. Briefs in this matter are due on June 2, 2006.

OAL

On February 18, 2005, the matter was transmitted to the Office of Administrative Law ("OAL") as a contested case and assigned to Administrative Law Judge ("ALJ") Richard McGill.

On March 4, 2005, pursuant to *N.J.A.C.* 1:1-13.1 et seq., a prehearing conference was held before Judge McGill in which discovery and testimony filing schedules were established. The prehearing order was issued on April 5, 2005. Judge McGill granted intervenor status to 20 parties and participant status to 6 parties.[3]

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[2] Exelon Corporation Public Service Enterprise Goup, Inc., FERC Dkt. No. EC05-43-000, Order Authorizing Merger Under Section 203 of the Federal Power Act, (July 1, 2005)

[3] The following parties were granted intervenor and participant status: Jersey Central Power and Light and First Energy Solutions Corporation; PPL Electric Utilities Corporation; Rockland Electric Company; International Brotherhood of Electrical Workers, Local 94; International Brotherhood of Electrical Workers, Local 97; Office and Professional Employees, Local 153; Utility Workers of America, AFL-CIO Local 601; Public Utility Construction and Gas Appliance Workers, Local 855; International Brotherhood of Electrical Workers, Local 1289; Gerdau Ameristeel Corporation; Mount Holly Municipal Authority and Stony Brook Regional Sewage Authority; New Jersey Large Energy Users; Amerada Hess Corporation; Cinergy; Constellation NewEnergy, Inc.; Direct Energy and Energy America East Coast Power, L.L.C.; Independent Energy Producers of New Jersey; Midwest Generation, LLC; Philadelphia Gas Works; Retail Energy Supply Association; Natural Resources Defense Council; New Jersey

Hearings in the instant case were originally scheduled to be held from October 11 through October 21, 2005; however, the hearing dates were rescheduled by consent of the parties, and the other procedural deadlines were extended. The new hearing dates covered the period from November 28 through December 14, 2005.

As noted above, the merger of PSE&G and Exelon would result in the largest combined electric and gas utility in the country. The size of the proposed company raised issues of market power at the Board and as a result, on March 29, 2005 the Board requested that the PJM Interconnection Market Monitoring Unit ("MMU ") analyze the potential effects of the proposed merger on the PJM market. Dr. Joseph Bowring, General Manager of the MMU responded, stating that in order to evaluate the proposed merger the Joint Petitioners would need to specify the generation units that were to be divested in his May 24, 2005 Initial Report. On June 16 and October 14, 2005, Dr. Bowring filed supplemental reports.

While this discussion of market power was taking place, discovery in the case continued. By letters dated August 3 and September 28, 2005, Joint Petitioners filed the Direct Testimony of Ruth Ann Gillis, who adopted the testimony of Pamela Strobel, who was retiring. On August 15, 2005, the Joint Petitioners submitted additional testimony by the following witnesses:

JP-6 Rodney Frame
JP-8 E. James Ferland and Thomas O'Flynn
JP-9 Frank Cassidy
JP-10 Kenneth Cornew

On October 7, 2005 Judge McGill issued an Order rescheduling the hearing dates to the period between January 4 and January 20, 2006.

Department of Environmental Protection; New Jersey Public Interest Research Group Citizen Lobby, Inc.; Elizabethtown Gas Company; New Jersey Natural Gas Company; South Jersey Gas Company; City of Philadelphia; and New Jersey Citizen Action.

On November 14, 2005 Board Staff and the Intervenors filed testimony. The Ratepayer Advocate filed the direct testimonies of the following witnesses:

RA-1, RA-2	Nancy Brockway (Public and Confidential versions)
RA-3	Roger Colton
RA-4	Richard LeLash
RA-5, RA-6	Bruce Biewald, Robert Fagan and David Schlissel (Public and Confidential versions)

On November 28, 2005 the Ratepayer Advocate filed additional direct testimonies:

RA-8	Robert Henkes
RA-9	Mathew Kahal
RA-10	David Peterson
RA-65	Nancy Brockway

In December, 2005 the Joint Petitioners filed Rebuttal Testimony of 27 witnesses. On December 27, 2005 Intervenors, Board Staff and the Ratepayer Advocate filed Surrebuttal Testimony. The Ratepayer Advocate filed the testimonies of the following witnesses:

RA-11	Nancy Brockway
RA-12	Robert Henkes
RA-13	Matthew Kahal
RA-14	Richard LeLash
RA-15	David Peterson
RA-16	Bruce Biewald, Robert Fagan, David Schlissel (Public version)
RA-17	Bruce Biewald, Robert Fagan, David Schlissel (Confidential version)
RA-66	Nancy Brockway

During the discovery and testimony periods, the market power issue continued on a parallel track. On December 28, 2005, Joint Petitioners requested that the MMU analyze eight potential divestiture scenarios of specific fossil plants. Subsequently, other parties, including the Ratepayer Advocate, requested that the MMU analyze additional scenarios. This resulted in Judge McGill's extending the hearing schedule for testimony by Dr. Bowring and other witnesses regarding market power. On March 17, 2006, the Ratepayer Advocate filed the Supplemental Testimony of David Schlissel and Robert Fagan (*RA-62*)

Hearings in this matter concluded on March 31, 2006.

Initial briefs in this matter are due on April 26, 2006. Reply briefs are due on May 10, 2006.

Standard of Review

Until this matter was brought before the Board, the Board had not established a uniform standard of review for all utility mergers and acquisitions. Two standards of review for utility mergers and change of control matters have traditionally been used: the "no harm" standard and the "positive benefits" standard.

By letter dated April 15, 2005 Board Staff notified Judge McGill that the standard of review for the merger might be at issue. At the May 5, 2005 Agenda meeting, the Board recalled this issue from the OAL, requesting that the parties submit comments regarding the proper standard of review to be used in this case. *Secretary's letter dated May 5, 2005.* On November 9, 2005 the Board issued an Order declaring that the proper standard of review in the instant proceeding should be the positive benefits standard.[4]

[4] I/M/O The Joint Petition of Public Service Electric and Gas Company and Exelon Corporation for Approval of a Change in Control of Public Service and Gas Company and Related Authorizations, BPU Dkt. No. EM05020106, Order on Standard of Review, July 9, 2005.

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

The Joint Petitioners filed their petition for approval of the proposed merger pursuant to *N.J.S.A. 48:2-51.1*. Under that statute the BPU is required to look at four criteria in reviewing the merger: impact on competition, impact on employees, impact on ratepayers, and impact on gas and electric service.

The specific statutory language is:

> In considering a request for approval of an acquisition of control, the board shall evaluate the impact of the acquisition on competition, on the rates of ratepayers affected by the acquisition of control, on the employees of the affected public utility or utilities, and on the provision of safe and adequate utility service at just and reasonable rates.

N.J.S.A. 48:2-51.1

The statute also requires that the Board issue a written report detailing its decision including findings of fact and conclusions of law.

In addition to its review pursuant to the statutory criteria, the Board has adopted a "positive benefits standard" as the standard of review for this case This is in contrast to, and imposes a higher burden than, the "no negative impact" standard that was used in some prior mergers. In examining the impact of the merger Your Honor must look at whether or not the Joint Petitioners have met this standard as it is applied to the statutory criteria.

In discussing this standard the Board said:

> Pursuant to the positive benefits standard, in order for the proposed acquisition of control and transfer of stock to be approved by this Board, the Joint Petitioners must show and the Board must be satisfied that positive benefits will flow to customers and to the State as a result of the proposed change in control, and, at a minimum, that there are no adverse impacts on any of the criteria delineated in *N.J.S.A. 48: 2-51.1*.

The Board has recently adopted a regulation, *I/M/O the Standard of Review of Petitions for Approval of Mergers, Consolidations, Acquisitions and/or Changes in Control, N.J.A.C. 14:1-5.14(a) to (e),* BPU Dkt. No. AX05080742, which establishes the Positive Benefits Standard as the requirement for all mergers and acquisitions that are proposed for New Jersey utilities.

III. SUMMARY OF POSITIONS

The New Jersey Division of the Ratepayer Advocate and its consultants have reviewed thousands of discovery responses, read hundreds of pages of testimony, and participated in 17 days of hearings before Your Honor, and none of this has changed its position as articulated by Seema M. Singh, the Ratepayer Advocate, at the first evidentiary hearing on January 4, 2006:

> As filed, the merger should not be approved. If Your Honor and the Board determine to approve the merger it should only be done with the implementation of conditions and guarantees to protect the ratepayers, citizens and economy of New Jersey.
> TR10:L12-18 (1/4/06)

Ms. Singh also stated:

> [T]he most important issue in this proceeding is the impact of the proposed merger on ratepayers now and in the future. This impact must not be examined only in dollar terms but also in safety and reliability. TR11:L5-9 (1/4/06)

Based on the record in this proceeding, the statutory criteria applicable to the merger, and the Board's Positive Benefits Standard, the Joint Petitioners have failed to establish a case for the merger as filed. The Joint Petitioners have refused to provide a reasonable market power mitigation proposal, have rejected virtually all of the Ratepayer Advocate's proposals in other areas, and have offered an abysmally low monetary settlement for New Jersey ratepayers.

The Joint Petitioners have provided no commitments to low income ratepayers, there are no guarantees of service quality or reliability, there is minimal sharing of synergy savings and there are too many instances in which Joint Petitioners ask Your Honor and the Board to trust them, rather than provide concrete proposals or commitments to protect New Jersey ratepayers. The only purported benefit to ratepayers being proposed is promise of lower future rate increases. This is simply unacceptable.

As stated in Ms. Singh's initial testimony:

> Simply put, the risks are too great and the rewards too small, for the proposed merger, as filed, to meet all four statutory criteria with positive benefits. TR12:L13-16 (1/4/06)

The Joint Petitioners have missed the opportunity to prove that statement wrong. It is as true today as it was on January 4, 2006.

Having had the opportunity to develop a record that addresses the statutory criteria and the burden of proof established by the Board, Joint Petitioners leave Your Honor and the Board little choice now that the hearings are over. Your Honor and the Board should reject the proposed merger for failing to establish "positive benefits" for the citizens of New Jersey.

IV. EVALUATION OF OVERALL BENEFITS

Joint Petitioners have the burden of proof in this matter and must satisfy the Board's positive benefits standard as it is applied to each of the statutory criteria. As set forth in the remainder of this initial brief in much greater detail, Joint Petitioners have failed to carry their burden and, as filed, the merger should be denied.

Joint Petitioners have proposed benefits of $120 million in rate credits to be spread over three or four years and a plethora of "trust me" future benefits. These benefits are too small, particularly when contrasted with the real possibility of the exercise of market power, the loss of jobs and the resultant damage to the economy of New Jersey.

Throughout this proceeding the Ratepayer Advocate has waited for the Joint Petitioners to present proposals that would meet the Board's standard, the statutory criteria and provide benefits to the New Jersey ratepayers. In the absence of any such proposals, the Ratepayer Advocate's witnesses presented a number of specific, achievable recommendations, few of which have been accepted by the Joint Petitioners. Therefore, the Ratepayer Advocate's position has not changed from the testimony filed by Nancy Brockway when she was asked to summarize her analysis of the proposed merger. In summary Ms. Brockway stated:

> Joint Petitioners propose a merger that would create the largest utility in the industry…They claim the merger will bring benefits to the electricity market through increased nuclear power production, but they refuse to consider any mechanism to ensure that these benefits are realized by New Jersey consumers. They claim the merger will not lead to any deterioration in PSE&G's gas and electricity service quality and reliability, but they refuse to accept any mechanism that could make their claim enforceable, and protect New Jersey in the event their promise turns out to have been unfounded. They claim that the creation of an entity that is the largest generating company in the country, a leading energy marketer, the owner of significant gas resources, and the operator of the largest string of nuclear power plants, will have no market power and will not be in a position to increase energy prices for New Jersey consumers, but they will not consider proposals to mitigate the risk that they will indeed be able to dominate utility energy markets affecting New Jersey. Finally, they claim that New Jersey's ability to oversee

> the behemoth that emerges from this merger will not be affected in any way by the merger; a claim that defies common sense and long regulatory experience.
>
> The witnesses for the Ratepayer Advocate have put forward targeted and responsible proposals to ensure that claimed benefits are fairly shared, and that plausible risks are safely mitigated. In purely dollar terms, the amounts at stake are over $1.5 billion dollars. If Your Honor and the Board are inclined to approve the merger, Joint Petitioners should not be permitted to conclude their proposed merger without putting real resources behind their promises and assurances to New Jersey. *RA-66 at 35-36*.

The Joint Petitioners have made an effort to characterize the proposed merger as one that will not harm New Jersey ratepayers, PSEG employees, competition in New Jersey energy markets and the provision of safe and adequate utility service at just and reasonable rates, and will provide some benefits to them as well. Nevertheless, it has been evident to nearly all the other parties in this matter that the Joint Petitioners' claims are unproven and unreliable. Their promises are attractive, but there is little substance to them. In addition, the Joint Petitioners downplay the risks posed by the merger, and do not advance any concrete steps to protect New Jersey and PSE&G customers from these risks.

The Joint Petitioners have only belatedly attempted to put some meat on the bones of their proposal, but even this late effort is insufficient to satisfy the burden of proving positive benefits to New Jersey customers and the State that the Board has established for this matter. This section of our initial brief will describe the alleged benefits of the merger proposal and how the allegations are largely unfounded. We will also note the key risks of the merger. The Ratepayer Advocate respectfully submits to Your Honor and the Board that the merger proposal should be rejected as inadequate to provide the required positive benefits or even the absence of adverse impacts on New Jersey customers and the State. If Your Honor and the Board nonetheless determine the merger should go forward, we recommend specific conditions to ensure that promised benefits materialize, and that New Jersey and PSE&G ratepayers are protected against potential adverse consequences to the extent possible.

In his testimony, the CEO of Exelon, John Rowe, described the impacts of the proposed merger as follows:

> We expect the Merger to produce substantial benefits in several important ways. We will increase value for our shareholders through cost synergies and new competitive opportunities. We will continue to improve our service to our customers through best practices and economies of scale. We will also maintain our substantial presence in the cities and communities we serve, and create opportunities for our employees. We have a strong culture and a strong vision for our new company. It is underpinned by one main tenet – *to live up to our commitments.*

JP-2 at 6 (emphasis in original).

Mr. Rowe also promised that the proposed merger would bring Exelon increased scale, scope and operational diversity, as well as financial strength and flexibility. He further testified that Exelon has a commitment to high quality service, to the sharing of best practices and that the proposed merger would produce synergies and that Exelon and PSE&G are committed to competition in the electricity and natural gas wholesale markets.

Joint Petitioners argue that, over time, regulated rates will reflect the impact of cost reductions brought about by merger synergies. In statements to the press, Mr. Rowe also stated that the synergy benefits on the regulated side amount to only 30% of the overall benefits of the merger, regulated and unregulated. He asserted that ratepayers would benefit from claimed reductions in wholesale power costs brought about by the Joint Petitioners' anticipated increases in PSEG nuclear plant output. *Id.* Ratepayer Advocate witness, Nancy Brockway, listed Mr. Rowe's specific representations on these points in Exhibit NB-2 attached to her prefiled direct testimony. *RA-65 at 5 and Exhibit NB-2.*

James E. Ferland, Chairman, Chief Executive Officer and President of PSEG, has publicly stated that the merger benefits include the following -- substantial cost savings shared between customers and shareholders; combined experience and resources to achieve ongoing improvements in safe reliable and low-cost customer service; improved nuclear operations; better balance and risk diversification; greater financial strength and flexibility; and greater opportunities for employees. *RA-65 at 5.*

Joint Petitioners' witness William D. Arndt identified net regulated synergy savings allocable to PSE&G of about $504 million in nominal dollars over ten years, an average of $50 million annually over this period. Given his proposal for the timing of recognizing costs-to-achieve, Mr. Arndt calculates the average annual savings allocable to PSE&G over the first 4 years post-merger at only $16.4 million. *Exhibit JP-5, WDA Exhibit 6.*

Joint Petitioners also reject any suggestion that customers be assured a share of the asserted benefits from increased nuclear operations. They dismissed out of hand a sensible proposal to share such nuclear benefits via the provision of BGS services at a reasonable cost, despite the fact that Exelon determined the merger of the regulated entities was necessary as a condition of its merger of the nuclear operations. *RA-66 at 21-22.*

Messrs. Rowe and Ferland (and the other Joint Petitioner witnesses) provide few specifics about how these lofty goals will be attained and little if any guarantee that New Jersey ratepayers will ever see these benefits. Moreover, many of the claimed benefits are the kind that will accrue to shareholders, not ratepayers or the State of New Jersey, and the largest portion of the claimed benefits are expected to go to the unregulated businesses of the Joint Petitioners and not the utility operations. It is also important to note that several of the claimed benefits, such as sharing some of the best practices of the utility industry, are ones that PSE&G could accomplish without the merger. Below, we return to the question of benefits, and how, should the merger be approved, they should be assured to ratepayers.

The Joint Petitioners also do not persuasively address the risks of the merger. The key problem areas include the possibility that wholesale prices will rise as a result of the exercise of enhanced market power, the risk that PSE&G's performance may slip due to less resources being devoted to, and less attention being paid to, the New Jersey utility operations that will be a minority part of the Exelon's total operations, and the risk that since PSE&G's utility operations and customer service already display better performance statistics than Exelon's two operating utilities, the benefits of best practices may flow out from PSE&G, not toward it.

Taking these up in reverse order, we note that despite the Joint Petitioners' protestations to the contrary, the merged company's attention to strictly New Jersey interests including the customers and our economy will have to be reduced. Currently PSEG's top management personnel have only one "all New Jersey" utility to operate. After the merger, management personnel at the top of the new Exelon organization chart will have a third large utility with combined electric and natural gas services to oversee, and there are only so many hours in the day to do it. Even a company as efficient as Exelon claims to be cannot add more hours to the day. If this merger is allowed to go through, it will create a gigantic firm of which PSE&G's New Jersey operations will be a small piece. PSE&G's annual revenues of $6.9 billion would comprise only 25% of the entire firm, compared to the 63% share it now represents of PSEG's annual revenues. PSE&G would go from representing 100% of PSEG's gas and electric retail customers to 78% of Exelon's gas customers and only 28% of Exelon's electric customers. *RA-65 at 10.* PSE&G now holds almost 50% of PSEG's assets. Post-merger, PSE&G's assets will be only 19% of Exelon's. *Id.*

PSE&G's image of itself and its image to New Jersey customers will necessarily change from one as the largest New Jersey electric and gas utility to being just one of many parts of a Chicago-based conglomerate. PSE&G will need to compete for resources within the holding company structure and will lose its autonomy to chart policy directions under the oversight of the Board. The locus of management would shift to Chicago. *Id. at 10.* While the announced post-merger president of PSE&G, Ralph A. LaRossa, would remain in Newark, he will now report to Exelon management who will not always be in New Jersey and who will have management responsibilities for three public utilities, not just one. *JP-13 at 2.*

Ralph Izzo is currently President and COO of PSE&G, but he will become President of Exelon Energy Delivery and will have the management responsibility for the three Exelon utilities. *JP-11 at 1.* As compared to today, he will necessarily have to devote less than 100% of his time to PSE&G's performance. Mr. Izzo has testified that he expects to spend "About a day in New Jersey, one or two days a week in Philadelphia, and then the balance in Chicago." T3432:L16-18 (3/31/06).

As a lesser piece of the conglomerate, it will be more difficult for PSE&G to get the attention it needs from senior management and the Exelon Board of Directors than from the current PSEG management and Board of Directors. *RA-65 at 10-11.* In addition, the current PSE&G retail service area is entirely within New Jersey, and all of its distribution utility revenues come from New Jersey operations subject to Board oversight. PSE&G's 2.1 million electric customers and 1.6 million gas customers have the undivided attention of the New Jersey-based management. Post-merger PSE&G would be a small part of the Exelon family. PSE&G has 2.1 million retail electric customers, compared to Exelon's 5.2 million. PSE&G has $700 million in net utility operating revenues, compared to $1.9 billion for Exelon's two utility operating companies. According to the press release announcing the merger, the annual revenue for EEG as a whole, post-merger, would be $27 billion. *Id. at 12.*

Another merger risk is that centralization of operations and the pursuit of standardization across the three utility operating companies would result in PSE&G's customers having to settle for the less customer-friendly methods that Exelon has imposed on its Pennsylvania and Illinois customers, such as the apparent ban against face-to-face encounters with actual customers that is largely the practice at the other two utilities that either have no walk-in customer centers or have only one such center for the many customers that would want or need such assistance. Cost-cutting efforts designed to reach synergy savings targets and "improve shareholder value" may exacerbate these risks.

On the questions of gas and electric operations and performance, the merger similarly poses the risk of "regression to the mean" in standards. PSE&G's first quartile results may not continue when it must standardize operations with its less-proficient proposed merger partners. At the very least, the record does not show how PSE&G's operations will be improved by a merger with ComEd and PECO. The result is likely to be the other way around. When the proposed merger was first announced, Mr. Rowe acknowledged that "there are many areas in T&D [transmission and distribution] that PSE&G does better than we do. And we will seek to learn from this." *RA-65 at 15.* Ms. Brockway has proposed a Service Quality Maintenance Plan to help prevent the erosion of service quality and reliability.

The Ratepayer Advocate is especially concerned that any diminution in customer service that could be caused by the merger will disproportionately degrade the quality of life of the many low income customers in PSE&G's service territory. These customers are the least likely to be able to convince the utility to address their needs post-merger, so their needs must be addressed before any merger approval can be granted. Ratepayer Advocate witness Roger Colton has made several cogent recommendations concerning low income customers including some modest investment in improving their utility services. Philadelphia and Chicago are the two large cities that comprise much of Exelon's utility service territories and include many low income customers whose special needs are not served by the dearth of utility offices where they can go to speak to a customer service representative and "present their case" for the assistance they require, especially in the face of Exelon's harsher collection and payment plan policies. The low income customers in PSE&G's many urban centers should not have to face these additional risks.

A number of merger-related risks associated with capital structure, the Money Pool, affiliate transactions, and merger accounting were identified by Messrs. Kahal, LeLash and Peterson. These issues should be addressed in the manner proposed by those witnesses before any merger is approved.

There is also the risk inherent in any merger that the expected benefits of combining operations may not materialize and that the difficulty of merging large companies may cause both of them to become less efficient instead of more efficient. The testimony of the Ratepayer Advocate witnesses is replete with examples of the flaws in the Joint Petitioners' claims and their evidence that purports to support the claims. These are described in more detail below.

In addition to these risks is the fact that the Joint Petitioners refuse to quantify many of the claimed benefits and provide a manner to pass them along to the customers. Even as the Joint Petitioners' shareholders have already reaped large financial benefits of the proposed merger by the increase in the price of their stock, customers must await the fulfillment of these promises until well after the merger is consummated, when it will be too late to undo any damage that will have been done due to the problems inherent in the merger proposal, especially in the area of the exercise of market power in the electricity and natural gas markets, let alone the corollary negative impacts on the New Jersey economy.

Another vital issue that the Joint Petitioners have not adequately addressed is the potential for the merger to adversely impact the Board's ability to perform its regulatory duties as to PSE&G. The merger as proposed poses significant risks to the Board's ability to regulate PSE&G and to preserve PSE&G's provision of safe, adequate and reliable service at just and reasonable rates. Ratepayer Advocate witness Ms. Brockway also observed that claims made to the Board and to other regulatory commissions in the past by other merging utilities have not been borne out by experience, further supporting the view that Your Honor and the Board should look with skepticism on vague and unsubstantiated merger claims. *Id. at 7.* Ms. Brockway's policy testimony included a discussion of the service problems that arose after the FirstEnergy-GPU merger, which eventually required the Board to adopt "behavioral tools and aggressive regulatory intervention to promote improvements in service quality and reliability." *RA-65 at 17.*

The proposed merger raises the real danger that creating such a mammoth company will dilute the Board's ability to regulate the utility operations in New Jersey. As stated by Ms. Brockway, the proposed merger would, as a practical matter, hamper the Board's effective control over PSE&G. Exelon will be too big and too remote to make New Jersey concerns a priority. Regulators cannot always succeed in forcing an unwilling management to behave as desired. In this case, increased regulatory efforts will have to compensate for the dilution of structural focus on New Jersey priorities. Further, regulation will have less leverage over a subsidiary of a huge out-of-state holding company system than it has had over a firm whose regulated holdings are all in New Jersey. *RA-65 at 12.*

Ms. Brockway also testified to her reasons for her belief that PSE&G under Exelon will be more difficult to regulate than PSE&G under PSEG:

> Exelon has acknowledged its intention to centralize regulatory policy development within the firm. Ruth Ann Gillis, President of Exelon Services Company, adopting the prefiled testimony of her immediate predecessor, Pamela S. Strobel, testified that after the merger, the Exelon Business Services Company will supply managerial oversight for a number of functions within the operating utilities. Exhibit JP-7 at 7. In response to RAR-SQ-67, Ms. Strobel explained that, while the responsibility for developing proposed changes to existing legal and regulatory requirements will reside at the local utility level, it will be subject to executive oversight and direction by the EDSS [Energy Delivery Shared Services Group of the Exelon Business Services Company], "to ensure quality and consistency with system- wide operational and functional goals." While this answer was in the context of customer service decisions, there is no reason to think that Exelon will not similarly move managerial control away from local management in other aspects of operations, and centralize it in the service company and holding company.
>
> In addition, from a regulatory standpoint, it is just more difficult to understand, much less regulate, a multi-state holding company. Even in a state like New Jersey, whose regulatory agency has substantial staff resources to devote to analyzing the merger documents, and identifying problems once they arise, the Board will have difficulty assessing every detail of the transaction. The enormous complexity of the legal arrangements being proposed, where the merger proponents have drafted the documents to suit their own interests, means there can be no certainty that all changes to current arrangements have been identified and dealt with in a suitable manner. Surprises are likely.

RA-65 at 13-14.

Ms. Brockway's recent five years of service as a Commissioner of the New Hampshire Public Utilities Commission ("NHPUC") from 1998 to 2003 and her additional fifteen years of experience involving public utility regulation are ample evidence for the reasons why her testimony concerning the difficulty of regulating such a large company post-merger should be given great weight. As she persuasively testified, "As a regulator, I have seen the loss of regulatory control when a once-significant utility became a small part of a large and remote utility. I have observed the failure of merger promises to be realized." *RA-65 at 18.*

Ms. Brockway enumerated several cases involving regulatory problems that arose after a utility merger including New England Electric System (where Mr. Rowe was CEO), NiSource and Bay State Gas Company, and Keyspan Corporation (who recently announced its own proposed acquisition by another utility, National Grid) where additional regulatory resources and efforts were needed to enforce compliance with the agencies' policies. *RA-65 at 18-20.*

She also testified to her experience as a Commissioner of the NHPUC with merged utilities whose attention to NHPUC policies waned after the merger. In those circumstances the new merged company chose to standardize policies and practices regardless of the consistency with New Hampshire issues. Those utility decisions then created problems for the regulators who received "much stiffer push-back from management than before the merger. . . ." *Id. at 19-20.*

An additional risk this proposed merger presents to PSE&G and its customers is the fact that Exelon is facing an uncertain regulatory situation in its home state of Illinois, which puts the prospects of the merger and the analysis of its impact in doubt. The management of Commonwealth Edison in Chicago has gone as far as to threaten to place the utility in bankruptcy if it does not receive the requested regulatory treatment for its power supply procurement needs. *Id. at 31.* The Ratepayer Advocate respectfully submits that it would be unwise to combine PSE&G now into a holding company that owns a large utility that faces bankruptcy.

With regard to risks, the key risk posed by the merger remains the potential exercise of market power by the merged entity, with the result of driving up wholesale power prices. The Ratepayer Advocate witnesses from Synapse Energy Economics, Inc. ("Synapse") have shown that the Joint Petitioners have yet to produce a satisfactory market power analysis. As will be discussed below, the only reliable market power analyses in the record demonstrate the real danger that the proposed merger will push up wholesale electric prices. Synapse estimates that a 1% increase in wholesale electricity prices due to the increased market power would raise electricity bills in New Jersey by $64 million per year. *RA-65 at 26.* Despite the overwhelming evidence in the record concerning increased market power, the Joint Petitioners decline to implement sufficient measures to protect New Jersey customers from this danger.

On the benefits side, the net merger savings calculated by the Joint Petitioners on the regulated side of PSEG are small relative to the size of the proposed merger. Making that problem even worse is the Joint Petitioners' efforts to reduce the net savings that could accrue to customers by overstating the costs to accomplish the merger that could be charged to customers, omitting some of the claimed benefits and truncating the time frame the synergy study should cover. Ratepayer Advocate witness Mr. Peterson testified that certain items have been included in the calculation of costs to achieve that are contrary to New Jersey merger precedent. Excluding these cost offsets and reflecting the purported benefit of lower capital costs increases the net benefit of the merger to $635 million over ten years. But even with a corrected synergy estimate, the net savings that would be allocated to PSE&G and its customers amounts to an average of only about $64 million a year. *RA-65 at 9.*

In any event, as stated by our witness, Ms. Brockway, the meager merger savings identified by Joint Petitioners do not justify a merger of this size:

> If Exelon guaranteed PSE&G customers a revenue savings of $64 million a year every year for ten years, flowed directly through to ratepayers, it would produce a small effect on annual revenue requirements and associated rates. Considering the size of the proposed merger, the synergy savings estimated by the Joint Petitioners are negligible. If PSE&G were a stand-alone utility, it

> would not undertake a merger of this size merely to produce the synergy savings anticipated by Mr. Arndt for the regulated side of PSEG. The synergy savings allocable to PSE&G are small even if the size of the estimate is corrected as recommended by Messrs. Kahal and Peterson to take into account the promised reduction in cost of capital, and corrections to the recoverable costs-to-achieve. Given the risks posed by the merger and the failure of the Joint Petitioners to assure these savings will be passed through, the net allocable synergy savings represent an exceedingly modest entry on the "benefit" side of the merger analysis.

RA-65 at 9-10.

As noted above, a complete analysis of the alleged benefits of the proposed merger would have to include the benefits that the Joint Petitioners claim will arise from the nonregulated side of the merged company. In fact, Mr. Rowe has publicly stated that the greatest benefit of the merger to New Jersey customers would come from the nonregulated side of the new company. *RA-65 at 23.*

The Joint Petitioners claim that increased nuclear operations will reduce wholesale electric prices, but have not adequately addressed the looming danger that the post-merger increase in market power by the merged firm will have the opposite result, higher wholesale electric prices. The Joint Petitioners have also not adequately responded to the testimony of Ratepayer Advocate witness Richard LeLash concerning the potential for the post-merger company to gain a commanding position in the natural gas markets and thereby increase natural gas prices. Since natural gas is often the fuel that is burned in electrical generating stations that set the market clearing prices in the PJM wholesale electricity markets, market power in the natural gas markets has the dual potential adverse impact on both markets. New Jersey utility customers could, therefore, receive a double hit to their energy bills due to this market power problem.

While the Joint Petitioners argue that Your Honor and the Board should approve the proposed merger in large measure because of the alleged nonregulated benefits, the Joint Petitioners refuse to assure that New Jersey customers will receive the benefits in a material way. Joint Petitioners also refuse to incorporate tools for protecting New Jersey from the price impacts of the exercise of any market power they will gain as a result of merging generation positions.

Ratepayer Advocate witness Ms. Brockway proposes a method to assure New Jersey customers a share in the nuclear output benefits and also protect the customers from the exercise of market power post-merger. She recommends that the Joint Petitioners be required as a condition of the merger, if the merger is to be approved, to pass along to New Jersey customers a fair share of the benefits that the Joint Petitioners so strongly contend will arise from the merger, and protect New Jersey consumers from the risk of price increases made possible by increased market power from the merger.

Ms. Brockway recommends that New Jersey customers receive an annual $62 million as their fair share of the merger benefits that come from the expected increased output of PSEG's nuclear power plants. *Id. at 36.* The $62 million figure is calculated as follows. The Ratepayer Advocate witnesses from Synapse Energy Economics, Inc. estimate that Exelon will receive $200 million in additional pretax revenues from the increased nuclear output. The after-tax revenues would be approximately $124 million. A 50% share of the $124 million should go to New Jersey customers, or $62 million.

Ms. Brockway proposed a method to pass along to New Jersey customers the alleged benefits of the increased nuclear plant output that would involve the merged company providing tranches of reasonably priced electric supply to be used as part of the basic generation service ("BGS") supply that would otherwise be procured through the BGS auctions. *RA-66 at 21.* The tranches could be priced at the cost of nuclear output including a return. Ms. Brockway provided the outlines of a process to determine how much electric supply would have to be provided to meet this benefit. *Id. at 22-26.* Once the Board decides to adopt this proposal to assure a fair share of the expected additional nuclear output for New Jersey customers and lays out the broad parameters of such a sharing, the Board could require the Joint Petitioners to make a compliance filing to meet this requirement. *Id. at 26.*

In addition, Ms. Brockway proposes that the Joint Petitioners also pass along to New Jersey customers $64 million per year which represents the above-mentioned potential 1% increase in electricity costs for New Jersey customers due to the heightened market power caused by the merger. As Ms. Brockway testified, the $64 million benefit is a conservative estimate, and does not reflect the merger-related potential increases in natural gas prices that would flow through to the retail level. *RA-65 at 36.* Using the tranche approach as recommended by Ms. Brockway ensures that consumers are not given double-benefits from any nuclear output increases, and similarly do not receive a windfall from this merger condition's provision for protecting them against the risk of increased wholesale prices associated with market power.

The proposed merger also presents the problem of adverse impacts to the New Jersey economy. The Joint Petitioners have announced the expectation of eliminating approximately 950 jobs in New Jersey if the merger is consummated. The economic loss of these jobs will ripple through the New Jersey economy. The multiplier effect causes the impact of the job loss to be larger than just the loss of salary and associated benefits. *RA-65 at 28.* To help protect the New Jersey economy from the adverse impacts of the proposed merger, Ratepayer Advocate witness Ms. Brockway proposes that, if Your Honor and the Board should decide to approve the merger, then the Joint Petitioners should be required to provide New Jersey customers with a $143 million annual benefit to offset the merger's negative effects on the New Jersey economy.

There should also be added to the above required benefits the amount calculated by the Ratepayer Advocate witnesses Mr. Peterson and Mr. Henkes concerning the merger synergy benefits. Mr. Peterson's original calculation of the merger synergy benefits to be flowed through to customers upon merger closing was approximately $42.7 million per year. As will be discussed more fully below, Mr. Peterson's original calculation may have to be adjusted slightly to approximately $41 million per year. This adjustment would be recommended if the Joint Petitioners are able to provide conclusive proof that Mr. Peterson's original calculation should not have included the savings related to PSE&G's transmission services.

Ms. Brockway included with her November 28, 2005 prefiled testimony (RA-65) the Exhibit NB-5 based on the original calculation of synergy savings as approximately $42.7 million. Using that figure, the total annual flow through of merger benefits to New Jersey customers would be $312 million. If it becomes appropriate to use the amended figure for synergy savings of $41 million, then the total annual flow through of merger benefits to New Jersey customers would be $310 million.

The Ratepayer Advocate continues to urge Your Honor and the Board to reject the proposed merger. However, if Your Honor and the Board should decide to approve the merger, then the Ratepayer Advocate respectfully requests that the merger approval be conditioned upon all of our recommendations, including without limit the annual flow through of total merger benefits as calculated herein, and the flow-through of sufficient price benefits to allow a share in the nuclear output benefits and protection against price increases due to the exercise of market power.

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

A. Service Quality

1. Joint Petitioners Have Failed To Demonstrate That Positive Benefits In The Areas Of Service Quality And Reliability Will Flow To New Jersey Ratepayers As A Result Of Their Proposed Merger

In reviewing the Joint Petitioners' merger petition, Your Honor and the Board must evaluate the proposed merger's impact on "the provision of safe and adequate service at just and reasonable rates." *N.J.S.A. 48:2-51.1.* As previously stated, the Board has mandated a showing of positive benefits to New Jersey and its ratepayers as a prerequisite to merger approval. In the areas of both service quality and reliability, the Joint Petitioners have failed to satisfy this standard.

The Joint Petitioners make the vague claim that "[t]he [m]erger should enhance PSE&G's ability to render safe and reliable service as a result of local management having access to an energy delivery organization of a much larger scale and geographic scope." *JP-3, p. 3*. The Joint Petitioners further allege that the sharing of so-called "best practices" in the post-merger Exelon organization "should result in improved, more efficient and effective work practices throughout the Exelon organization, including here in New Jersey." *Id. at 4.* These sweeping statements amount to little more than hollow representations. Indeed, the Joint Petitioners have not offered even a single commitment to maintain, much less improve, PSE&G's service quality or reliability performance post-merger. Nor have they even offered a specific plan for how they will accomplish any alleged improvement, and instead rely on vague allusions to the sharing of "best practices" post-merger. Perhaps the Joint Petitioners' lack of specific guarantees is attributable to the fact that PSE&G proposes to merge into a holding company whose two utilities, ComEd and PECO, have historically performed worse in these areas than PSE&G. In any event, the Joint Petitioners' mere speculation that PSE&G's service quality and reliability may improve in a post-merger environment, devoid of any concrete, enforceable commitments, should not be mistaken for a demonstration of positive benefits. It is not.

2. Summary of the Ratepayer Advocate's Proposed Maintenance Plan.

Should Your Honor recommend merger approval, the Ratepayer Advocate urges Your Honor and the Board to adopt the Ratepayer Advocate's proposed Service Quality Maintenance Plan ("Maintenance Plan") as detailed in the service quality testimony of Ratepayer Advocate witness Nancy Brockway, *RA-1 at 43-50*. The goal of the Maintenance Plan is to provide a level of protection, which is notably missing from the Joint Petitioners' merger filing, against a decline in reliability and customer service performance as a result of the proposed merger. While the Maintenance Plan will be explained in greater detail below, for convenience we offer the following summary. The Maintenance Plan would require:

- PSE&G to maintain performance within the first quartile of regional utilities in four key reliability/safety metrics: SAIFI, CAIDI, percent emergency calls answered in 30 seconds, and percent emergency calls responded to in one hour or less.
- If PSE&G fails to attain first quartile in any or all of the four metrics, as reported to the Board quarterly, the Board may assess a penalty on PSE&G. The Ratepayer Advocate recommends a maximum annual penalty range of ½% to 2% of revenues.
- In addition to the four key metrics, PSE&G shall report quarterly to the Board on its performance in all "Balanced Scorecard" metrics, with targeted performance equating to PSE&G's internal targets, i.e., historical or quartile performance.

In addition to our Maintenance Plan, the Ratepayer Advocate also recommends several other merger conditions in the areas of reliability and customer service which are explained below.

3. Joint Petitioners Have Not Proven That PSE&G's Reliability Performance Will Benefit From The Proposed Merger

a. PSE&G's Electric Reliability Has Historically Exceeded and Presently Exceeds Both ComEd and PECO.

Reliability of electric service is characterized by low frequency of outages, outages that are short in duration, speedy responses to outages, steady voltage levels, and a low incidence of momentary outages. *RA-1 at 28*. Two very important measures of electric reliability are CAIDI and SAIFI. CAIDI, which is an acronym for Customer Average Interruption Duration Index, measures the average length of sustained customer outages. SAIFI, an acronym for System Average Interruption Frequency Index, measures the average frequency with which customers experience sustained outages. *Id. at p. 29*. For both CAIDI and SAIFI, lower numbers translate into better reliability.

PSE&G's internal goal for CAIDI and SAIFI is to perform in the first quartile among regional utilities. RA-1 at 30. PSE&G has achieved first quartile SAIFI results each year since 2000, and has been in the first quartile for CAIDI since 2003. *Id. at 31*. PSE&G's electric reliability performance far exceeds the performance of both ComEd and PECO. Indeed, even accounting for ComEd's apparent improvement in CAIDI and SAIFI in recent years, PSE&G continues to exceed both ComEd and PECO in both of these metrics. *See, RA-11 at 33-34, 42-43*.

For example, PSE&G's average outage length was 40 minutes (30%) shorter and its frequency of outages has averaged *less than half* that of ComEd, for the period of 1998 through 2004. *Id. at 8*. As recently as 2003 and 2004, the average duration of outages experienced by

ComEd customers still remained over two hours. *Id.* Similar results can be seen for PECO; in 2004, PECO customers experienced outages about 50% more frequently than PSE&G customers, and on average the outages lasted 41 minutes longer than PSE&G's average outage duration. *Id. at 33-34*.

In the area of electric reliability, the Joint Petitioners have not met their burden of showing that the merger would create positive benefits that will flow to PSE&G ratepayers. Given PSE&G's patently superior performance to either PECO or ComEd, it is difficult to see how the Joint Petitioners could meet this burden. Indeed, Ralph LaRossa, PSE&G Vice President Electric Delivery, has admitted that PSE&G's CAIDI is so low that it would be difficult to lower it any further. *RA-1 at 33*. Even by their own admission, the Joint Petitioners' claim of potential benefits to PSE&G's customers stemming from this merger does not extend to the area of electric reliability.

Staff witness Frank DiPalma also believes it difficult to imagine that PSE&G could improve its electric reliability through partnership with Exelon. Regarding post-merger reliability improvement, Mr. DiPalma testified that "Exelon places high value on standardization and reduced costs through improved processes…Based on this approach it is hard to envision that the same superior results would be achieved." *S-1B at 52*. In fact, given ComEd's and PECO's inferior reliability records, and Exelon's emphasis on standardization and potential post-merger cost-cutting, the Ratepayer Advocate is concerned that the proposed merger will place PSE&G at risk for declining performance. Mr. DiPalma shares the same concern, asserting that "it is likely that post-merger financial, operational, organizational, and other changes would have a potentially negative impact on distribution system reliability." *Id. at 13-14*.

In an apparent attempt to circumvent the obstacle that PSE&G is requesting approval to merge with two utilities with worse reliability track records, the Joint Petitioners point to ComEd's and PECO's recent reliability improvements. *See, JP-10 at*, *6-19*. The Joint Petitioners try to create a causal relationship between the ComEd/PECO merger and improved reliability, once again making vague references to the alleged sharing of "best practices" between the two utilities without providing a single detailed example of an adopted "best practice." *Id. at 7, 9*. If, by reference to the ComEd/PECO merger, the Joint Petitioners are asserting that PSE&G will experience reliability improvements by merging into Exelon, there are several flaws with this argument.

First, at the time of the ComEd/PECO merger, both ComEd and PECO had much worse reliability track records than PSE&G currently enjoys. *See,* RA-*11 at 33-34, 42-43*. Simply stated, both ComEd and PECO had much greater room for improvement in the reliability area than PSE&G currently has. As stated earlier, even Mr. LaRossa claims that PSE&G's CAIDI is so low that it would be difficult to lower it any further. *RA-1 at 33.*

Secondly, although the Joint Petitioners attempt to link improved reliability to the ComEd/PECO merger, such a causal connection is not evident. On the one hand, the Joint Petitioners, through Mr. O'Brien, make sweeping, repeated references to "literally hundreds of new practices…including electric distribution operations" developed by ComEd and PECO post-merger, *JP-10 at p. 9*. On the other hand, however, when asked to describe any of the best practices resulting from the merger of PECO into Exelon, the Joint Petitioners have stated that they failed to track the sharing of best practices stemming from that merger. *RA-1 at 9*. The Joint Petitioners' touting of best practices as responsible for improved reliability performance at ComEd or PECO is unproven at best, given that they apparently do not even know which "best practices," if any, they shared during that merger process. Indeed, one questions how PECO and ComEd can even remember if they shared best practices post-merger, to what extend such sharing occurred, and whether any of the "best practices" were ultimately implemented, given that they failed to keep track of this sharing process. Ironically, this elusive sharing process is now being touted by the Joint Petitioners in this merger petition as one of the biggest benefits of a PSE&G/Exelon merger. The Board and Your Honor should place no weight on the Joint Petitioners' repeated references to reliability improvements at ComEd and PECO as allegedly stemming from the merger of those two utilities.

Additionally, forces external to the ComEd/PECO merger may very well be responsible for ComEd's improvement in reliability in recent years. Throughout the 1990's ComEd had underfunded both maintenance and capital improvements to its transmission and distribution system which culminated in numerous, lengthy outages in the summer of 1999. *RA-11 at 6-7, 39*. ComEd was forced to make investments to improve its reliability due to the resulting outcry from the public, the Mayor of Chicago, and state regulators. *Id. at 35-41*; T708:L16-23 (1/10/06). Clearly, ComEd's improved reliability cannot be exclusively attributed to its merger with PECO.

b. The Joint Petitioners Have Failed to Show That PSE&G's Gas Reliability Will Maintain its Current Level of Performance, Much Less Improve, As a Result of the Proposed Merger.

Due to the volatile nature of natural gas, gas system reliability and gas safety are inherently linked. A safe, reliable gas distribution network is defined by few system leaks, speedy attention to identifying and repairing leaks, speed with which leak reports and other emergencies are received by a utility, timely replacement of at-risk facilities (pipes, pumps, services) and proper mark-outs of facilities prior to any digging. *RA-1 at 35.*

Since PSE&G has historically maintained a safe and reliable gas distribution network, the Ratepayer Advocate's main concern is that this performance level be maintained post-merger. Of the two Exelon utilities, ComEd and PECO, only PECO maintains a gas distribution operation. The Ratepayer Advocate agrees with the concerns expressed by Staff witness Salvatore Marano, that the proposed merger presents no tangible benefit in terms of gas safety or reliability, and in fact may lead to a risk of declining performance from standardization of practices across the utilities, and from Exelon's efforts to reduce spending. *S-2B at 6.*

Exelon may require PSE&G, in order to achieve synergies, to reduce its current practices to minimum regulatory standards. As Mr. Marano notes, PSE&G may struggle for its share of capital resources within the Exelon organization, thus creating a risk of decline in maintenance of and investment in PSE&G's infrastructure. For example, both PSE&G and PECO have a large amount of cast iron and bare steel mains. *Id. at 24*. Although PSE&G's system has more cast iron than PECO, PECO's cast iron system is at greater risk because PECO operates a greater percentage of the system at high pressure and with a greater percentage of small diameter mains. *Id.* Moreover, PSE&G has committed to replacing all bare steel mains within 10 to 15 years, an example of its active approach to main replacement as opposed to PECO's reactive approach. *S-2B at 25*. The Ratepayer Advocate concurs with Mr. Marano's concern that "in a post-merger environment, PSE&G would be required to alter its main replacement programs to reduce capital spending and to adopt a different/common model with PECO that conflicts with PSE&G's current methodology." *S-2B at p. 26*. The Ratepayer Advocate is further concerned, as is Mr. Marano, that Exelon would shift funding for PSE&G's cast iron replacement to accelerate replacement of PECO's higher risk system. *Id. at 27*. Simply put, PECO's infrastructure could improve at the expense of PSE&G's system. Before this proposed merger, this concern was non-existent.

[CONFIDENTIAL INFORMATION BEGINS] [redacted] .**[CONFIDENTIAL INFORMATION ENDS]**.

Accordingly, as with electric reliability, the Joint Petitioners have offered no discernible benefits in the area of gas reliability.

c. The Ratepayer Advocate Recommends that Your Honor and the Board Adopt Our Proposed Service Quality Maintenance Program to Encourage PSE&G to Maintain its Current Performance in the Area of Reliability.

It is evident that Exelon is offering very little to PSE&G in terms of improved electric or gas reliability and, to the contrary, this proposed merger creates a risk of backsliding in the area of reliability. In particular, PSE&G has been a much better performer in the area of electric reliability than either of the two utilities with which it proposes to merge. For these reasons, the

Ratepayer Advocate strongly recommends that the merger be rejected. If your Honor and the Board decide to approve the merger, the Ratepayer Advocate strongly recommends that Your Honor and the Board also adopt our proposed Service Quality Maintenance Plan (hereinafter referred to as the "Maintenance Plan") as described in the service quality and reliability testimonies of Ratepayer Advocate expert witness Nancy Brockway. *See, generally RA-1 at 42-50.*

The main goal behind the Maintenance Plan is to prevent PSE&G's reliability performance from slipping. Maintenance of reliability at current levels could be perceived as "no adverse impact" on this area during Your Honor and the Board's review of the proposed merger. However, the Ratepayer Advocate does not perceive the mere maintenance of reliability and customer service at current levels to be a positive benefit to ratepayers. For example, even if the Board were to impose on PSE&G the maximum penalty suggested under our plan for declining performance, the monetary compensation would amount to only a few dollars per PSE&G ratepayer. The overwhelming majority of ratepayers would hardly consider that more frequent outages and/or slower responses to natural gas emergencies in exchange for a few dollars a year as a positive benefit to them or the State. Rather, the Maintenance Plan is designed to prevent a decline in PSE&G's reliability, and in the event slippage does occur, to encourage PSE&G to strive to improve its performance back to the first quartile level which it has claimed is its goal, and which it has in fact attained in recent years.

The Maintenance Plan, as recommended by Ms. Brockway, would require PSE&G to maintain performance within the first quartile of regional utilities in four key reliability/safety metrics (collectively the "Four Key Metrics"):

1. SAIFI
2. CAIDI

3. Percent emergency calls answered in 30 seconds.
4. Percent emergency calls responded to in one hour or less.

[*RA-1 at 46*].

PSE&G would be required to report its performance to the Board and the Ratepayer Advocate annually. If PSE&G fails to attain first quartile performance in any or all of the four key metrics, the Board may assess a penalty on PSE&G. *Id. at 47*. The Ratepayer Advocate recommends to Your Honor and the Board a maximum annual penalty range from ½% to 2% of revenues. *RA-1 at 45*. Each of the four metrics would be subject to a maximum penalty of one-fourth of the maximum annual penalty. The Board could also subdivide the potential penalty, such that decreasing performance levels draw a greater penalty, up to a performance level at which the maximum penalty will be imposed. *Id.*

Despite the Joint Petitioners' repeated mischaracterizations, the penalty mechanism proposed under our Maintenance Plan is not "automatic." As always, the Board could take into account special conditions out of PSE&G's control in determining the amount of a penalty to impose. *Id.* Penalty amounts will always be within the Board's discretion.

The Ratepayer Advocate believes that first quartile is the appropriate standard for measuring PSE&G's reliability performance for several reasons. As noted by Ms. Brockway, the Ratepayer Advocate is simply recommending that PSE&G be held to the same standard that it has set for itself internally, namely first quartile performance. *RA-1 at 50*. Indeed, PSE&G has achieved first quartile SAIFI results each year since 2000, and has been in the first quartile for CAIDI since 2003. *RA-1 at 31*. If the Joint Petitioners are sincere in their representations that PSE&G's performance will at a minimum remain unaffected, and indeed, hopefully will improve as a result of this merger, then they are in no way harmed or placed at additional "risk" by the Ratepayer Advocate's Maintenance Plan. Simply stated, PSE&G's performance would have to backslide in order for PSE&G to be vulnerable to a penalty under our Maintenance Plan, and the Joint Petitioners have essentially promised it will not backslide .

Secondly, despite Mr. Izzo's contention that the Maintenance Plan is "extreme and completely unreasonable in light of the many factors that can impact reliability performance but are outside of the utility's control, such as weather," in fact one significant advantage of measuring performance by a quartile standard is that such a standard naturally compensates for poor weather trends. *JP-11 at 12-13*. A quartile standard would benefit PSE&G in a year, for example, where the region experiences numerous storms that impact reliability but do not rise to the level of a "major event." Since quartile ranking is determined based on PSE&G's performance compared to other regional utilities, presumably those utilities' CAIDI/SAIFI results will be similarly impacted by regional weather patterns.

Holding PSE&G to a first quartile standard is especially appropriate in light of the uncertainty of the applicability of the Board's Interim Electric Distribution Service Reliability and Quality Standards, *N.J.A.C. 14:5-7.1 to 7.13* (hereinafter referred to as the "Interim Standards"). This is true despite the Joint Petitioners' apparent desire to stipulate that they are subject to the Interim Standards. Mr. Joseph Dominguez, a PECO attorney, has asserted that he will "stipulate that PSE&G believes that [the Interim Standards] continue to apply…." T698:L9-10 (1/10/06). The Ratepayer Advocate asserts that Mr. Dominguez, a PECO attorney, cannot make such a stipulation on behalf of PSE&G.

Despite Mr. Dominguez' assertion, the applicability of the Interim Standards to PSE&G is not at all clear since they appear to be obsolete. The Interim Standards establish a CAIDI/SAIFI benchmark based on a 10-year average for the years 1990-1999, and only set minimum reliability levels for the year 2001 and 2002 based on the benchmark with two standard deviations. *N.J.A.C. 14:5-7.10*. Holding PSE&G merely to the minimum levels of the Interim Standards would allow slippage in PSE&G's reliability performance without consequence. Indeed, even Mr. Izzo seems to acknowledge the ineffectiveness of the Interim Standards through his testimony that PSE&G "would support a formal rulemaking that would develop performance standards." *JP-11 at 13*.

The final aspect of Ms. Brockway's Maintenance Plan involves reporting requirements on various aspects of service quality and reliability. The Ratepayer Advocate recommends that Your Honor and the Board require PSE&G to report quarterly to the Board and the Ratepayer Advocate on the Four Key Metrics, as well as the metrics PSE&G includes in its "Balanced Scorecard." *RA-1 at 49*. For the "Balanced Scorecard" metrics, the Ratepayer Advocate recommends PSE&G be held to the same standards it targets internally, such as historical performance or quartile performance. *Id. at 50*. If performance in a particular area or areas slip, the Board could take action to protect ratepayer interests, such as requiring a remediation plan, reducing PSE&G's allowed return on equity, etc. *Id.*

d. The Ratepayer Advocate Recommends That Any Merger Approval Be Conditioned on a Requirement that PSE&G Will Not Be Permitted to Outsource the Markout Function Without Prior Board Approval.

To ensure gas system safety, prior to any digging near gas distribution facilities, a utility must locate and mark the facilities so they will not be struck and damaged. A utility's role in this process is known as the markout function. PSE&G uses its own internal staff to perform markouts. *RA-1 at 37-38*. By contrast, PECO outsources markouts to outside vendors, as does ComEd for its service areas outside of the City of Chicago. *Id. at 37*.

The Ratepayer Advocate is concerned that Exelon's obvious propensity for outsourcing the markout function may compromise PSE&G's gas system safety. Board Staff witness Mr.

Marano agrees with our concern, noting that "in-house resourcing of mark-outs would be outsourced to reduce O&M expenditures, and that overall accountability for damage prevention would be fragmented." *S-2B at 36.* **[CONFIDENTIAL INFORMATION BEGINS]** [redacted]

[CONFIDENTIAL INFORMATION ENDS]

The Ratepayer Advocate understands that PSE&G entered into an agreement with its unions whereby PSE&G agreed to maintain the markout function in-house until May 2011. PSE&G witness Peter Cistaro claims that this agreement has made outsourcing of the markout function a non-issue in this merger proceeding. In his words, Mr. Cistaro asserts "there is no issue." *JP-14 at 19.* The Ratepayer Advocate respectfully disagrees.

While a positive step, this agreement only binds PSE&G for a limited period of time, and therefore does not satisfy the Ratepayer Advocate's general concern that safety could be compromised if Exelon decides to outsource markouts once PSE&G's contractual obligation to its unions expires. Indeed, PSE&G's obligation to its unions ends in 2011, but if this merger petition is approved, Exelon's control will last indefinitely. Exelon has not assured, or even suggested, that PSE&G will be allowed to maintain the markout function in-house once this time period negotiated with the unions ends. Therefore, in an effort to protect the safety of PSE&G customers and employees, the Ratepayer Advocate recommends that if Your Honor and the Board decide to approve the merger, that approval be conditioned on a requirement that PSE&G must seek and obtain Board approval if it desires to outsource gas and/or electric markout functions. In contrast to the Union agreement being touted by PSE&G, such a condition serves to protect the citizens of New Jersey indefinitely, not merely for a four to five year period of time.

e. The Ratepayer Advocate Recommends That Any Merger Approval Be Conditioned on a Requirement that PSE&G Report to the Board and the Ratepayer Advocate on its Efforts to Attract and Maintain Adequate Linemen and Gas Operations Personnel.

As Ratepayer Advocate witness Ms. Brockway has testified, "[a]ll electric utilities today are facing the need to replace an aging workforce of linemen." *RA-1 at 34*. A properly trained staff of linemen and gas operations personnel are necessary for any utility to maintain system safety and reliability. As Ms. Brockway has testified, the Ratepayer Advocate recommends that Your Honor and the Board condition any merger approval on a requirement that PSE&G be required to continue efforts to recruit and train an adequate staff of linemen and gas operations personnel, and that such efforts be periodically reported to the Board and the Ratepayer Advocate. This recommendation appears to be non-controversial, as the Joint Petitioners never challenged it in their rebuttal testimonies or throughout the evidentiary hearings. If Your Honor chooses to recommend merger approval to the Board, we urge that this requirement be adopted.

4. Joint Petitioners Have Not Proven That PSE&G's Customer Service Performance Will Benefit From The Proposed Merger.

a. PSE&G's Performance Already Exceeds ComEd's and PECO's Performance in Several Areas of Customer Service, and Has Recently Shown Improvement in the Speed of Answer Area.

Customer service involves a utility's interaction with its customers, such as signing up customers for service, the speed and quality of answering customer questions, meter reading, all aspect of billing, including accuracy, flexibility in payment arrangements, etc. *RA-1 at 20*. In the area of customer service, the Joint Petitioners have failed to satisfy their burden of proving that the proposed merger will benefit PSE&G ratepayers.

PSE&G's customer service performance exceeds its two proposed merger partners, PECO and ComEd, in several areas. As Ms. Brockway testified, PSE&G has consistently met over 97% of its service appointments with customers from 2000-2004; neither PECO nor ComEd maintained such high performance during that time period. *Id. at 25*. Concerning the level of complaints to the relevant state regulatory agencies, while ComEd has maintained a level of complaints comparable to PSE&G, PECO's number of complaints per 1000 customers was as much as 5 times that of PSE&G. *RA-1 at 27.*

Moreover, although ComEd and PECO appear to exceed PSE&G in the area of speed in answering customer calls, in fact PSE&G's performance in this area recently has shown impressive improvement. While PSE&G's average speed of answer exceeded three minutes in 2003 and two minutes in 2004, in 2005 PSE&G was able to reduce that number to 56 seconds. RAR-SQ-13 (Update), provided in response to TR-585, Line 17. Indeed, PSE&G was able to reduce its average answer speed while still maintaining its goal to resolve customer concerns in one call, a policy known as First Call Resolution. T572:L5-8 (1/09/06).

According to Staff witness Mr. Rafferty's testimony, which PSE&G does not dispute, PSE&G's decline in average speed of answer during 2001-2004 was attributable to an internal policy that permitted employees to bid on other jobs within the PSE&G organization, resulting in rapid employee turnover. *S-3A at 13*. PSE&G amended that policy and answering speed statistics have improved. *Id.* PSE&G's improvement in this area demonstrates how PSE&G was able to identify a problem (employee turnover) and take effective steps toward solving that problem – a process that, notably, they were able to accomplish as a stand-alone company.

PSE&G's speed of answer improvement illustrates that PSE&G does not need to merge with Exelon in order to accomplish customer service improvements.

b. Exelon's Intention to Align the Call Centers Across All Three Utilities Could Potentially Harm Call Center Performance for PSE&G Customers.

PSE&G currently maintains the call center function internally, and operates a total of four call centers. *S-3A at 10.* One call center is dedicated to inbound and outbound calls for credit and collections, while another handles in-bound calls for construction issues. *Id.* at 11. The remaining two call centers – the main call center in Cranford and the satellite center in Bordentown - handle all other customer concerns. *Id.* Exelon operates three call centers – two in Illinois for ComEd customers, and one in Pennsylvania for PECO customers. PECO outsources the call center function for credit related issues, while ComEd outsources collections. *Id.*

Although Exelon does not currently share calls between its ComEd and PECO call centers, it has announced its intention to "align" the call centers across all three utilities if and when the merger with PSE&G is approved. *JP-5 at 30.* The Ratepayer Advocate is apprehensive that this proposal, if implemented, may harm customer service for PSE&G customers. As Ms. Brockway testified, by aligning the call centers, Exelon intends to take advantage of the different time zones between Chicago and the New Jersey/Philadelphia area so that customer service representatives from each utility can help handle high call volume during times when their own centers may not be experiencing high call volumes. *RA-1 at 21.* Simply put, when a New-Jersey based PSE&G customer calls PSE&G for help, they may be speaking with an Exelon employee in Chicago. By aligning the call centers, Exelon will eventually be able to decrease the total number of employees who staff the call centers. *Id.*

Exelon's proposal to align the call centers is a cost saving measure, and not a customer service improvement, despite Exelon's claim to the contrary. The Ratepayer Advocate is concerned that calls answered by out-of-state representatives could lead to diminished performance from a customer's perspective, since such representatives may not have necessary local knowledge of New Jersey, such as New Jersey geography, information on New Jersey payment assistance programs, etc. Moreover, the Ratepayer Advocate is concerned that the proposed merger will inevitably lead to diminished local decision-making authority by PSE&G customer service employees. For example currently PSE&G empowers its representatives to resolve customer issues up to $200. *S-3A at 20.* With standardization in operating practices across the three utilities and the proposed "alignment" of call centers, local discretion will surely be diminished at both the customer service representative and executive levels. Indeed, Staff witness Mr. Rafferty concurs with the Ratepayer Advocate's opinion, noting he is "concerned that the level of ultimate local authority to resolve customer issues, currently at the VP level may be reduced and/or relocated out of state, which could diminish customer service and satisfaction." *Id. at 21.* Exelon, in fact, confirmed this loss of local authority during the evidentiary hearings through its witness M. Bridget Reidy, Senior Vice President of Customer and Marketing Services for Exelon Energy Delivery. Through cross-examination of Ms. Reidy, the Ratepayer Advocate was able to ascertain that in a post-merger environment, Ms. Reidy, an Exelon employee working out of Chicago, will be in charge of PSE&G call centers. T590:L18-23 (1/9/06).

Accordingly, the Ratepayer Advocate recommends that, should Your Honor recommend merger approval, the Joint Petitioners be required to maintain and fully staff the New Jersey call centers, and should not be permitted to reduce call center staff or make use of out-of-state customer service representatives for a period of time of at least four years. *RA-1 at 50*. Following this four year period, if PSE&G desires to relocate call centers out-of-state, PSE&G should be required to obtain Board approval by demonstrating that customer service would improve with such a move. *Id.* Although the Joint Petitioners now claim they have no current plans to close any of the call centers, mere assertions are not commitments and in fact say nothing about what Exelon's post-merger plans may be. The Ratepayer Advocate's recommendation would go a long way towards maintaining customer service for PSE&G customers. Indeed, our recommendation is particularly crucial in light of the fact that the Board's regulations do not require utilities such as PSE&G to obtain Board approval in order to close call centers. We urge Your Honor and the Board to adopt our recommendation.

c. Customers Should Be Compensated for Any and All Billing Errors that Arise from Exelon's Plan to Migrate PSE&G to its Common Billing Platform.

ComEd currently utilitizes a billing and customer information system known as the Customer Information Management System ("CIMS"). Exelon has announced its intention to migrate PECO to this system by the end of 2006 and PSE&G in 2008. *JP-16 at 11*. Despite PSE&G's acknowledgement that its current system can function for at least another 3-5 years, Exelon has already decided that PSE&G should be migrated to the CIMS. *RA-11 at 11-12*.

The Ratepayer Advocate is concerned that the proposed implementation of the CIMS will lead to diminished customer service performance during and after the migration period. History justifies our concern. As noted in Ms. Brockway's testimony, when Conectiv, the parent of Atlantic City Electric Company ("Atlantic") and Delmarva Power & Light ("Delmarva"), moved to a new billing system in December 1999, it experienced numerous problems that eventually forced Atlantic to suspend disconnections on delinquent accounts for more than one year. *RA-1* *at 25*. Delmarva, meanwhile, eventually compensated customers in the amount of $2.5 million for the billing errors. *Id.*

The Joint Petitioners dismiss our concern by claiming such risks "exist any time there is a system change." *JP-16 at 13*. While the Ratepayer Advocate agrees that risks are always present to some degree, we submit that a company that has historically functioned as a team will be better equipped to address concerns arising out of a new billing platform than a newly merged company such as Exelon. Under Exelon's proposal, which includes alignment of the call centers as well as migration to CIMS, customer relations personnel at all three utilities will be contending with computer glitches while also trying to learn the laws and regulations of one or two other states, not to mention dealing with the numerous other changes that accompany a newly merged environment.

Accordingly, the Ratepayer Advocate recommends that, should Your Honor recommend merger approval, such approval be conditioned on a requirement that Exelon must report to the Board and the Ratepayer Advocate on its planning and execution of PECO's migration, and eventually PSE&G's migration, to the CIMS. Moreover, as Ms. Brockway testified, the Ratepayer Advocate recommends that PSE&G customers' accounts should be credited $10 for every instance where customers experience a billing error during and after the migration to CIMS. *RA-1 at 51-52*. Exelon's commitment to integrating CIMS across all three utilities is driven by their desire to standardize operations across the holding company. PSE&G customers should not bear the risk that accompanies this desire and should be at least minimally compensated for subsequent errors.

Moreover, the Ratepayer Advocate notes that precedent exists for such a customer service guarantee in the billing area. In 2002, in approving the merger of Atlantic into Conectiv, the Board approved a similar bill credit as part of numerous customer service guarantees which stemmed from that merger. *I/M/O 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, Order dated July 3, 2002. We urge Your Honor and the Board to adopt this recommendation.

B. Impact on PSE&G’s Electric and Natural Gas Service Reliability.

1. Joint Petitioners Have Failed to Demonstrate that the Merger Will Provide Positive Benefits to PSE&G's Gas Ratepayers.

In their Petition, discovery and testimony Joint Petitioners failed to provide definite plans describing how PSE&G's gas operations will be structured if the proposed merger is approved. In the Petition they asserted that PSE&G would continue to receive its total firm gas supply requirements from a nonregulated PSEG affiliate, PSEG Power's Energy Resources & Trade ("ER&T") or a successor company. *RA-4 at 5.* Superficially, it would appear that the proposed merger would not affect PSE&G's gas business and its customers. However, the potential change in ownership and the need to recoup acquisition costs could potentially cause problems that Your Honor and the Board should address in this proceeding. *RA-4 at 5.*

Effective May 1, 2002 the Board approved a transfer of PSE&G's gas supply and capacity contracts from the utility to its unregulated affiliate, ER&T. Pursuant to the terms of the Requirements Contract, ER&T was required to provide to PSE&G its total gas requirements of gas for its BGSS customers. *Contract Transfer Order, Docket No.* GM00080564*, dated April 17, 2002.* After the Board’s approval of the capacity transfer, the reliability of PSE&G's interstate gas supply became dependent upon the performance of ER&T. The Requirements Contract ("Requirements Contract" or “Contract”) that became effective on May 1, 2002 was subsequently amended by a Supplemental Operating Agreement on September 10, 2003. *RA-4 at 22.*

As the Ratepayer Advocate's witness Richard LeLash testified in this proceeding, "a change in ownership and future operational changes may affect provisions of the existing Contract, and will not ensure on-going supply under commensurate terms and conditions." *RA-4 at 6.* If the merger is approved, ER&T or a successor entity under Exelon's ownership and control could contend that its prospective obligation to PSE&G is limited to the specific terms and conditions of the amended Requirements Contract. Moreover, "the Requirements Contract is neither clear nor comprehensive on procurement matters, and there is a need to fully define and obtain commitments concerning the Board's prospective authority over procurement and the Requirements Contract provisions." *RA-4 at 31*.

In the testimony of its witness Mr. LeLash, the Ratepayer Advocate addressed major Contract shortcomings relating to the prospective reliability of PSE&G's gas service and the costs incurred for its gas supply.

a. Capacity Margin Sharing.

First, "the Contract is silent concerning the capacity management function of ER&T with respect to non-jurisdictional transactions that utilize capacity paid for by PSE&G's customers. There is no specification as to the types of transactions that generate margins or credits, the methodology for determining such margins or credits, or ER&T's obligation to pay such margins or provide such credits to PSE&G." *RA-4 at 24.*

Neither the Board's Order in the Contract Transfer case nor the subsequent Board Order Adopting Stipulation in Docket No.GR01110768 fully delineates the post-transfer mechanics of margin-sharing on capacity transactions. *IMO Proposal for Reduction on Commodity Charges* *(formerly, LGAC) and Changes in Tariffs, Docket No. GR01110768, dated Jan. 9, 2002*. Unless these mechanics are fully spelled out in the Contract, the margin issue could be subject to dispute under Exelon's ownership of ER&T. *RA-4 at 28.* These margins, which have averaged about $38.5 million per year since the contract transfer, are currently shared between the BGSS customers and PSE&G. Mr. LeLash testified that, in order to protect ratepayers, "what is needed [in a post-merger world] is a clear specification of which ER&T transactions will generate margins or credits, how such margins or credits will be determined and the mechanism for allocation of the margins or credits among various customers that receive and pay for the associated gas supply." *RA-4 at 29.*

b. Level of Capacity Resources.

Second, "the Contract also allows ER&T to unilaterally amend, extend, replace or supersede any of the gas purchase contracts in order to meet its full requirements obligation to PSE&G." *RA-4 at 23*. Accordingly, "The Board has no explicit authority over any changes to the capacity portfolio. Were ER&T to maintain excess capacity levels, the associated charges would be paid by PSE&G." *RA-4 at 25.* Presumably, PSE&G would seek to pass through the costs of the surplus capacity to regulated customers, thereby raising their BGSS rates above a just and reasonable level.

It is quite possible that, under the provisions of the merger, capacity paid for by PSE&G's gas customers and held by ER&T would become surplus. For example, under the generation mitigation plan proposed in this proceeding, some of PSEG's gas fired generation would be eliminated, and, without provision for PSE&G to continue to supply gas for the new owner of such generation or for ER&T to assign capacity to the generators, an excess supply of capacity would result. *RA-4 at 25*. As Mr. LeLash noted, "The prospect of excess capacity is troubling because it burdens ratepayers with unnecessary costs and it rewards PSE&G's parent company, PSEG, with incremental profits, if such capacity can be used for secondary market transactions. Thus, PSEG has a potential conflict of interest in matters related to the matching of demand and supply for ER&T's gas supply and capacity portfolio." *RA-4 at 26.* It is therefore necessary for the Board to establish conditions that prevent such a conflict.

c. Board Oversight of Capacity.

Third, in the Contract Transfer proceeding the Board conceded that, "The gas contract transfer would mean that the Board would not have the ability to delve into the gas procurement practices of [ER&T]. Nor will it have the ability to alter the pricing agreements between PSE&G and [ER&T] or any contractual terms of the PSE&G/[ER&T] agreement," *Contract Transfer Order at 10; RA-4 at 29.* This situation will become more problematic if the merger is approved.

In addition, the year-to-year nature of the Requirements Contract after March 31, 2007 is of great concern. As Mr. LeLash testified, "At a minimum, this situation gives ER&T the right to give notice and thereby negate the full requirements provisions of the Contract. With such notice, ER&T would no longer be responsible to meet PSE&G's gas requirements in excess of those existing on the date of notice. If the merged entity were to decide it no longer wanted to continue the Contract, it could direct its subsidiaries to terminate the Contract". *RA-4 at 27.* Such a circumstance would require PSE&G to purchase gas from a third party supplier at potentially higher prices, resulting in additional costs being passed on to ratepayers through the BGSS.

d. Other Contract Issues.

The Requirements Contract contains other deficiencies that the Board should correct in this proceeding.

- The Requirements Contract provides that [ER&T] has the authority to direct [PSE&G] to curtail or interrupt non-firm customers consistent with the terms and conditions of all applicable rate schedules and service agreements. *RA-4 at 24.*
- Section 4 of the Stipulation of Settlement in the Contract Transfer proceeding states that "PSE&G and ER&T are obligated to adhere to all relevant legal requirements regarding affiliate standards approval by the FERC and the Board. In the Contract the only related provision is a narrow requirement that ER&T will not provide any undue preference to retail gas supplier affiliates. *RA-4 at 31.*
- Under the Requirements Contract, ER&T can be excused for a failure to perform by Force Majeure events which are defined to include any cause beyond the reasonable control of the party asserting a Force Majeure. This would include, according to Joint Petitioners, any weather events. *RA-4 at 31-32.*
- The Contract, as it is currently written, does not address two capacity release provisions that may or may not affect the level of capacity available to PSE&G prospectively. Specifically, in the Stipulation of Settlement in Docket No. GM0008064 there are provisions for an Initial Firm Transportation Capacity Release Program and a Permanent Capacity Release/Assignment Program for the benefit of Third Party Suppliers ("TPSs"). *RA-4 at 32.*

Each of these provisions requires clarification as to how it will be applied if Exelon to obtains ownership of ER&T. With ER&T or its planned successor being an unregulated entity owned by an Illinois company, it is quite possible that current procurement practices and operations could be materially altered absent clear guidelines and prohibitions in the Requirements Contract.

e. Recommended Modifications and Regulatory Protections.

As a condition of any merger approval, the Board should require the following:

- The Contract should be modified to include a provision requiring Board approval for any material modification of the level or cost of gas capacity required by PSE&G. Such material modifications should include contract termination, capacity enhancements or substitutions and any changes to the nature or scope of operations of ER&T or its successor. *RA-4 at 35.*
- The Contract should specify all transactions related to the PSE&G capacity, the determination of margins and credits, and the allocation of such margins to gas ratepayers, and it should incorporate all relevant margin provisions as set forth in applicable prior Board Orders. *Id.*
- There should be a commitment for the continuation of the current BGSS service and its pricing provisions and a requirement that residential customers have the right to receive cost-based gas supply that is subject to annual reconciliation. The commitment also should prohibit PSE&G from adopting any monthly indexed price procedure for its residential BGSS-RSG service. *Id.*
- The Contract should specify that only PSE&G should have the authority to control service interruptions and Force Majeure provisions should only allow weather-related

claims if the average daily mean temperature is below the level incorporated into the Company’s latest design day requirements determination. *Id. at 36.*

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

f. Venue for Requirements Contract-Related Issues.

During this proceeding the Joint Petitioners did not rebut the issues raised by the Ratepayer Advocate, nor did they cross-examine Mr. LeLash on any of his testimony. The only related issue was raised by Joint Petitioners' witness Frederick Lark concerning whether the merger case is the proper venue to address Requirement Contract related issues. In his rebuttal testimony Mr. Lark declared that issues concerning BGSS and the Requirements Contract should not be addressed in this proceeding but should be considered in a BGSS proceeding. *JP-21 at 8.*

Contrary to Mr. Lark's assertion, the instant proceeding is precisely the proper forum to address issues concerning the Requirements Contract. As Mr. LeLash stated in his surrebuttal testimony, "The Board's standards for review of any proposed merger include its impact on the rates of utility ratepayers and the utility's ability to provide safe and adequate service at just and reasonable rates . . . . As such, a change in ownership with the potential to alter contractual obligations, to modify operational procedures, and to diminish the Board's regulatory oversight over New Jersey utility operations is very germane to the current proceeding." *RA-14 at 2.*

At the heart of this issue are the Requirements Contract and any modifications that are required in order to preserve at least the current level of service and its associated costs.

The Ratepayer Advocate, therefore, respectfully submits that Your Honor and the Board cannot reach conclusions regarding whether safe and adequate service will be adversely affected by the merger absent determinations concerning gas and capacity availability and cost impacts associated with a change in ownership.

C. Low Income Issues.

1. Introduction and Summary of Recommended Conditions.

In New Jersey, many households live in poverty. A generally accepted measure of "being poor" in the United States is the "Federal Poverty Level" published each year by the United States Department of Health and Human Services. Each year the Federal Poverty Level establishes income levels below which households of a given size are considered "poor." *RA-3 at 3, Schedule RDC-1.* Since the Federal Poverty Level is generally considered too low to serve as a definition of the poverty line, "being poor" is sometimes defined at higher levels, such as 150% or 200% of the Federal Poverty Level. *RA-3 at 3.* Approximately 14% or one in seven persons in New Jersey lives at 150% of the Federal Poverty Level. Of these, over half live at or below Poverty and nearly one-third live at or below 50% of the Federal Poverty Level. These statistics are mirrored in PSE&G's service territory, which includes 70% of New Jersey's residential electric and gas utility customers, and which includes some areas of profound poverty. *RA-3 at 4; JP-15 at 9.*

The Joint Petitioners have failed to show that the merger will create positive benefits for PSE&G's low income customers. Indeed, if the merger is approved, Exelon's planned cost-cutting measures can be expected to have a disproportionate impact on PSE&G's low income customers. Low-income customers rely disproportionately on customer call centers for services such as negotiation of payment plans and referrals to sources of public and private assistance. *RA-3 at 7.* In addition, low income customers without telephones or bank accounts rely on walk-in centers for a variety of services including bill payment. *RA-3 at 7.* The merger would reduce the number of call center staff, and place PSE&G's call centers and walk-in Customer Service Centers at risk. *RA-3 at 8-12.* The Joint Petitioners' proposed consolidation of their call centers and potential elimination of walk-in centers would increase the remoteness of customer service representatives from New Jersey and thus undermine the local knowledge and local contacts that are important sources of assistance to low income customers. *RA-3 at 14-21.* Exelon's planned transition to standardized customer service functions and policies can be expected to result in a move away from PSE&G's current credit and collection policies, which provide customer service representatives with the reasonable flexibility needed to address the diverse payment troubles of low income customers, and toward the more mechanistic, computer-driven policies used by Commonwealth Edison. *RA-3 at 22-48.*

These potential impacts are detailed in the prefiled testimony of Ratepayer Advocate witness Roger Colton. *RA-3.* Mr. Colton's testimony remained virtually unchallenged. No party cross-examined him. T769:L9-18 (1/10/06). The Joint Petitioners' rebuttal testimony, while making a number of assertions about Exelon's intent post-merger, did not seriously challenge any of the wealth of factual detail contained in Mr. Colton's testimony or relied upon by him to support his conclusions about the adverse impacts likely to result from the merger. *JP-12 at 2-4, 18-19; JP-15 at 9-12; JP-16 at 15-18, JP-27 at 20-22*.

If Your Honor and the Board decide to approve the merger despite the concerns expressed by the Ratepayer Advocate, a number of conditions are needed to mitigate the adverse impacts of the merger on PSE&G's low income customers and assure that the "positive benefits" standard is met for these customers. In addition, reporting requirements are needed to allow the Board to monitor Exelon's performance in serving this vulnerable customer group. A summary of the recommended conditions is as follows:

- PSE&G should be required to maintain its sixteen Customer Service Centers, including all services currently performed at these centers, and at current staffing levels, for at least ten years following the merger.

- PSE&G currently operates a temporary service center, without a bill-payment function, in Elizabeth. PSE&G should be required, by September 1, 2006, to maintain a fully-functioning Customer Service Center in Elizabeth.

- PSE&G should file annual reports on the use of its own Customer Service Centers and authorized third-party centers for bill payment.

- The $1 fee charged at third-party payment centers should be eliminated, and PSE&G should be prohibited from imposing such fees at its own Customer Service Centers.

- PSE&G should be required to file and regularly update a report explaining and justifying the methodology it uses to make credit and collection decisions.

- PSE&G's shareholders should be required to contribute $8 million over a period of four years to New Jersey SHARES. The Company should also implement a check-off box on the customer bill for contributions to a low income crisis fund.

- PSE&G's shareholders should be required to spend $1.2 million over four years for additional outreach to encourage low income customers to apply for the federal Earned Income Tax Credit.

- PSE&G should be required to file a report detailing its procedure for negotiating deferred payment arrangements, including documentation of how it intends to advise customers at the beginning of negotiations of their right to make a down payment of less than the full amount demanded in a notice of disconnection.

- The Board should impose data reporting requirements that will allow the Board to track the impact of the merger on PSE&G's low income customers. The proposed reporting requirements would build on data already being reported by gas and electric utilities in connection with the Board's Universal Service Fund program.

The following sections below will discuss how the proposed merger can be expected to affect PSE&G's low income customers, and the conditions the Board should impose to protect and assure positive benefits for this vulnerable customer group.

2. Impact of Merger on Low-Income Customers.

The risks that the proposed merger will lead to deterioration in PSE&G's customer service performance have been previously discussed. While such deterioration would affect all of PSE&G's customers, the most serious impacts are likely to fall on PSE&G's low income customers. As explained in Mr. Colton's testimony, the merger is likely to (1) reduce the level of resources available to assist low income customers, (2) undermine the quality of the local knowledge and local contacts needed to connect low income customers with sources of bill payment assistance, and (3) replace PSE&G's credit and collection policies with a standardized, computer-driven system that is less responsive to the needs of low income customers.

3. Reduction in Level of Resources.

The proposed merger is likely to reduce two types of resources devoted to assisting low income customers: customer service personnel and funds available for crisis energy assistance. As explained in Mr. Colton's prefiled testimony, low income customers rely disproportionately on certain services. Since low income customers are disproportionately payment-troubled, they often require negotiation of deferred payment arrangements and referrals to sources of public and private payment assistance. *RA-3 at 7.* Low-income customers are disproportionately mobile, and therefore have more need for contacts with the utility to establish and transfer service. *RA-3 at 7, 27-28.* Since many low income customers do not own their homes or have long-term leases, they must often contact the utility to establish credit-worthiness in other ways. *RA-3 at 7.*

Low-income customers also rely disproportionately on walk-in customer service centers. Low-income customers without telephone service tend to rely on walk-in centers to conduct business with the utility. *Id.* Many low income customers lack checking accounts, and thus require a location to pay bills in cash. *Id. at 7, 33.* In addition, a major function of walk-in centers for low income customers is to provide a location for them to present proofs of identity and other required documentation. As an example, under PSE&G's current customer service policies, a customer seeking to commence service as a new customer at a location that has previously been disconnected for non-payment may be required to present written proof of identity and written proof of prior address. *Id. at 7-8.*

The merger could result in substantial reductions in the number of personnel available to handle personal contacts with customers. PSE&G and Exelon have already targeted a reduction of 115 call center personnel for the combined companies. *RA-3 at 9.* Further, these reductions could be only the beginning. PSE&G and Exelon have not ruled out the possibility of closing the New Jersey call centers. *Id.*

The Joint Petitioners also have not ruled out the possibility of closing PSE&G's walk-in customer service centers. *Id. at 10.* PSE&G currently operates fifteen permanent walk-in centers throughout its service territory as well as a temporary center in Elizabeth. Customers can pay a bill at any of these centers with the exception of the temporary center in Elizabeth. At all sixteen centers, customers can conduct business in person through personal contact with a customer service representative who can handle transactions including responding to inquiries about bills, negotiating deferred payment arrangements, resolving pending disconnections, and negotiating reconnections after disconnections from nonpayment. *Id.* The sixteen walk-in centers employ more than 100 company personnel and handle in excess of 2.5 *million* customer contacts annually. *Id. at 11.*

The proposed merger would place PSE&G's walk-in centers in jeopardy. Although the Joint Petitioners assert that they "do not currently plan to consolidate the in-person customer service offices throughout New Jersey," they state that "[t]the specific decisions concerning the continued operation of the Customer Service centers at their current locations will not be made until after the merger is consummated." *Id. at 10.*

Based on Exelon's current practices, it appears likely that PSE&G's walk-in centers would be a target for consolidation or elimination. ComEd, Exelon's Illinois utility affiliate, currently has no walk-in centers, and its Pennsylvania utility affiliate, PECO, has only a single walk-in center. *Id. at 10-11.* ComEd appears to have followed an aggressive policy of closing its walk-in centers beginning in the mid-1990s. As Joint Petitioners' witness M. Bridget Reidy acknowledged on cross-examination, in 1996 ComEd closed 14 of its then-existing 23 customer service centers, and limited the functions of eight of the remaining nine centers. T594L10-22. (1/9/06). By the end of 2002, all of the remaining nine centers had been closed. T594:L23 - T595:L1. *South Austin Coalition Community Council v. Commonwealth Edison Co.* ICC Dkt. No. 02-0706, Order at 2 (Jan.11, 2005) (available at: http://eweb.icc.state.il.us/e-docket/).[5]

Based on the testimony of Ms. Reidy during her redirect examination, ComEd appears to believe telephone and Internet access to be an adequate substitute for walk-in centers.

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[5] Your Honor and the Board are respectfully requested to take official notice of the referenced Order of the Illinois Commerce Commission.

> Q. Was there some change in the computer system at ComEd that allowed customers to access their accounts without having to walk into a customer service center?
> A. Well, the CIMS system that we utilized in the ComEd territory provides numerous options for our customers to interact with the system, to interact with the company in a way that they can't in PECO territory, for example, so we did put the system in at that point and gave a lot of customers a lot more options.
> Q. So ComEd has a computer system that allows its customers to interact with their accounts without having to get out of their house and go over to a service center. Is that right?
> A. That's correct.
>
> * * *
>
> Q. Have you found that customers would prefer to access their accounts through the Internet, through the telephone and interact as opposed to having to go down to a customer service center?
> A. In Illinois, about 46 percent of the transactions in the interactions that we have with our customers are through the automated system and in the PECO territory that number is about 38 percent today.

T600:L15 - T601:L21 (1/9/06). This view reflects insensitivity to the needs of low income customers. As Ms. Reidy acknowledged on recross examination, telephone and Internet access are not attractive options for customers who lack telephone and Internet service. T613:20 - T614:L15 (1/9/06).

Joint Petitioners' witness Cecil House asserts that the Ratepayer Advocate's concern about the continued existence of PSE&G's walk-in centers is "misplaced" for two reasons: (1) the BPU's regulations require BPU approval to close or relocate a walk-in center, and (2) "PSE&G has no present intention to close" any of the centers. *JP-15 at 9-10.* Mr. House's testimony does not provide sufficient assurance that the services provided by the walk-in centers will be maintained post-merger. First, Mr. House's testimony addresses only *closures*, not reductions in the functions performed by the walk-in centers. Second, during cross-examination

Mr. House acknowledged that his testimony addressed only PSE&G's *present intentions* not what PSE&G's or Exelon's intentions might be post-merger. T576:L20 - T577:L11 (1/9/06).

Post-merger decisions on all issues related to customer service will be centered in Illinois, not New Jersey. PSE&G's customer service operations are currently headed by Mr. House, as Vice President of Customer Operations. *JP-15 at 1.* After the merger PSE&G's customer service operations would become part of a single customer and marketing service organization for Exelon Electric and Gas, headed by Joint Petitioners witness Ms. Reidy, as Senior Vice President of Exelon Energy Delivery Customer Operations. *JP-16 at 2;* T590:L5-17 (1/9/06). Reporting to Ms. Reidy would be a number of vice presidents—all part of the centralized organization—responsible for different functional areas across all of the Exelon utilities. T588:L4-13; T590:L5-13 (1/9/06). This centralized organization would be responsible for PSE&G's walk-in centers, along with call centers and other functions relating to customer accounts, billing and collection. T585:L20 - T586:L6; T590:L18 - T591:L1 (1/9/06). PSE&G's "present intention" has little relevance to Exelon's intention post-merger.

It is clear from the above that the proposed merger will reduce the level of customer service resources available to serve PSE&G's low income customers. At a minimum, the positions of 115 call center personnel will be eliminated, and the Joint Petitioners have not ruled out further reductions, or even closure of the New Jersey call centers. Further, PSE&G's walk-in centers, which handle over 2.5 million customer contacts annually and provide in-person services that are relied upon by low income customers, are at risk. A merged company could not eliminate 115 or more call center positions and close some or all of PSE&G's capacity to handle walk-in contacts, while maintaining the same level of service to PSE&G's low income customers.

Another area in which the merger is likely to reduce the resources available to low income customers is support for private fuel funds. Currently, PSE&G solicits customer contributions for a private fuel fund, New Jersey SHARES, and provides some matching funds from shareholders. *RA-3 at 12-13.* While these efforts are relatively modest, they exceed ComEd's commitments in this area. ComEd makes no shareholder contributions, and does not solicit contributions, to private fuel funds. *RA-3 at 12.* T595:L22 - T597:L18 (1/9/06). Given ComEd's lack of support for private fuel funds, there is a risk that a merger could further reduce PSE&G's commitments in this area. *RA-3 at 13.*

4. Reduction in Local Knowledge and Local Contacts.

In addition to reducing the *level* of resources available to PSE&G's low income customers, cost-cutting measures by Exelon also can be expected to undermine the *effectiveness* of those resources by making customer service personnel more remote from local contacts in New Jersey. Successful resolution of low income customers' payment troubles often depends on the quality of customer service representatives' contact with the organizations providing assistance to payment-troubled customers.

It is important that customer service representative be familiar with both the types and amounts of assistance available, and how to coordinate various sources of energy assistance. *RA-3 at 14.* Beyond technical expertise, moreover, successful resolution of payment troubles often depends upon customer service representatives' relationships with the organizations providing assistance. As Mr. Colton explained, representatives of the utility and local agencies typically develop, "a trusting relationship and a shared sense of values (involving customer and company responsibilities)." *Id. at 16.* These important relationships are undermined when utilities move to remote call centers. *Id. at 16.* Utility mergers across the country have made it more difficult to resolve payment problems because customer service representatives lacked familiarity with issues such as specific policies or financial resources of local energy assistance agencies or local rules governing disconnections of service. *Id. at 16-17.*

At a minimum, the proposed merger will result in some re-routing of customer telephone inquiries to out-of-state call centers. The Joint Petitioners have stated in discovery responses that they intend to "promote some level of coordinated coverage of service territories across the Exelon system for call centers presently operated by PSE&G in NJ," an effort that will include "automatic phone call re-routing" among Exelon's utility affiliates. *Id. at 15.* Moreover, as noted above, the Joint Petitioners have not ruled out the possibility of closing the New Jersey call centers, or closing some or all of PSE&G's walk-in customer service centers.

The Joint Petitioners state that they intend to cross-train the non-New Jersey-based representatives to deal with New Jersey issues. *Id.* Such training is not a complete substitute for continuing local contacts. The knowledge base needed to resolve low income customers' payment troubles "comes from repeated local involvement in problem resolution." *Id. at 17.*

Another cause for concern is the level of Exelon's commitment to finding and referring customers to sources of assistance. In a response to a Ratepayer Advocate discovery request, Exelon's Illinois utility affiliate, ComEd, stated that it does not refer customers to sources of private fuel assistance. *Id. at 19.* In addition, Exelon's current utility affiliates devote a lower level of resources than does PSE&G to helping low income customers find resources to pay their utility bills. PSE&G has an annual budget of $1.4 million devoted to outreach to a variety of sources of assistance. *Id.* In addition to promoting programs specifically geared to energy assistance, PSE&G promotes programs such as the federal Earned Income Tax Credit ("EITC"), which is frequently used to pay utility bills. *Id. at 20, 58.* By contrast, PECO spends $200,000 annually, and ComEd spent $214,000 on outreach for the federal Low-Income Home Energy Assistance Program ("LIHEAP") program. Unlike PSE&G, neither PECO nor ComEd promotes programs other than LIHEAP. *Id. at 20.*

Finally, the proposed merger of PSE&G into a large, multi-state organization can be expected to lead to a reduced emphasis on the specific needs of PSE&G's customers in New Jersey. Needs created by local developments such as plant closings are likely to be less well served by a non-local company. Examples of local issues being addressed by local utility representatives include the economic fall-out to the airline industry in Pittsburgh in the post 9/11 environment, "walk away homes" in New Orleans, and low income customers living in rural areas in Iowa who were difficult to reach via traditional print and electronic media. *Id. at 21.* A large multi-state organization can be expected to have less familiarity with and concern about developments unique to New Jersey.

5. Less Responsive Credit and Collection Policies.

The proposed merger will place at risk a number of policies that currently allow PSE&G's customer service representatives the flexibility to address the payment troubles of its low income customers in ways that make business sense for the company. ComEd, by contrast, "appears to rely on an automated, mechanistic approach, leaving little room for the use of customer service representative discretion in working with the unique circumstances of individual customers." *RA-3 at 22.* The Joint Petitioners have acknowledged that they intend to standardize customer billing and payment processes across Exelon's utility affiliates, a process that has already begun for PECO. *Id. at 23.* As was made clear during the cross-examination of Joint Petitioners' witness Ms. Reidy, this standardization process will be directed by the Exelon executives who will oversee a single, multi-state, customer service organization. T587:L15-24;

T589:L18 - T590:L17 (1/9/06). Thus, PSE&G's current policies can be expected to migrate toward the more mechanized, computer-driven system now in place at ComEd. *Id. at 23.*

Some specific examples of the kinds of changes that can be expected post-merger are discussed in Mr. Colton's testimony. In the event of a merger, PSE&G's low income customers can expect to see harsher, less flexible policies with regard to deposit requests, payment options, collection procedures, and deferred payment arrangements. Some of the differences between the policies of PSE&G and the two current Exelon utility affiliates are discussed below.

<u>Deposit Requests</u>. According to ComEd's training materials for customer service representatives, the company's computer system "automatically requests a deposit for all accounts as provided for under the Illinois Commerce Commission guidelines." *Id. at 25.* For customers switching service to another location, these criteria include all customers having a past due balance of $10 or more from a previous residential account. *Id. at 26.* PSE&G provides a higher degree of customer protection, requesting deposits only for customers seeking to transfer service only if the customer has received a shutoff notice. *Id. at 26-27.* PSE&G, moreover, allows its customer service representatives to waive deposit requests using their exercise of "good judgment" based on the customers' overall payment history. *Id. at 38-39.*

<u>Payment Options</u>. PSE&G customers wishing to pay their bills in cash have two options. They may pay at any of 15 PSE&G walk-in centers, with no extra charge, or they may pay at one of approximately 230 Western Union agents, which charge a $1.00 transaction fee. In either event, the payment will be posted to the customer's account on the same day the payment is made. *Id. at 29.* Neither ComEd nor PECO provides a no-cost payment option. ComEd maintains no utility operated walk-in centers. *Id. at 30.* While PECO maintains a walk-in center at its main office building, the payment function is outsourced to a vendor that charges a

"convenience fee" of up to $1.00. *Id. at 30-31.* Further, both ComEd and PECO accept payments through "unauthorized" agents, a process that can result in a significant delay in the posting of the payment to the customer's account. *Id. at 31.* Additionally, both ComEd and PECO rely heavily on check-cashing outlets as payment stations. Specifically, nearly half of PECO's outsourced payment stations, and more than 40% of ComEd's, are check cashing stations, compared to about 15% for PSE&G. *Id. at 32.* As Mr. Colton explained, Exelon's heavy reliance on check-cashing outlets encourages the use of these facilities, which typically charge high fees to convert paychecks to cash. *Id. at 32-33.*

<u>Collection Activities</u>. ComEd's collection activities are driven by computer-generated credit assessments, with little or no room for the exercise of discretion. In fact, ComEd's customer service representatives are specifically cautioned against making adjustments to the computer-generated credit assessment based on the personal knowledge of the representatives. *Id. at 37.* PSE&G, by contrast, directs its customer service representatives to exercise "tact and restraint" in dealing with its customers, and to use credit assessment codes to "help in making collection decisions" concerning individual customers. *Id. at 39.*

<u>Deferred Payment Arrangements</u>. ComEd also provides its customer service representatives with little discretion to negotiate deferred payment arrangements. When a customer requests a deferred payment arrangement, the customer service representative accesses the computer system, which generates a "System Generated Contract" specifying the down payment amount (in the maximum amount allowed under Illinois regulations), the number of installments, and the installment amounts. *Id. at 40-42.* PSE&G's policies, by contrast, allow its customer service representative some discretion in establishing the amount of the down payment, and "significant latitude" in establishing the length of the deferred payment arrangement. The

emphasis is on establishing "a reasonable payment plan the customer can meet," rather than applying a computer-generated plan. *Id. at 44-45.*

As Mr. Colton explained, there is room for improvement in PSE&G's process for negotiating deferred payment plans. Specifically, PSE&G's customer service representatives are directed to begin the negotiation by demanding payment of the full amount of the outstanding bill. Then, if the customer cannot pay that amount, the customer service representative is directed to request the full amount appearing on the notice of disconnection or other activity, and, if the customer cannot pay that amount, an amount "close" to the notice amount. *RA-3 at 46.* This practice appears inconsistent with BPU regulations, as it requires customers to reject three successive demands before being advised that they are entitled by regulation to a deferred payment arrangement provided they make a down payment of "up to 25%" of the delinquent amount. *Id. at 46-47, N.J.A.C.* 14:3-7.13(c). Nevertheless, PSE&G overall allows for more discretion in negotiating a deferred payment arrangements than does ComEd.

It is clear that the merger is likely to result in the adoption of policies that will limit customer service representatives' flexibility in dealing with the payment troubles of low income customers. A computer-driven mechanistic standardization process directed by Exelon executives in Illinois can be expected to result in a move toward the harsher, less flexible policies currently being followed by ComEd and PECO.

6. Recommended Conditions.

If Your Honor and the Board should decide to approve the proposed merger despite the concerns expressed by the Ratepayer Advocate, the merger should be subject to a number of conditions to address some concerns with the current quality of service to PSE&G's low income customers, and to assure that these customers suffer no adverse impact and receive positive benefits as a result of the merger.

7. Walk-in Centers.

The Service Quality section above discusses the Ratepayer Advocate's recommendation that PSE&G be required to maintain its New Jersey call-in centers for a minimum of four years post-merger, in order to maintain the quality of customer service for all customers. In addition to this requirement, there is a need to maintain PSE&G's walk-in Customer Service Centers. In view of the crucial importance of walk-in centers for low income customers, and Exelon's apparent policy against maintaining walk-in centers, the Ratepayer Advocate is recommending that any merger approval be conditioned on a requirement that PSE&G maintain all of its walk-in centers for a period of at least ten years. The walk-in centers should be required to continue performing all of the services they currently perform, and should be maintained at current staffing levels. PSE&G should be required to seek Board approval for any closures, reduced staffing, or change in functions after the ten-year period.

8. Elizabeth Walk-In Center.

As discussed above, PSE&G is currently operating a temporary walk-in center, with no bill payment function, in Elizabeth. This situation should be remedied as a condition of the merger. PSE&G operated a full-service customer service center at 531 North Broad Street in Elizabeth until May 2003, when it was forced to vacate this location as a result of the New Jersey School Construction Corporation's exercise of its eminent domain authority. EE03020120 *I/M/O PSE&G Request for Closure of the Elizabeth Customer Service Center*, BPU Dkt. No. EE03020120, Order at 1 (May 12, 2003). The Board authorized PSE&G to close this office, but subject to conditions requiring PSE&G to open a temporary facility within Elizabeth and to provide weekly reports on its progress toward opening a new permanent center in Elizabeth. *Id. at 4-5.* Despite the passage of nearly three years since the Board authorized the closure, the company has not yet opened a permanent, full-service center. As of July 2005, the Company reported that it had identified a possible site for a permanent center and estimated a time frame of 18 to 24 months to obtain the necessary approvals and complete work on the permanent center. *RA-3 at 50-51.* In this prefiled rebuttal testimony Joint Petitioners' witness Mr. House expressed confidence that a new location for the permanent center could be found by early 2006. *JP-15 at 10.* More recently, Joint Petitioners' witness Mr. Izzo testified at the evidentiary hearing in this matter that PSE&G has signed a lease for a permanent center, and that the center "should become operational in August of this year" T3406:L21-T3407:L5; TR-3408 (3/31/06). Based on PSE&G's estimated time, as most recently updated by Mr. Izzo, September 1, 2006 would be a reasonable deadline for the company to open a permanent center in Elizabeth. In view of the length of time it has taken PSE&G to accomplish this task, a sanction of $20,000, to be used for low income assistance in Elizabeth, should be imposed for each month after September 1, 2006 a permanent center is not in operation. *RA-3 at 49 - 52.*

9. Customer Payment Centers.

The Ratepayer Advocate is further recommending conditions to preserve customers' ability to make a cash payment, and to remedy the current inequity resulting from the transaction fees currently charged at PSE&G's authorized Western Union payment centers. First, PSE&G should be required to file an annual report containing information on the use of walk-in payment locations for purposes of bill payment. The report should include both company-operated centers and Western Union offices, and should include monthly data on the number and amounts of payments received at each location. The reports will allow the Board to assure that customers' ability to make cash payments does not deteriorate following the merger.

In addition, the Board should require PSE&G to absorb the transaction fees charged by Western Union payment centers and prohibit the company from imposing such fees in the future at PSE&G's company-operated walk-in centers. While a fee of $1.00 per month may appear small, it can place a significant burden on a household living in poverty. As the Mayor of Elizabeth stated in correspondence filed with the Board in connection with the closure of PSE&G's Elizabeth walk-in center, ". . . it may be an easy thing for some to dismiss a $1.00 processing charge, but with our poverty rate at 18 percent, I urge the Commission to consider what $12 can mean to a struggling family or senior citizen—a pair of new shoes, 48 boxes of macaroni, 300 slices of bread. For those of our community members who work hard and spend smart to keep their budget needs afloat, these items are critical. Every dollar is critical." *RA-3 at 53.* PSE&G currently absorbs, and includes as part of its overall rates, the costs of other bill payment options. For example, PSE&G does not charge a transaction fee to cover the cost of processing customers' checks, or to cover the charges the company pays to an outside vendor to handle withdrawals from the accounts of customers who use the company's automatic payment option. *Id. at 53.* Low-income customers who need to pay their bills in cash should be placed on the same footing as customers with other options.

10. Justification of Risk Assessment Methodology.

In order to assure that PSE&G's credit and collection practices are appropriately documented and justified, and are fair to PSE&G's customers, the Board will need information concerning those practices as they currently exist, and as they may change following the merger. The Ratepayer Advocate therefore is recommending that PSE&G be required to file with the Board, with a copy provided to the Ratepayer Advocate, a detailed explanation of, and justification for, the credit risk scoring system it currently uses for purposes of determining whether to request security deposits and to implement other credit and collection measures. The initial filing should be updated to reflect any changes that occur following the merger. The filings should be subject to hearing upon complaint by the Ratepayer Advocate or other interested party, or on the Board's own motion, to assure that it meets the following criteria:

- The data used to develop the system must constitute an appropriate sample of the customer base;
- The system should predict customer creditworthiness with respect to explicitly articulated legitimate business interests of the Company;
- The "risk assessment" measures should be developed and validated using accepted statistical principles and methodology; and
- The "risk assessment" measures should be periodically reviewed and revalidated as to their predictive ability and adjusted accordingly.

The recommended filings will allow the Board, the Ratepayer Advocate, and other interested parties to assure the fairness of PSE&G's credit and collection practices as they currently exist and as those practices change following the merger.

11. Private Fuel Fund Contributions.

As a condition of the merger, PSE&G should be required to file an action plan in which it commits to assuring that New Jersey SHARES, which serves customers in need of bill-payment assistance who do not qualify for other forms of assistance, remains meaningfully funded. The plan should include both shareholder contributions and efforts to solicit customer contributions. Initially, PSE&G's shareholders should be required to contribute $8 million to New Jersey SHARES over a period of four years. This amount is consistent with the commitment made in connection with the Pennsylvania Public Utilities Commission's approval of the PECO-Unicom merger and the proposed PSE&G-Exelon merger, taking into account PSE&G's much larger residential customer base. *RA-3 at 56.* Further, PSE&G's current shareholder contributions should be indexed to changes in the Consumer Price Index (Urban consumers) for energy prices. *Id. at 57.* PSE&G should also implement a check-off system to allow customers to contribute to a low income crisis assistance fund when they pay their utility bills. *Id. at 56.*

12. Earned Income Tax Credit Outreach.

As a further mitigation measure, PSE&G should also be required to commit to spending $1.2 million over four years on additional outreach to encourage low income customers to apply for the federal Earned Income Tax Credit ("EITC"). The EITC is particularly helpful to low income utility consumers, as the payments are received at the end of the winter when bill payment problems tend to be particularly severe. *RA-3 at 57-58.* The proposed outreach budget is consistent with the budget for low income rate assistance agreed to in the Pennsylvania proceeding for approval of the proposed PSE&G-Exelon merger. *Id. at 58-59.*

13. Deferred Payment Plan Negotiation Procedure.

PSE&G should be required, as a condition of the merger, to remedy its current failure to advise customers on a timely basis of their right to enter into a deferred payment arrangement which does not require them to pay the full notice amount as a down payment. As discussed above, a customer must reject at least three down-payment proposals by PSE&G before being advised of the customer's rights under the Board's regulations governing deferred payment plans. PSE&G should be required to file with the Board, with a copy to the Ratepayer Advocate, a plan documenting how it intends to inform all customers of their rights under the Board's regulation at the beginning of their negotiations with the company.

14. Low-Income Collections Reporting.

In addition to the specific conditions detailed above, the Board should establish as a principle for this and future mergers that the merger will not be allowed to create adverse impacts on low income customers. Since it is impossible to review each reduction in staff, and each change in operations and policy, to determine whether low income customers have been adversely affected, the Board needs information that will allow it to evaluate the overall impact of the merger on low income consumers. The Ratepayer Advocate recommends that the Company be required to file, for ten years following the merger, annual reports containing monthly data relating to collection outcomes for PSE&G low income customers. Copies of the reports should be provided to the Ratepayer Advocate. The data should be reported for all PSE&G customers participating in the Board's Universal Service Fund program, as well as all customers whose accounts bear a "Pay Assist Code" used for purposes of determining eligibility for the Winter Termination Program. The following specific data elements to be included in the recommended reports are as follows:

Data to be Included in Collections Report
For Confirmed Low-Income Customers

Report	Frequency	Notes
Number of confirmed low income customers	Monthly	
Distribution of full retail bills	Monthly	
Number of accounts	Monthly	Active accounts
Number of discontinuance (i.e., disconnection) notices	Monthly	
Number of Fresh Start* reminders	Monthly	
Number of Fresh Start* final reminders	Monthly	
Telephone contacts	Monthly	Tracking inbound and outbound calls should occur separately if available through USF.
Number of residential field visits	Monthly	
Number of residential terminations	Monthly	
Number of residential reconnections	Monthly	
Charge-Offs (Gross)	Monthly	Number of accounts and total dollars
New deferred payment arrangements	Monthly	

Data to be Included in Collections Report For Confirmed Low-Income Customers		
Report	**Frequency**	**Notes**
Distribution of overdue accounts by dollar amount	Monthly	Number of accounts and total dollars (1-100, 101-500, 500-1000, 1000+)
Distribution of overdue accounts by payment status (i.e., current, 30 days, 60 days, 90 days or more)	Monthly	Number of accounts and total dollars

* The Fresh Start program is a component of the USF Program that allows participants to earn forgiveness arrearages accumulated before they began receiving USF benefits by paying their current utility bills.

RA-3 at 71, Schedule RDC-8. The recommended reports build on the reporting requirements already implemented by the Board in connection with its Universal Service Fund program, and therefore should not be unduly burdensome for PSE&G.

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

A. Impact of the Merger on Distribution Rates.

Another area that Your Honor and the Board must examine is the proposed merger's effects on rates. While the Joint Petitioners have belatedly made an offer to reduce PSE&G's rates over the next three to four years post-merger, that offer has been reviewed and found wanting. The Ratepayer Advocate continues to recommend that the proposed merger petition be rejected even as amended orally by Exelon's witness, John Rowe, at the January 4, 2006 evidentiary hearing.

Concerning the proposed merger's affect on rates, the Ratepayer Advocate presented the expert testimony of David E. Peterson. Mr. Peterson found that the proposed merger does not adequately protect New Jersey ratepayers. *RA-10 at 4.* When Mr. Peterson's direct testimony and surrebuttal testimony were first filed, the original merger petition did not include any immediate rate reductions post-merger. The Joint Petitioners eventually realized that this position was totally unreasonable and amended their petition by proposing a rate reduction of $120,000,000 to be spread over three or four years post merger.

As Mr. Rowe stated:

> With respect to merger synergy, Exelon and PSE&G are willing to commit to refund 120 million dollars to PSE&G's customers through rate credits, commencing within 30 days of closing the merger. . . . We suggest these rate credits of 120 million be provided to customers over a three or four year period, to help offset other costs increases. After that we would expect to file a rate case with the Board when PSE&G's operating cost [sic] reflect the efficiency that Mr. Arndt described, as well as other cost changes which this Board is familiar with.

T79:L14 to T80:L3 (1/4/06).

When asked for more details about the proposal, Mr. Rowe declined to provide more, but basically suggested that the parties try to work out the details in a settlement of the case.

> Q. And can you provide any more details about the rate credit other than it would be 120 million dollars over three or four years?
>
> A. I cannot remember detail of how PSE&G's overall rate situation works, which are to some extent beyond my can [sic] and our best workout [sic] with this in the context of other issues that are before this Board.
>
> Q. All right. I'm going to ask you a few questions about it anyway and then if you don't have any additional information, that's fine. But is the proposal 120 million dollars per year?
>
> A. No, sir. It is over three or four years.
>
> Q. And this proposal to be evenly over those three for [sic] four years, if it was three years would it be 40 million per year or there is not much detail?
>
> A. I think that is one way it could be done, sir.
>
> Q. And is the proposal to reduce gas and electric distribution rates by the 120 million dollars or would it just be electric?
>
> A. Well, we thought of it in terms of electricity because that is where the bulk of the synergies probabilities are, but if in working things out with you and the Staff you wish to share it differently, that would be a proper matter for negotiation. We're very sympathetic to where the most immediate burdens on customers are.

T88:L2 to T89:L7 (1/4/06).

The Ratepayer Advocate believes that it is inappropriate for the Joint Petitioners to make a rate credit proposal leaving the details so open-ended and then ask the parties to negotiate its terms. Unfortunately, that method of operation is characteristic of how cavalierly the Joint Petitioners have treated this entire merger review process. They have repeatedly made promises of benefits without details and hard evidence to support them and left the parties, Your Honor and the Board to attempt to fill in the details from an inadequate record. It should not avail the Joint Petitioners anything that the record in this case is so large or that discovery has produced so many pages of documents when it is the quality of the proofs that matters, not the quantity. The Joint Petitioners have not provided a sufficient quality of proofs to carry their burden of demonstrating enough positive benefits from this merger and without adverse impacts to justify approving the merger petition.

Mr. Rowe testified that the Joint Petitioners drew the $120,000,000 rate credit figure from their estimates of the kind of synergies described in the synergy study performed by their witness, William D. Arndt. T89:L19-21 (1/4/06). However, as compellingly described in the testimony of the Ratepayer Advocate witness, Mr. Peterson, Mr. Arndt's study had several flaws that Mr. Peterson was required to fix.

One flaw was the failure of Mr. Arndt to abide by the Board's practice of using a ten-year period to calculate synergy savings and costs to achieve. *RA-10 at 8.* The Joint Petitioners' synergy analysis only covered four years after the merger, which was assumed to be the years 2006 through 2009. *Id. at 7.* Mr. Peterson testified that it is preferable to use a ten-year analysis because the anticipated savings from the merger are long-term in nature and will extend well beyond the four years included in the Joint Petitioners' analysis. *Id. at 8.*

Other parties to this case also considered a ten-year analysis more appropriate, and the Joint Petitioners extended their analysis for six additional years. *RA-10, Exhibit DP-1.* The ten-year analysis shows that PSE&G's share of net savings over that time frame was estimated to be approximately $503.8 million. *Id. at 9.* As Mr. Peterson testified, unfortunately the veracity of the estimated savings and costs to achieve cannot be verified for the reasons discussed below.

Mr. Arndt's study assumes that over 50 percent of the projected gross synergies would come from jobs that will be eliminated following the merger. However, the Joint Petitioners' working groups that provided data for the synergy analysis performed no formal workforce requirement studies. Nor have the Joint Petitioners undertaken any formal study of their post-merger workforce requirements. Because over one-half of the expected synergies are from assumed personnel reductions, over which Exelon has considerable control, Exelon has it within its power to meet and even to significantly exceed the level of synergies shown in Mr. Arndt's study by the employment policies it adopts post-merger, which have not been shared with the parties in this proceeding. Thus, the parties, Your Honor and the Board have no way to verify these and the other synergies projections included in Mr. Arndt's analysis prior to the closing of the merger. *Id. at 11.* Once again, while the effort that went into producing the Joint Petitioners' study may have been prodigious, the quality of the study is grossly lacking. This is another aspect of this case in which the Joint Petitioners have favored the quantity of data over the quality of it.

Mr. Arndt alleged that the synergy study was indeed verifiable, but this allegation was totally refuted by Mr. Peterson. *JP-29 at 3, 10-12; RA-15 at 2-3.* Mr. Arndt seems to believe that it is enough for the Joint Petitioners to allege that the workforce reductions (and the related synergy savings) are "reasonable and attainable." While the estimated reductions may be reasonable and attainable, the Joint Petitioners have repeatedly refused to state that the estimates used in the study will in fact reflect how the merged company operates after the merger closing. Until the parties, Your Honor and the Board have assurances that the merged company will actually operate according to the plan used to create the synergy study, the reliability of the study remains in question. The Joint Petitioners have had several opportunities to lay this question to rest, but they have repeatedly refused to do so. They alone must bear the brunt of this refusal, not the ratepayers or the State of New Jersey.

Although the Ratepayer Advocate continues to believe that the synergy study is not verified or verifiable, we have tried to improve it and make it a more useful tool in deciding what conditions should be placed on the merger approval if Your Honor and the Board should decide that the merger may go forward. For instance, Ratepayer Advocate witness, Mr. Peterson, identified other savings opportunities that were not included in the synergy study. The Joint Petitioners have emphasized that one of the benefits to the merged company would be increased financial strength and flexibility. These alleged benefits could create significant cost savings for the New Jersey utility, but no savings estimates to reflect the additional financial strength and flexibility have been included in the study. One example is the Joint Petitioners' claim that PSE&G's participation in the utility money pool could save short term debt costs in the range of five to ten basis points. *RA-10 at 11.* Another Ratepayer Advocate expert witness, Matthew I. Kahal, discussed the benefits that the Joint Petitioners may enjoy through a reduced cost of common equity. The Joint Petitioners did not take the opportunity to include this type of savings in the study.

Another major issue concerning the synergy study involves the costs needed to accomplish the merger ("costs to achieve"). The Joint Petitioners have allocated to PSE&G $138,450,000, or approximately 39% of the total costs to achieve. *RA-10 at 12.* Mr. Peterson discovered, however, that many of the claimed merger-related costs should not be the responsibility of PSE&G customers.

One category of such costs that the Board previously decided not to charge to ratepayers is "merger transaction costs." Mr. Peterson cited the Board's order in the Conectiv-Pepco merger docket. In that order the Board decided as follows:

> The position that shareholders absorb merger transaction costs represents part of the Board's commitment to balancing interests

> since it is the shareholders who receive the benefit of any increased share value from the merger and who also share in the merger savings.

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. Mr. Peterson found that removing the merger transaction costs from the amounts that could be netted against gross merger savings would reduce PSE&G's share of costs to achieve by $8,046,000. *RA-10 at 14.*

Another category of costs to achieve that should be disallowed in this matter is the severance payments to corporate executives who lose their positions due to the merger. These types of costs are commonly called "golden parachutes." The synergy study includes $70.7 million severance payments for 35 senior level positions assumed to be eliminated, or an average of over $2 million per executive. *Id.* On the other hand, the synergy study estimates an approximate $74,000 per person for severance payments for other non-executive employees. Mr. Peterson testified that since it is the executives who are largely driving this merger, they should not be permitted to promote their self- interests at the expense of ratepayers by including the golden parachute costs in the recoverable allowance for costs to achieve. *Id.* He also included in his testimony the fact 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.) *Id.* Removal of the golden parachute payments would reduce the costs to achieve that could be netted against gross savings by $10.181 million. *Id. at 14-15.*

Mr. Peterson also removed $1.492 million allocated to PSE&G for costs incurred to retain certain corporate and administrative employees post-merger. *Id. at 15.* Here again, it was the executives who decided to propose this merger and create a situation where it is financially lucrative for certain employees to leave the company, a situation of their own creation. The Ratepayer Advocate agrees that customers should not be responsible to reimburse the Joint Petitioners for retention benefits paid to corporate and administrative employees who now have an incentive to leave the company because of the merger.

Approximately $700,000 for costs due to signage changes allocated to PSE&G should also be removed. *RA-10 at 15.* Ratepayers will not benefit from the proposed changes in signs and stationery and should not bear these costs. The Joint Petitioners have said that PSE&G will maintain its corporate identity so that the New Jersey utility's image would remain prominent on all signs, stationery, communications, etc. Including the Exelon corporate logo on these items only promotes Exelon's corporate branding, would not benefit the ratepayers, and would likely create some confusion. These are all good reasons to remove these costs.

Another issue that needs to be addressed is the alleged goodwill premium of $3.363 billion that the Joint Petitioners would allocate to PSE&G. Mr. Peterson testified that the goodwill premium does <u>not</u> represent an out-of-pocket expense associated with the merger. Under the purchase accounting method required by Generally Accepted Accounting Principles, a goodwill premium arises when the purchase price exceeds the fair value of the assets and liabilities to be acquired. The purchase accounting method is a fair value business combination because the assets and liabilities of the acquired company are recorded at their market values at merger closing. Any excess of the acquisition price over the fair value of the net assets acquired is recorded as goodwill. *Id. at 17.*

A goodwill premium arises when there is an increase in the liability side of the balance sheet that is not matched by any corresponding increase in the physical or monetary assets of the corporation. The goodwill premium is a bookkeeping entry necessary to create the "balance" in the balance sheet, but does not represent any increase in the physical or monetary assets of the corporation. If an acquisition results in an increase in the physical or monetary assets, then the increase in those assets would create the bookkeeping balance necessary to offset the increase in liabilities. In that situation, there would be no need for an accounting entry to record a goodwill premium. *Id. at 18.*

Mr. Peterson recommends that PSE&G's rates not reflect an amortization of goodwill premium. *Id.* The goodwill premium does not represent any new facility or equipment that will be devoted to public service. It is only an accounting mechanism to reconcile the assets and liabilities acquired in the merger with the purchase price. Because the goodwill premium does not represent acquired facilities that are being devoted to public service, it would be unreasonable to charge customers for it. Mr. Peterson further stated that the prohibition against recovering a goodwill premium from ratepayers derives from the fact that the premium normally does not represent capital devoted to public service matched by a corresponding investment in new physical or monetary assets. Instead, it represents capital devoted to a transfer of financial interests from one group of shareholders to another. Customers do not participate in the transaction and do not receive any *per se* benefit from it, anymore than they do from the daily transactions of the utility's common stock.

Ratepayers should be no more responsible for paying for the goodwill premium than they are for compensating investors for the day to day fluctuations in the market price of Exelon's common stock. In this way, the proposed transaction between Exelon and PSEG differs from daily stock market transactions only in form, not in substance. The merger savings that are due to PSE&G's customers should not be reduced by any amortization of the goodwill premium in rates. *Id. at 19.*

Having made his entirely appropriate and necessary adjustments to the synergy study of the Joint Petitioners, Mr. Peterson then calculated a rate benefit for the customers of PSE&G that should be implemented at the merger closing if Your Honor and the Board should decide the merger may go forward.

Mr. Peterson's Exhibit DP-2 attached to his November 28, 2005 prefiled testimony (RA-10) contained his original development of the rate adjustment. This schedule reflected the adjustments to Mr. Arndt's claimed merger-related costs referred to above. This schedule also reflected $11 million in annual synergy savings from a reduction in PSE&G's cost of equity capital resulting from the merger, as explained in the testimony of Ratepayer Advocate witness Mr. Kahal. Further, it was based on a ten-year amortization of the remaining costs to achieve, so as to better match cost recovery with anticipated merger-related benefits. Normally, the Board establishes rates that all parties expect to be effective for more than one year. That is, we do not usually anticipate annual base rate filings. Therefore, Mr. Peterson recommended that PSE&G's rates be reduced by an amount that reflects anticipated net savings over the first three years post-merger. Using a simple annual average net savings over the first three years post-merger, PSE&G's rates would be reduced by $42,694,000 per year.

However, counsel for the Joint Petitioners produced at the January 11, 2006 evidentiary hearing three pages from the workpapers for Mr. Arndt's synergy study that were marked into evidence as Exhibit JP-114. T984:L9 to T985:L1 (1/11/06). This document contained Mr. Arndt's calculation of synergy savings related to transmission service provided by PSE&G.

Counsel for the Joint Petitioners asked Mr. Peterson to assume that in PSE&G's last base rate case the Board removed from the revenue requirements any items related to transmission service. T986:L6-10 (1/11/06). Mr. Peterson agreed that assuming counsel for the Joint Petitioners was correct that transmission service is not included in PSE&G's Board-regulated rates, then it would be appropriate to remove the net transmission-related synergy savings from his calculation of the rate reduction. T987:L5-9 (1/11/06).

Referring to Exhibit JP-114, counsel for the Joint Petitioners alleged that removing the transmission-related items would decrease Mr. Peterson's rate reduction by approximately $5 million per year. T987:L10-23 (1/11/06). However, a more in-depth examination of that exhibit shows clearly that the $5 million per year relates only to the "Total Utility Savings" not the "Net Regulated Savings."

The Net Regulated Savings are the savings after deducting the Regulated Costs-to-Achieve and Regulated Pre-merger Initiatives. *JP-114.* Once those items are deducted, the Net Regulated Savings related to transmission services for the three years from 2006 to 2008 are approximately $5.2 million. Averaging the $5.2 million over the three years produces approximately $1.7 million per year that could be deducted from Mr. Peterson's original $42.7 million annual rate reduction.

The Ratepayer Advocate has attached to this initial brief as Attachment A the calculation of the annual rate reduction of $40,965,000 after removing the items related to transmission service. Assuming that the Joint Petitioners are correct that PSE&G's Board-regulated rates do not include any accounting for transmission services, the Ratepayer Advocate would recommend that the annual rate reduction for the three years post-merger be $40,965,000. This latter amount should be allocated between PSE&G's electric business unit and gas business unit according to the calculation made by the Ratepayer Advocate witness Robert Henkes which is also reflected on Attachment A, i.e., $24,759,000 would be allocated to the electric business unit ("EBU"and the remaining $16,206,000 would be allocated to the gas business unit ("GBU").

However, before Your Honor and the Board decide to reduce Mr. Peterson's original calculation of $42,694,000 per year, the Joint Petitioners should be required to provide to Your Honor and all parties incontrovertible proof that their assumption is in fact correct.

VII. IMPACT OF THE MERGER ON PUBLIC UTILITY EMPLOYEES.

Approximately 54% of the anticipated merger savings for regulated operations are expected to come from reductions in workforce requirements after the merger. The Joint Petitioners have announced that they expect to eliminate 1,400 to 1,500 positions across all the merged companies including regulated and non-regulated companies by doing away with redundant positions. The job reductions are not expected to exceed 950 in New Jersey, 250 in Pennsylvania and 300 in Illinois. However the precise positions to be eliminated and their locations have not been revealed. *RA-10 at 21.*

Furthermore, the Joint Petitioners have not performed a detailed and formal workforce requirements study for the post-merger operations. *Id.* The synergy study presented by the Joint Petitioners includes job reductions within the corporate, shared services, and utility support centers. The study presumes 528 personnel reductions out of 2,848 corporate and shared services positions. However, the Joint Petitioners refuse to commit that the post-merger workforce will actually reflect the assumptions in the synergy study.

Originally, the only assurances that the Joint Petitioners offered on this issue were commitments to honor existing collective bargaining agreements, pension agreements and retirement obligations. In response to this lack of commitment, Ratepayer Advocate witness, Mr. Peterson, recommended that PSE&G field level workers should be protected post-merger. *RA-10 at 23.* More specifically, he recommended that the Board require the Joint Petitioners to commit to a moratorium on reductions in field level positions for 36 months post-merger, other than for normal turnover. *Id.* Mr. Peterson believed that this commitment was necessary to ensure that field level positions would not be eliminated for the purpose of meeting corporate synergy and earnings projections in a manner that would jeopardize service reliability.

However, in November 2005 the Joint Petitioners were able to reach an agreement with the bargaining units of PSE&G, PSEG Services and PSEG Power. That agreement provided that there would be no forced layoffs among the bargaining unit employees during the life of the existing contracts which are expected to terminate April 30, 2011. *JP-27 at 7;* T992:L15-19 (1/11/06). Since that timeframe is longer than Mr. Peterson's 36-month moratorium, he stated that the Joint Petitioners had essentially complied with his recommendation. T992:L20-25 (1/11/06).

Mr. Peterson also stated that the Ratepayer Advocate had concerns that reductions in the New Jersey workforce should be implemented fairly, that departing employees be given reasonable severance packages and that Exelon employees must not be given job preference simply because of their present location. He further noted that the majority of corporate headquarters operations will likely remain in Chicago after the merger closes and that PSEG corporate and shared services employees will likely experience more than a ratable share of elimination of redundant positions. *RA-10 at 22.*

The Ratepayer Advocate continues to maintain these concerns even in the face of the Joint Petitioners' agreement with the various bargaining units. Because the Joint Petitioners refuse to identify the specific positions that will be eliminated and their locations, the Ratepayer Advocate respectfully submits that the Joint Petitioners have not carried the burden of proving that the proposed merger will have any positive benefits for New Jersey employees or even that the employees will not be adversely affected. For these reasons, the Ratepayer Advocate respectfully recommends that Your Honor and the Board reject the merger proposal.

VIII. IMPACT OF THE MERGER ON COMPETITION.

A. Introduction.

The size of the proposed merger is unprecedented. The proposed merger would create a new company, Exelon Electric & Gas Corporation ("EEG") with a very significant presence in the PJM Interconnection, LLC's ("PJM") control area. Post-merger, EEG would own approximately 40,475 MW of capacity in PJM Expanded, pre-mitigation, and 34,000 MW of capacity if the Joint Petitioners' mitigation plan is approved and implemented.[6] Pre-mitigation, EEG's share of capacity would amount to approximately 23.0 percent of the total capacity in the PJM Expanded footprint. If the Joint Petitioners' mitigation plan is approved and implemented, EEG would still own 34,000 MW, or approximately 19.2 percent, of the total capacity in PJM Expanded. *RA-5* at 16. In PJM East, EEG would own more than 11,900 MW, or 28.7 percent, of the capacity even if the Joint Petitioners' mitigation proposal is implemented. *RA-5* at 17. Clearly, the combined entity would be a giant in PJM.

In summary, as set forth below and in the testimony of the Ratepayer Advocate's witnesses,[7] it is reasonable to expect that the combined entity created by the proposed merger will be able to exercise market power in the relevant electric markets. For this reason, the Ratepayer Advocate respectfully recommends that Your Honor and the Board reject the proposed merger. However, if Your Honor and the Board decide to approve the proposed merger, the following measures should be applied, with respect to the electric markets:

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[6] *JP-6 Suppl.*, Exhibit RF-8 at 2.

[7] With respect to electric market power, on November 14, 2005 the Ratepayer Advocate submitted the testimony of Messrs. Bruce Biewald, Robert Fagan, and David Schlissel of Synapse Energy Economics, Inc. ("Synapse"), *RA-5* (Redacted) and *RA-6* (Confidential). On December 27, 2005, the Ratepayer Advocate submitted the surrebuttal testimony of Messrs. Bruce Biewald, Robert Fagan, and David Schlissel of Synapse, *RA-16* (Redacted) and *RA-17* (Confidential). On March 17, 2006, the Ratepayer Advocate submitted the supplemental testimony of Messrs. Robert Fagan and David Schlissel of Synapse, *RA-62*. With respect to gas market power, on November 14, 2005, the Ratepayer Advocate submitted the testimony of Mr. Richard LeLash, *RA-4*, and on December 27, 2005 submitted the surrebuttal testimony of Mr. LeLash, *RA-14*. Please note that references herein to the redacted testimony also refer to the corresponding confidential testimony.

- There should be no virtual divestiture. All divestiture should involve the actual sale of ownership of capacity and energy.
- The amount of capacity that would have to be divested as part of the merger should be based on Synapse input assumptions and a strategic bidding analysis.
- The amount of capacity that would have to be divested also should be based on the actual units to be divested.
- The BPU should set limits on the parties that could purchase the divested capacity.
- The PJM Market Monitoring Unit's suggestions about expanding the application of bid capping and/or bidding at marginal cost should be adopted.
- The Joint Petitioners should agree that after the merger is closed, the BPU would retain the same jurisdiction to address market power issues as it has before the merger.
- The BPU should conduct more detailed oversight of the BGS auction process in order to permit a meaningful investigation of whether any post-merger bidders, including EEG, exercise market power in the annual BGS auctions.[8]

The amount of capacity that would have to be divested as part of any approval of the merger should result in satisfying the Board's "positive benefits" standard, which includes no weakening of the degree of competitiveness of the wholesale energy, capacity, and ancillary service markets.

Furthermore, each of the major forms of competitive analysis undertaken or described in this proceeding should be applied to the actual, proposed post-merger ownership structure and each form should result in positive benefits to ratepayers. Synapse's ELMO modeling and Synapse's suggestion of a more in-depth form of strategic bidding analysis, of which incorporate assessment of both the incentive and the ability to exercise market power, should lead to results indicating improved competitive market performance. Joint Petitioner witness Mr. Rodney Frame's Delivered Price Test (with correct input assumptions, as noted in Synapse's testimony) must lead to no increases in supplier concentration in the relevant geographic and product markets. PJM's Dr. Joseph Bowring's more limited analyses (though incorporating review of

[8] *RA-5* at 15-16.

many potential divestiture scenarios) of the potential ability to exercise market power (but exclusive of an assessment of the incentive to exercise market power) should also be considered as providing an insightful glimpse into the extent of the lack of competitiveness of the actual hourly aggregate energy market; and showing a dimension of the PJM East marketplace that has not been considered before – i.e., the "constraint" market. All of these tools provide different forms of analysis that when taken together can help provide the Board with a full package of information about the likely degree of change to the post-merger wholesale competitive electric market.

Concerning gas market issues, which will be discussed in greater detail in sub-heading C (Vertical Market Power), the proposed merger of PSE&G and Exelon will create an entity that will serve over 1.6 million retail gas customers in New Jersey and over 460,000 retail gas customers in Pennsylvania. *JP-1 at 8.* Of major concern to the Ratepayer Advocate is the resultant concentration of at least 35.6% of the pipeline capacity in the PJM East market within the post-merger company, EEG. *RA-4 at 15.*

Creation of an energy company with control of 35.6% of pipeline capacity raises vertical market power concerns due to the company's ability to manipulate prices in both the gas and electric markets. As explained in the testimony of Ratepayer Advocate witness, Richard LeLash, given the current volatility in the gas market, any minor fluctuations in demand or supply can directly influence gas pricing. *RA-4 at 17-18.* Accordingly, the Ratepayer Advocate respectfully recommends that the merger should be rejected. However, should Your Honor and the Board decide to approve the merger, the approval should require the Joint Petitioners to retain the gas operations and trading functions in New Jersey and simultaneous with such approval, modify the terms, conditions and Board oversight of the Requirements Contract ("Contract") between

PSE&G and its unregulated affiliate, ER&T or its successor as outlined in our recommendations in this brief.

1. Standard of Review.

Here, a notable flaw in the Joint Petitioners' case is their failure to apply the standard of review which the Board ordered to be applied to this matter, the "positive benefits" standard. As set forth below and in filed testimony, the Joint Petitioners rely on the less stringent standard set by the FERC. For ratepayers, the difference between the two standards of review is significant.

The Board has a statutory obligation to consider the impact of the merger on competition and rates. As set forth in *N.J.S.A*. 48:2-51.1, the Board must consider the impact of the proposed merger on "competition, on the rates of ratepayers affected by the acquisition of control … and on the provision of safe and adequate service at just and reasonable rates." Furthermore, in its review of the proposed merger under *N.J.S.A*. 48:2-51.1, the Board has stated that it will apply the "positive benefits standard of review."[9] Moreover, the Board ruled that the burden lies with the Joint Petitioners to show positive benefits for ratepayers:

> [T]he Joint Petitioners must show and the Board must be satisfied that positive benefits will flow to customers and to the State as a result of the proposed change in control, and, at a minimum, that there are no adverse impacts on any of the criteria delineated in N.J.S.A. 48:3-51.1.[10]

As demonstrated herein, the Joint Petitioners have failed to demonstrate that positive benefits will flow to ratepayers from the proposed merger's impact on competition.

Instead, the analyses proffered by the Joint Petitioners in support of their Petition utilize the less stringent merger review criteria used by the FERC.[11] Pursuant to the Federal Power Act,

[9] 11/9/05 Order (*S-519*) at 25.
[10] 11/9/05 Order (*S-519*) at 25.
[11] In support of their Petition, the Joint Petitioners submitted the market power testimony of Mr. Frame (*JP-6*, *JP-6 Suppl*., *JP-6 Addl*., *JP-24*, *JP-4*) and Messrs. Frame and Schnitzer (*JP-146, -146A*). In addition, the Joint Petitioners

Section 203, the FERC must first find that the proposed transaction is in the "public interest" before it approves a merger. 16 USC 824(b). The FERC's Rules state that the FERC considers, among other factors, in determining whether a proposed transaction is in the public interest, the effect of the transaction on competition, rates, and regulation. *See,* 18 CFR Sec 2.26(b) (2004). The FERC's Rules also set forth the filing requirements for applications under Section 203 of the Federal Power Act. *See,* 18 CFR Sec. 33 (2004). Among the FERC's filing requirements is the submittal of a horizontal Competitive Analysis Screen, otherwise referred to as an Appendix A analysis. 18 CFR Sec. 33.3 (2004).

The FERC's merger policy was annunciated in a policy statement ("Merger Policy Statement").[12] In its Merger Policy Statement, the FERC adopted the US DOJ Merger Guidelines[13] as the basis for its framework of evaluating the competitive effects of mergers.[14]

In contrast to the more stringent "positive benefits" standard, the Joint Petitioners utilized the FERC's Appendix A criteria ("FERC Guidelines") in their analyses of the impact of the proposed merger on competition. Based on the US DOJ Merger Guidelines, the FERC's Appendix A analysis relies on Herfindahl-Hirschman Indices ("HHI") in evaluating the impact of a merger on competition, where the HHI is the sum of the squares of the market shares of all firms in a market.

The FERC's Merger Policy Statement characterizes a market as "unconcentrated" when the HHI is below 1,000 and proposed mergers resulting in HHI's less than 1,000 are not

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submitted the testimony of Professor William Hogan (*JP-23*); Mr. Henderson (*JP-19*); Mr. Sorenson (*JP-20*); Mr. Lark (*JP-21*); Mr. Cassidy (*JP-9*); Mr. Cornew (*JP-10*); and Mr. Morris (*JP-22*; *JP-39*).

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

[13] *JP-148*.

[14] FERC Merger Policy Statement at 68606.

considered by the FERC to have an adverse affect on competition.[15] Notably, in contrast to the "positive benefits" standard articulated by the Board, the FERC may find that the merger has no adverse impact in competition even when the proposed merger results in an HHI increase. For example, the FERC considers a market "moderately concentrated" when the HHI is between 1,000 and 1,800. However, using the FERC's HHI criteria, in a moderately concentrated market, only if the HHI increase is greater than 100 points does the FERC consider the merger to potentially raise significant competitive concerns.[16] The FERC considers a market with an HHI greater than 1,800 to be "highly concentrated."[17] Nonetheless, in a highly concentrated market, only if the HHI increase is greater than 50 points does the FERC consider the merger to potentially raise significant competitive concerns.[18]

In sum, the FERC merger criteria applied by the Joint Petitioners' to evaluate the proposed merger's impact on competition uses a standard much different from that articulated by the Board. Unlike the Board's positive benefits standard, the FERC market power criteria used by the Joint Petitioners considers a pre- to post-merger HHI increase as in compliance, notwithstanding the fact that the merger would result in an increase in market concentration. Notably, in its review of the merger, the PJM MMU also relied on the FERC Guidelines in its analyses conducted in the review of the proposed merger. Therefore, both the Joint Petitioners' analyses and those conclusions in the PJM MMU analyses which rely on the FERC criteria should not be viewed as conclusive by Your Honor and the Board.

Aside from using a standard other than the applicable positive benefits standard ordered by the Board, the Joint Petitioners' reliance on HHI-based analyses fails to recognize other

[15] FERC Merger Policy Statement at 68609.
[16] *Id*.
[17] *Id*.
[18] *Id*.

possible ways for an entity to exercise market power, such as strategic bidding or withholding available capacity in order to increase market clearing prices. In evaluating the proposed merger's impact on competition, the Ratepayer Advocate respectfully submits that Your Honor and the Board should also consider other measures of market power, such as the strategic bidding analyses performed by Synapse. *See, RA-5* at 26-28, 81-89.

B. Horizontal Market Power Issues.

In this sub-section, horizontal market power issues related to the proposed merger are examined. First, horizontal market power issues related to the electric markets are presented.

1. Electric Horizontal Market Power.

Given the scale of the proposed merger and its potential to adversely affect ratepayers, as set forth above and in the testimony of its witnesses, the Ratepayer Advocate respectfully submits that Your Honor and the Board should consider a number of significant factors in its evaluation of the proposed merger's impact on competition in electric markets.

First, the analyses of market power must consider the relevant standard of review. In the instant matter, the relevant standard of review is the Board's "positive benefits" standard, as contrasted to the less stringent FERC standard followed by the Joint Petitioners in their proffered analyses.

The results of Synapse's analyses of the electric energy markets using Mr. Frame's Delivered Price Test ("DPT") mitigation scenarios indicate that using even the less stringent FERC Guidelines results in screen failures. Synapse has shown that straightforward corrections to Mr. Frame's DPT assumptions concerning transmission allocation into PJM East, and nuclear outage rates and operating performance, result in the proposed merger failing the FERC Guidelines screen in 23 of 30 load periods across three sets of Mr. Frame's mitigation scenarios

(scenarios 1, 2 and 3) for the PJM East market.[19] Using realistic mitigation scenario assumptions (Synapse scenarios 4, 5 and 6) where the Joint Petitioners' divested capacity is purchased by entities already owning capacity in PJM results in the proposed merger failing the FERC Guidelines screens in 30 of 30 load periods across three sets of alternative mitigation scenarios in PJM East.[20]

The results of the PJM MMU's analyses of alternative divestiture scenarios demonstrates that when recent, albeit limited, historical data is used to determine supplier concentration levels in the aggregate PJM energy market, under all scenarios, including the Joint Petitioners' limited subset of alternatives, the proposed merger fails the Board's positive benefits standards in all hours and fails the less stringent FERC Guidelines screen test in significant numbers of hours. *RA-62* at 17, Table S-1; *S-584*, and *S-585*.

Second, since there are no significant restrictions on the purchasers of the divested fossil and nuclear capacity, an analysis of market power must consider a wide range of purchasers for the divested assets. Contrary to the Joint Petitioners' witnesses' contention that the scenarios proposed by the Joint Petitioner "bracket a reasonable range of alternatives,"[21] the Joint Petitioners' set of scenarios represents an extremely limited, and selective, subset of the plausible permutations of buyers of the divested capacity and energy. As Synapse has shown, and the PJM MMU analyses have confirmed, the proposed merger fails both the Board's positive benefits standard and the FERC Guidelines if reasonable assumptions are made about the putative buyers of the divested capacity and energy. The proposed merger should be required to pass the Board's positive benefits standard for a wide range of possible mitigation scenarios. However, as the

[19] *JP-6* at 77, ln. 22 to p. 79, ln. 15, Exhibit BFS-6, page 2.
[20] *JP-6* at 77, ln. 22 to p. 79, ln. 15, Exhibit BFS-6, page 2.
[21] *JP-146A* at 21, ln. 6.

results of the Synapse analyses and the PJM MMU analyses have shown, many of those scenarios do not pass even the more lenient FERC Guidelines.

Third, the Ratepayer Advocate respectfully submits that the Board should not rely solely on HHI analyses, but should also consider other analyses examining different aspects of market power, such as strategic bidding analyses and other studies. As set forth below and in testimony, Synapse's use of their ELMO model illustrates the potential for the exercise of market power by the merged company. Synapse's ELMO analysis demonstrates that EEG would have a large incentive to exercise market power due to its holdings of extensive low-cost baseload power. The ELMO study also shows that exercises of market power that result in even extremely small price changes can lead to increased revenues for the merged company that will offset claimed net benefits. This demonstrates the need for more focused investigation using in-depth strategic bidding models that more carefully evaluate the incentives and the means to exercise market power, and that go beyond the more limited screening seen with the Delivered Price Test or the historical analyses conducted by the PJM MMU.

Fourth, these analyses must be performed before the merger is approved. The Ratepayer Advocate respectfully submits that the Board should not rely on post-merger analyses conducted by either the FERC or PJM MMU. As set forth below and in testimony, the Joint Petitioners' proposed post-merger reviews of its mitigation plan divestitures do not adequately protect ratepayers from the harm that might be inflicted by the exercise of market power post-merger.

Finally, the Joint Petitioners' virtual divestiture plan should not be considered as the equivalent of actual divestiture. The virtual divestiture of energy proposed by the Joint Petitioners is an inadequate structural remedy that will not sufficiently mitigate against the exercise of market power. As noted by PJM's Dr. Joseph Bowring during rejoinder cross-examination, virtual divestiture is one form of remedy on a continuum of possible remedies, and it is significantly different from other forms of structural mitigation such as actual sale of physical generation or contractual arrangements that resemble the longer-term power purchase agreements ("PPAs") or tolling agreements. *See,* T2822:L21-T2824:L14 (3/24/06). Virtual divestiture does not eliminate the incentive of the generation owner to increase market prices.

In all, the Joint Petitioners have not demonstrated that positive benefits will flow to New Jersey ratepayers from the proposed merger's impact on competition in the electric markets. As set forth below and in the testimony of the Ratepayer Advocate's witnesses, the merger -- as proposed -- does not meet the positive benefits standard set forth by the Board.

a. Mr. Frame's Energy Market Analyses.

The Joint Petitioners relied on HHI-based analyses using the FERC Guidelines as the basis for their conclusions regarding the impact of the merger on competition. However, the Joint Petitioners' market power analyses were fraught with errors and limited to a few unrealistic mitigation scenarios. In contrast, Synapse corrected material flaws in the Joint Petitioners' analyses and analyzed a range of realistic mitigation scenarios. Synapse found that when the divested capacity is purchased by entities who already are substantial participants in PJM, HHI changes in excess of even the less stringent FERC Guidelines result.

To analyze the impact of the proposed merger on competition in the relevant energy markets, the Joint Petitioners' market power witness, Mr. Rodney Frame, performed a Delivered Price Test following the FERC's Appendix A guidelines. Mr. Frame considered three relevant geographic energy markets: PJM East; PJM Pre-2004; and PJM Expanded. In addition, Mr. Frame analyzed the Northern New Jersey market. For his analyses, Mr. Frame used a 2006 calendar year, dividing the year into periods: Summer (June, July and August), Winter

(December, January, and February), and Combined Spring/Fall Shoulder (March, April, May, September, October, and November). Mr. Frame used four load periods in Summer (Extreme Peak, Super Peak, Peak, and Off Peak) and three load periods in the Winter and Combined Spring/Fall Shoulder (Super Peak, Peak, and Off Peak). *JP-6* at 32-33. Mr. Frame used both "Economic Capacity" and "Available Economic Capacity" to measure generation capacity and allocated transmission capacity using the "proportional" method. *JP-6* at 7, 36.

In his initial study, Mr. Frame found that the proposed merger would exceed the FERC's threshold change in HHI levels ('screen violations") in each of the three geographic markets during all or nearly all time periods studied, depending on the method by which capacity is measured (i.e., Economic Capacity or Available Economic Capacity). *JP-6* at 6, RF-6, -7. Nonetheless, Mr. Frame found that the Joint Petitioners' initial mitigation proposal resolved the screen violations. *JP-6* at 6, RF-6, -7. The Joint Petitioners' original mitigation proposal included the divestiture of 1,000 MW of peaking capacity in PJM East, 1,900 MW of coal and mid-merit capacity in PJM East, and the "virtual divestiture" of 2,400 MW of nuclear generation in PJM East and an additional 200 MW of nuclear generation anywhere in PJM Pre-2004.[22] In his analyses, Mr. Frame assumed that the mitigation amounts were sold to two different parties, neither of whom owned generation capacity in PJM. *JP-6* at 38.

Mr. Frame later revised his Delivered Price Test analyses to reflect corrections of some errors and the Joint Petitioners' new mitigation proposal.[23] Mr. Frame revised his analyses to reflect corrected heat rates for certain PSE&G combustive turbine ("CT") generating units and to properly reflect the current status of certain Pepco Holding Inc.'s ("PHI") units. The Joint

[22] *JP-6* at 17. Under the Joint Petitioners' original mitigation proposal, of the divested 1,900 MW of coal and mid-merit generation in PJM East, at least 550 MW would have been coal-fired. The Joint Petitioners' original mitigation proposal also placed restrictions on potential purchasers of the divested generation, based on capacity ownership percentages in PJM.
[23] *See JP-6 Suppl.*

Petitioners' revised mitigation proposal includes an additional 1,100 MW of generating capacity, increasing the total amount of affected capacity (including "virtual divestiture") from 5,500 MW to 6,600 MW. *JP-6 Suppl.* at 6. Furthermore, the Joint Petitioners' revised mitigation plan eliminated the restrictions on purchasers of the divested capacity. *JP-6 Suppl.* at 6.

Mr. Frame then re-ran his analyses, reflecting the Joint Petitioners' revised mitigation plan, under three different divestiture purchaser scenarios, using only the Economic Capacity measure.[24] Mr. Frame found that under each of the scenarios, the HHI changes were below the FERC's threshold level.

However, Synapse identified a number of serious flaws in Mr. Frame's analyses. Synapse concluded that these flaws render the results of Mr. Frame's HHI analyses "unrealistic" and caused Mr. Frame to "understate the post-merger and post-mitigation levels of concentration in the PJM East energy market." *RA-5* at 31-32. Moreover, Mr. Frame based his conclusions on only a limited set of mitigation scenarios, each based on unrealistic assumptions. Thus, even assuming *arguendo* the probative value of using the FERC Guidelines in the instant proceeding as the benchmark to assess the proposed merger's effect on competition, Mr. Frame's conclusions regarding compliance with the FERC's guidelines are based on flawed analyses and unrealistic mitigation scenarios.

Synapse found that Mr. Frame used a "proportional methodology" for allocating the limited transmission import capability across PJM's Eastern Interconnection, which Synapse testified tends to understate EEG's share of capacity imports and its total market presence. *RA-5* at 31. Mr. Frame also assumes that the capacity from all of the generating units being modeled are available to serve load in his targeted geographic areas and are not already committed to serving other load or diverted to other areas for economic reasons. *RA-5* at 31. Synapse

[24] *JP-6 Suppl.* at 8; RF-9, -10, and -11.

concluded that market concentration measures based on this assumption will not accurately reflect the amount of capacity that can actively compete in the market. *RA-5* at 31.

Synapse also found that Mr. Frame failed to reflect transmission system outages or deratings, thereby misrepresenting the amount of capacity that can reach markets or loads. *RA-5* at 31. Mr. Frame also treated forced and planned outages as a reduction of capacity in <u>all</u> hours, which Synapse testified would tend to minimize the effect of outages during <u>peak</u> hours. *RA-5* at 31. Additionally, Mr. Frame failed to fully reflect anticipated improved output and upratings for nuclear units, thereby understating market concentration. *RA-5* at 32. Mr. Frame also used industry average outage rates for generating units rather than unit-specific rates, a flaw which Synapse testified would understate the Joint Petitioners' available capacity.[25] Finally, Mr. Frame failed to include EEG's purchases of capacity from other PJM participants in his analyses. *RA-5* at 32. Synapse testified that under certain circumstances these purchases can enhance a firm's ability to exercise market power. *RA-5* at 32. In sum, the flaws in Mr. Frame's analyses identified by Synapse tend to cause Mr. Frame's market concentration findings to be understated.

In addition to the flaws in Mr. Frame's modeling identified by Synapse, Mr. Frame's analysis in his Supplemental Initial Testimony was limited to only a few mitigation scenarios. In his first mitigation scenario, Mr. Frame assumes that the virtual divestiture of nuclear capacity is to two parties that do not currently own any generating capacity in PJM and the fossil divestiture is split among Edison Mission Energy (50 percent), Mirant (25 percent), and Constellation (25 percent). *JP-6 Suppl.* at 8. In his second mitigation scenario, Mr. Frame assumes that the virtual divestiture of nuclear capacity is made on a pro-rata basis to the winning suppliers in the recent New Jersey BGS auctions, but excluding PSEG from that allocation, and the fossil divestiture was made equally to FirstEnergy, PHI, PPL, and Reliant. *JP-6 Suppl.* at 8. For his third

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[25] *RA-6* at 31; *see also JP-24* at 21-22.

mitigation scenario, Mr. Frame assumes that the virtual divestiture of nuclear capacity is made on the same basis as under his second mitigation scenario and all of the fossil divestiture is made to a single party that does not now own any generation capacity in PJM. *JP-6 Suppl.* at 8. Hence, Mr. Frame's analysis was limited to a very small range of scenarios and, in the absence of pertinent restrictions on purchasers, it is unlikely that the scenarios presented by Mr. Frame would ever materialize.

Synapse, in contrast, modeled the HHI changes in the PJM East energy market using three additional scenarios (mitigation scenarios four through six) which were more realistic than those modeled by Mr. Frame. *RA-5* at 75-80. Under mitigation scenario four, Synapse assumes that all of the divested capacity is purchased by PPL. Under mitigation scenario five, Synapse assumes that the divested nuclear capacity is purchased equally by PPL and PEPCO and the divested fossil capacity is purchased by PPL. Finally, under mitigation scenario six, Synapse assumes that the virtually divested nuclear capacity is purchased by PPL and the divested fossil capacity is purchased by PEPCO and Reliant.

In all, Synapse evaluated six mitigation scenarios, including Mr. Frame's three scenarios and their three additional mitigation scenarios, using two sets of input assumptions. Synapse ran the analyses using the input assumptions used by Mr. Frame. Synapse also ran the six scenarios using most of Mr. Frame's input assumptions, except that Synapse corrected Mr. Frame's nuclear and transmission assumptions. Synapse corrected Mr. Frame's input assumptions to reflect the proposed 2006 power uprate for the Hope Creek nuclear plant, the Joint Petitioners' claimed improvements in operating performance at both Salem and Hope Creek, the use of the recent performance data for Exelon's nuclear units, and the use of an economic allocation of the transmission import capability across the PJM East interface. *RA-5* at 77.

Synapse did not correct all of Mr. Frame's assumptions that were identified earlier. Synapse found that it was not possible to correct all of the identified problems and still be able to use Mr. Frame's database to run revised HHI analyses for the six scenarios. *RA-5* at 77. Instead, Synapse accepted most of Mr. Frame's input assumptions, reasoning that their use causes the post-divestiture levels of concentration in the PJM East energy market and the ability of EEG to exercise market power to be understated. *RA-5* at 77. Hence, Synapse's analyses might be considered conservative, from the point of view of the Joint Petitioners, insofar as they understate market concentration. *RA-5* at 77.

As a test of their modeling methods, Synapse first re-ran Mr. Frame's analyses for mitigation scenarios one through three using Mr. Frame's assumptions. In turn, Synapse obtained the same results as Mr. Frame.[26] Then, Synapse applied the aforementioned four changes to Mr. Frame's assumptions. Using the corrected assumptions, Synapse found that the proposed merger would fail the FERC Guidelines due to HHI changes greater than 100 in six of the ten hours studied in mitigation scenario one; in all ten of the hours studied in Mr. Frame's mitigation scenario two; and in seven of the ten hours studied in Mr. Frame's mitigation scenario three. Furthermore, in some of the hours studied by Synapse in these scenarios, the pre-merger to post-mitigation HHI changes were significantly higher than 100.[27]

For mitigation scenarios that incorporate the assumption that the divested capacity is purchased by parties which are already substantial participants in PJM, such as mitigation scenarios four through six, Synapse found that the proposed merger failed the FERC's Guidelines even when Mr. Frame's assumptions were used. When Synapse used Mr. Frame's assumptions in modeling mitigation scenarios four through six, the HHI changes from pre-

[26] *RA-5* at 77, BFS-6; compare to *JP-6 Suppl.*, RF-9 (Revised).
[27] *RA-5* at 78, Table 10, Exhibit BFS-6.

merger to post-mitigation are significantly above 100 in all ten hours examined.[28] When the four aforementioned corrections to Mr. Frame's assumptions were incorporated into the model, Synapse found that the proposed merger fails the FERC Guidelines by very substantial margins in all of the hours examined.[29]

Subsequently, in his filed rebuttal testimony, Mr. Frame provided the results of his revision of his earlier analysis to reflect unit-specific nuclear outage rates for Exelon's nuclear units.[30] Mr. Frame characterized his results as "little different" than the results of his earlier runs. *JP-24* at 22, ln. 10. However, Mr. Frame did not revise his assumptions to reflect Synapse's other concerns, namely the treatment of transmission and plant outages, planned nuclear unit uprates, and the likely destination markets for capacity outside PJM East. Hence, Synapse's valid concerns were not fully addressed by Mr. Frame and the results of Mr. Frame's revised analysis should, accordingly, be given no weight. Synapse, on the other hand, found that by making just four corrections to Mr. Frame's input data resulted in screen failures for nearly all of the hours examined. *RA-16* at 17-18.

b. The PJM MMU's Energy Market Analyses.

This sub-section is divided into two sub-parts. The first sub-part addresses the earlier PJM MMU reports dated before April 19, 2006, which can be distinguished from subsequent reports by their use of May 1, 2005 through July 31, 2005 data. The second sub-part addresses subsequent PJM MMU reports prepared in response to Board Staff's transcript request made at

[28] *RA-5* at 78-79, Table 11, Exhibit BFS-6.
[29] *RA-5* at 79, Table 11, Exhibit BFS-6.
[30] *JP-24* at 21-22; RF-9 (rev. 12/05/05), -10 (rev. 12/05/05); and -11 (rev. 12/05/05).

the hearing on March 24, 2006 (TR-2820) and can be distinguished by their use of May 1, 2005 through March 31, 2006 data.[31]

1. The PJM MMU's Analyses Using May 1 - July 31, 2005 Data.

The PJM MMU's long involvement in the instant matter was initiated by the Board. However, late in the proceeding, the Joint Petitioners requested that the PJM MMU perform certain additional analyses. *S-553*. As set forth below, the latter request led to a flurry of PJM MMU reports and additional modeling run requests from various parties. Notwithstanding the fact that the analyses performed by the PJM MMU were flawed in a number of ways, the results of those studies confirm Synapse's conclusions regarding the potentially significant adverse impacts of the proposed merger.

The PJM MMU's involvement in the instant matter was precipitated by a request from the Board, dated March 29, 2005. *S-546*. In response to the Board's request, the PJM MMU submitted a report entitled "Exelon/PSEG Merger Analysis" on May 24, 2005 ("May 24, 2005 PJM MMU Report"). *S-5*. In response to a subsequent request from the Board, the PJM MMU supplemented its May 24, 2005 Report with a Supplemental Report on June 16, 2005 and another report entitled, "Exelon/PSEG Merger Analysis Part Two," dated October 14, 2005.[32]

A second round of PJM MMU analyses was precipitated by a letter request by the Joint Petitioners, dated December 28, 2005. *S-553*. In response to that and subsequent requests by the Joint Petitioners, Board Staff, the Ratepayer Advocate, and PPL, the PJM MMU ultimately issued reports on February 9, February 17, and March 1, 2006 which evaluated over 220 different sensitivity analyses concerning the specific units that are potential candidates for

[31] Insofar as the April 19 and April 21, 2006 PJM MMU reports were produced very late in the briefing process, the Ratepayer Advocate respectfully reserves its right to further address these reports in its reply brief.
[32] Exelon/PSEG Merger Analysis Supplemental Report ("June 16, 2005 PJM MMU Report"), *S-5(a); S-548*; *S-5(b).*

divestiture by the Joint Petitioners and the potential buyers of the divested capacity and energy.[33] In addition, at the hearing on March 24, 2006, the PJM MMU's Dr. Joseph Bowring presented the results of additional analyses that had been undertaken by the PJM MMU in response to errors that had been identified by Synapse. *S-584* and *S-585*.

Each of the PJM MMU analyses suffered from several flaws, as identified in testimony by Synapse. *RA-62*. These flaws caused the PJM MMU analyses to understate the potential impact of the proposed merger on competition and the ability of the merged company to exercise market power in the PJM energy markets. *RA-62* at 2-4.

First, the conclusions drawn from the analyses by the PJM MMU relied on the FERC Guidelines - which allow defined increases in pre- to post-merger HHI's - for determining compliance, rather than the Board's positive benefits standard. *See, S-5(c)* at 3; *RA-62* at 6. For example, as Messrs. Schlissel and Fagan of Synapse testified, if the positive benefits test were applied to the PJM Aggregate Hourly Energy Market scenarios analyzed by the PJM MMU, none of the scenarios would have complied since all of the scenarios analyzed have changes in the minimum and average HHIs that are greater than zero. *RA-62* at 5.

Second, the PJM MMU initially (pre-3/24/06) reported the minimum and the maximum pre- to post-merger HHI changes in an incorrect manner, though this was subsequently corrected in exhibits which were introduced by Board Staff on March 24, 2006 during Dr. Bowring's cross-examination. *S-584* and *S-585*. For each scenario, the PJM MMU originally had reported the minimum HHI change by subtracting the minimum pre-merger HHI for any of the individual hours examined from the minimum post-merger HHI for any of the individual hours examined.

[33] "Exelon/PSEG Merger Sensitivity Analyses Revised" (*S-563*); The February 9, 2006 PJM MMU report corrects an error in the prior reports, dated January 25, 2006 (*S-560*); February 1, 2006 (*S-561*); and February 2, 2006 (*S-562*). The error relates to the attribution of ownership of certain nuclear units owned by an Exelon subsidiary. *See S-563* at 2.

RA-62 at 15. The PJM MMU's original (pre-3/24/06) reports ignored the fact that the minimum pre-merger HHI and minimum post-merger HHI may not have occurred in the same hour. *RA-62* at 15-16.

Furthermore, and critically, the PJM MMU judged each scenario's compliance with the FERC Guidelines based on the average pre-merger to post-merger HHI change over all of the 2,208 hours examined (during May 1, 2005 – July 31, 2005) rather than evaluating the pre-merger to post-merger HHI changes for each hour studied. *RA-62* at 14-15. As Synapse pointed out, the use of an average masks the fact that HHI changes greater than 100 occur in many of the hours examined and is inconsistent with the way HHI analyses are generally prepared and reviewed. *RA-62* at 4, ln. 11-13. Even the Joint Petitioners' witness Mr. Frame did not present the results of his analyses using one simple average HHI change, but rather reported the results in the form of 10 different season/load levels over the course of one year. *RA-62* at 15. For this reason, it is vital to note that the conclusions in the PJM MMU's February 9 and February 17, 2006 reports that certain Joint Petitioner scenarios comply with the FERC Guidelines are misplaced and must not be relied upon.

Third, the PJM MMU HHI analyses were based on actual historical data from May 1 through July 31, 2005. Therefore, the PJM MMU studies did not reflect changes that are expected to occur because of the merger or other changes that are expected to occur by the time the merger is expected to be consummated. *RA-62* at 11. For example, the actual historic data used in the PJM MMU analyses <u>did not</u> reflect increased nuclear plant output, the Hope Creek nuclear units uprate, the proposed merger of FPL and Constellation, the planned Neptune transmission line between New Jersey and New York, plant or capacity purchases by the merged company, plant retirements, load growth, the end of Exelon's obligation to supply ComEd standard offer load, or any future natural gas price changes. *RA-62* at 11-12. In sum, the PJM MMU analyses were "backward-looking" rather than "forward-looking," whereas, as Synapse testified, merger analyses "appropriately are forward looking analyses, not backward looking." *RA-62* at 11, ln. 14-15.

Finally, rather than analyzing the impact of the proposed merger over a range of seasons and load conditions, the PJM MMU analyses were based on only three months of data, from May 1, 2005 through July 31, 2005. Thus, the PJM MMU analyses do not examine the impact of the proposed merger over a full range of system, load, and generating unit outage conditions and, as Synapse testified, using only three months of data "is not predictive of what may occur over an entire year." *RA-62* at 14, ln. 9-10. Furthermore, the use of only three months of data is at odds with the FERC's pronouncements. In Order 642, the FERC required applicants to identify and separately analyze products differentiated by load level:

> Because demand and supply conditions for a product can vary substantially over the year, periods corresponding to those distinct conditions must be identified by load level, and analyzed as separate products. [34]

The FERC recently reaffirmed the necessity of performing Delivered Price Test analyses over a range of seasons and load conditions.[35] The use of such a timeframe is also at odds with the testimony of the Joint Petitioners' witness Mr. Frame. In testimony, Mr. Frame noted the importance of analyzing different seasons and load levels "in order to reflect a variety of demand and supply conditions." *JP-6* at 22, ln. 17-19.

Nevertheless, despite these flaws, the ultimate results of the PJM MMU analyses confirm the Synapse conclusion that the proposed merger will violate the Board's positive benefits

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[34] *Revised Filing Requirements Under Part 33of the Commission's Regulations*, Order No. 642 (November,15, 2000), FERC Dkt. No. RM98-4-000, 65 Fed. Reg. 70984, at 71016 (2000), 93 FERC 61,164 at 145.
[35] Order (April 14, 2004), FERC Dkt. No. ER96-2495-016 *et al*, 107 FERC ¶ 61,018 at 44.

standard in all hours and, notably, will also violate the less stringent FERC Guidelines in many individual hours.

For example, Synapse was able to use PJM input data to re-create the results presented in the February 17 and March 1, 2006 PJM MMU Reports. *RA-62* at 15-24. Prior to re-running the analyses, Synapse corrected for two of the identified problems with the PJM MMU analyses. Specifically, Synapse corrected the assignment of imports due to minor inconsistencies in naming PJM participants and corrected the way that the PJM MMU calculated pre-merger to post-merger HHI changes.[36] *RA-62* at 15-16. For each scenario, Synapse also compared the post-merger HHI for each individual hour with the pre-merger HHI for the same hour. *RA-62* at 15-16. Synapse was thus able to correct the results presented in the PJM MMU's February 17 and March 1, 2006 reports.

Synapse found that the proposed merger failed the Board's positive benefits test in 100 percent of the hours examined in the each of the Joint Petitioners' requested scenarios. *RA-62* at 17, Table S-1. In each of these hours, the pre-merger to post-divestiture HHI increase was greater than zero. In each of the Joint Petitioners' requested scenarios, the proposed merger even failed the more lenient FERC Guidelines in "a significant number of hours," according to Synapse, even if the Joint Petitioners' novel virtual nuclear divestiture was assumed to be effective. *RA-62* at 17, ln. 14-15, and Table S-1.

As Synapse noted in its testimony, the scenarios that the Joint Petitioners asked the PJM MMU to examine represented only a very small subset of the extremely large number of permutations of parties that might be buyers of the divested fossil capacity and nuclear energy and the amounts of such divested fossil capacity and nuclear energy that each potential buyer might purchase. *RA-62* at 8, ln. 3-20. Moreover, there is no guarantee that the various sets of

[36] The PJM MMU also corrected this error in subsequent reports. *See* T2811:L11-2813:L10. (3/24/06)

buyers for the divested fossil capacity and nuclear energy that the Joint Petitioners asked the PJM MMU to study actually would be the purchasers of the divested capacity and energy. *RA-62* at 7, ln. 1-15. Therefore, it is essential that the impact of the merger on competition be examined using a much broader range of possible buyer scenarios than the Joint Petitioners have proposed or asked the PJM MMU to examine.

For this reason, the Ratepayer Advocate also asked the PJM MMU to analyze a number of alternative, and very plausible, scenarios that assumed that the divested capacity will be purchased by buyers who already have a significant market share in PJM. Synapse re-ran the four sensitivity analyses which the Ratepayer Advocate originally asked the PJM MMU to perform, as well as the Joint Petitioners' requested scenarios. The Ratepayer Advocate had asked the MMU to examine four sets of divestiture scenarios. *RA-62*, Exh. FS-S1. Synapse was able to re-create the PJM model and, prior to re-running the analyses, corrected the assignment of imports due to minor inconsistencies in naming PJM participants[37] and corrected the way that the PJM MMU calculated pre-merger to post-merger HHI changes. *RA-62* at 15-16. For each scenario, Synapse compared the post-merger HHI for each individual hour with the pre-merger HHI for the same hour. Synapse was thus able to correct the results presented in the PJM MMU's February 17 and March 1, 2006 reports with respect to errors in assigning imports due to naming inconsistencies, and the pre- to post- merger HHI change calculations.

The Ratepayer Advocate's scenario Set One ("Set One") used the same buyers of the fossil capacity as the Joint Petitioners had asked the MMU to assume, but all of the virtually divested nuclear energy was assumed to be purchased by two parties that currently have significant market shares in PJM. Synapse found, using the PJM MMU input data, that all of the divestiture scenarios in Set One fail the Board's positive benefits standard in 100 percent of the

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[37] The PJM MMU also corrected this error in subsequent reports. *See* T2812:L1-24 (3/24/06).

hours. *RA-62* at 20-21, Table S-2. Furthermore, all of the Set One scenarios fail the FERC Guidelines in 51 percent or more of the individual hours. *RA-62* at 20-21, Table S-2. Even if only the average pre-merger to post-merger HHI changes were considered, these scenarios would fail the FERC Guidelines because each average HHI change amounted to more than 100. *RA-62* at 20-21, Table S-2.

The Ratepayer Advocate's second set of divestiture scenarios ("Set Two") also used the same buyers of the fossil capacity that the Joint Petitioners had asked the MMU to assume, but all of the virtually divested nuclear energy was assumed to be purchased by three parties that currently have significant market shares in PJM. All of the scenarios in the Ratepayer Advocate's Set Two also failed the Board's positive benefits standard in 100 percent of the hours. *RA-62* at 21, Table S-3. Furthermore, all of the scenarios in Set Two also fail the FERC's Guidelines in at least 31 percent of the individual hours. *RA-62* at 21, Table S-3. Indeed, four of the scenarios (2a, 2b, 2c, and 2d) even fail the FERC Guidelines if only the discredited average pre-merger to post-merger HHI change is considered. *RA-62* at 21, Table S-3.

The Ratepayer Advocate's third set of divestiture scenarios ("Set Three") assumed that all of the divested fossil capacity was purchased by parties that currently have significant market shares in PJM and that all of the virtually divested nuclear energy was assumed to be purchased by two parties that currently have significant market shares in PJM. *RA-62* at 19. After making the aforementioned corrections, Synapse found that all of the scenarios in Set Three fail the Board's positive benefits standard in 100 percent of the hours. *RA-62* at 22, Table S-4. Additionally, all of the Set Three scenarios also fail the FERC Guidelines in at least 64 percent of the individual hours, and these scenarios even fail the FERC Guidelines if only the average pre-merger to post-merger HHI changes are considered. *RA-62* at 22, Table S-4.

The Ratepayer Advocate's divestiture scenario Set Four ("Set Four") assumed that all of the divested fossil capacity was purchased by parties that currently have significant market shares in PJM and that all of the virtually divested nuclear energy was assumed to be purchased by three parties that currently have significant market shares in PJM Energy markets. *RA-62* at 19. After making the two corrections noted above, Synapse found that all of the scenarios in Set Four fail the Board's positive benefits standard in 100 percent of the hours. All of the Set Four scenarios also fail the FERC Guidelines in at least 39 percent of the individual hours, and all but two of these scenarios even fail the FERC Guidelines if only the average pre-merger to post-merger HHI changes are considered. *RA-62* at 22-23, Table S-5.

It is important to re-emphasize that there are no restrictions on the potential buyers of the divested fossil capacity and nuclear energy that would preclude or prevent any of the scenarios included in Ratepayer Advocate Sets One through Four. Therefore, the results of a wide range of scenarios, such as those proposed by the Ratepayer Advocate, must be considered when evaluating the impact of the proposed merger.

Finally, Synapse testified that if virtual divestiture was assumed to be not effective and, thereby, not considered in the evaluation of the Ratepayer Advocate's divestiture scenarios, all of the divestiture scenarios would fail both the Board's positive benefits standards and the FERC Guidelines. *RA-62* at 23. Notably, Dr. Bowring testified during cross-examination that there is a "significant difference, a practical difference" between actual sale and virtual divestiture proposals. T2823:L2 (3/24/06). Dr. Bowring went on to describe these differences, comparing virtual divestiture to Purchase Power Agreements such as those with tolling arrangements, and to actual physical sales. T2823:L5-21 (3/24/06). Clearly, Dr. Bowring's testimony at hearing did not support the view that the virtual divestiture arrangement is equivalent even to the tolling arrangement purchase power agreements, and certainly not equivalent to any actual physical sale of nuclear energy or capacity, which has not been proposed. T2827:L13-19 (3/24/06).

Synapse also evaluated divestiture scenarios posited by Board Staff whereby the divested nuclear energy is purchased by the next four largest buyers in PJM. *R-62* at 23-24, Table S-6. After making the two corrections noted above, all of the Board Staff scenarios examined by Synapse fail the Board's positive benefits standard in 100 percent of the hours. *R-62* at 23-24, Table S-6. The Board Staff scenarios examined by Synapse also fail the FERC Guidelines in at least 26 percent of the individual hours, and even three fail the FERC Guidelines if only the average pre-merger to post-merger HHI changes are considered. *RA-62* at 23-24, Table S-6.

At the hearing on March 24, 2006, Dr. Bowring presented two new exhibits that essentially confirmed the results of the Synapse analyses. *S-584* and *S-585*. Therein, Dr. Bowring's Tables S 6-3 and S 6-6 in *S-584* essentially confirm the results presented in Synapse's Table S-1 at page 17 of *RA-62*. Similarly, Tables S 5-3, S 5-6, S 5-9, and S 5-12 in *S-585* essentially confirm the results presented in Synapse's Tables S-2 through S-5 at pages 21-23 of *RA-62*.

In conclusion, the findings of the analyses prepared and presented by the PJM MMU and Synapse, using the May 1 through July 31, 2005 data, show that the proposed merger will fail the Board's positive benefits standard in the aggregate PJM Hourly Energy Market in all hours in all of the many scenarios proposed by the Joint Petitioners, the Ratepayer Advocate, and Board Staff. Furthermore, the proposed merger will fail the less stringent FERC Guidelines in the aggregate PJM Hourly Energy Market in many individual hours in all of the scenarios proposed by the Joint Petitioners, the Ratepayer Advocate, and the Board Staff. The results of the analyses show that it is vital for the Board to know the buyers of the divested capacity and energy and the specific units to be divested before it approves the proposed merger. Notably, these conclusions hold even when using the extremely conservative assumption that the mitigation value of virtual divestiture is the same as the mitigation value of real divestiture.

2. The PJM MMU's April 19 And April 21, 2006 Analyses.

The PJM MMU issued two new reports in response to Board Staff's transcript request of March 24, 2006. *See,* TR-2820 (3/24/06). The first PJM MMU report produced pursuant to the transcript request was dated April 19, 2006 ("April 19, 2006 PJM MMU Report ") and the second report was dated April 21, 2006 ("April 21, 2006 PJM MMU Report ").[38] Insofar as the April 21, 2006 PJM MMU Report was received too late to be included in the body of the Ratepayer Advocate's initial brief, the Ratepayer Advocate's analysis will be included in Attachment B to the initial brief.

The new PJM MMU analyses used eleven months of actual data, from May 1, 2005 to March 31, 2006, instead of the three months of data that the PJM MMU had used in each of its earlier studies of the scenarios requested by the Joint Petitioners, the Ratepayer Advocate, Board Staff, and PPL. Thus, the new PJM MMU analyses examined a total of 8,040 hours of data, or more than 3.6 times as much data as the 2,208 hours used in its earlier reports. Of the 8,040 hours examined in the new reports, 3,728 hours were on "peak" and 4,312 were "off-peak." *See,* April 19, 2006 PJM MMU Report at 4, Table 1-4.

In the April 19, 2006 PJM MMU Report, the PJM MMU re-examined the four sets of divestiture scenarios that the Ratepayer Advocate had earlier requested. These had previously been designated as Ratepayer Advocate Set One through Four in testimony. *RA-62* at 18-19. Key results of the April 19, 2006 PJM MMU Report are summarized below in Table [A]:

[38] Copies of the April 19, 2006 PJM MMU Report and April 21, 2006 PJM MMU Report were provided to Your Honor as *S-592* and *S-593*, respectively, under a cover letter from Margaret Comes, DAG, dated April 21, 2006.

TABLE [A]

Set	Scenario	Results Presented in	Percentage of Hours HHI Difference>0	Percentage of Hours HHI Difference>100	Percentage of Peak Hours HHI Difference>100	Percentage of Off-Peak Hours HHI Difference>100
RPA Set One	1A	Exhibit S-592	100%	66.83%	56.25%	75.97%
	1B	Tables 3-3 and	100%	64.05%	52.66%	73.91%
	1C	3-4	100%	60.87%	47.80%	72.17%
	1D		100%	67.60%	56.92%	76.83%
	2A		100%	66.73%	56.20%	75.83%
	2B		100%	66.06%	56.33%	74.47%
	2C		100%	68.32%	58.42%	76.88%
	2D		100%	67.80%	58.80%	75.58%
RPA Set Two	1A	Exhibit S-592	100%	47.52%	33.21%	59.90%
	1B	Tables 4-3 and	100%	45.52%	30.28%	58.70%
	1C	4-4	100%	41.28%	25.03%	55.33%
	1D		100%	47.00%	32.35%	59.67%
	2A		100%	47.85%	32.83%	60.83%
	2B		100%	47.35%	33.07%	59.69%
	2C		100%	48.18%	33.02%	61.29%
	2D		100%	47.70%	33.34%	60.11%
RPA Set Three	1A	Exhibit S-592	100%	71.92%	62.96%	79.66%
	1B	Tables 1-3 and	100%	71.02%	62.12%	78.71%
	1C	1-4	100%	80.88%	74.14%	86.71%
	1D		100%	82.33%	75.75%	88.01%
	2A		100%	74.85%	68.27%	80.54%
	2B		100%	74.14%	67.54%	79.85%
	2C		100%	84.88%	79.94%	89.15%
	2D		100%	83.46%	78.27%	87.95%
RPA Set Four	1A	Exhibit S-592	100%	50.05%	36.27%	61.97%
	1B	Tables 2-3 and	100%	48.47%	34.15%	60.85%
	1C	2-4	100%	60.95%	49.70%	70.66%
	1D		100%	63.45%	53.17%	72.33%
	2A		100%	53.43%	40.32%	64.77%
	2B		100%	52.86%	40.08%	63.91%
	2C		100%	66.02%	56.63%	74.14%
	2D		100%	64.78%	56.01%	72.36%

The results of the new analyses found in the April 19, 2006 PJM MMU Report, based on eleven months of actual data, show that the proposed merger fails both the Board's positive benefits standard and the FERC Guidelines if the reasonable assumption is made that the divested fossil capacity and/or nuclear energy is purchased by several parties that are already large participants. As Synapse has testified, and the Joint Petitioners have acknowledged, there are no guarantees in the proposed mitigation plan that would preclude the possibility that either the fossil capacity and/or the nuclear energy to be divested if the merger is closed actually would be purchased by only a few parties that already own significant amounts of capacity in PJM East. *RA-62 at 7-9*.

In its evaluation of Ratepayer Advocate Set One, the PJM MMU used the Joint Petitioners' assumptions as to the buyers of the divested fossil capacity. However, as requested by the Ratepayer Advocate, this set of scenarios assumed that the divested nuclear energy would be purchased by the next two largest existing participants in PJM after Exelon and PSEG. The results of the PJM MMU's analyses of the scenarios in Ratepayer Advocate Set One are presented in Tables 3-1 to 3-4 on pages 5 and 6 of *S-592*.

As shown in Table 3-3 on page 5 of *S-592*, each of the scenarios in Set One fails the Board's positive benefits test in every hour studied because the pre-merger to post-merger HHI changes are greater than zero in each hour. Moreover, because they have HHI changes greater than 100 in more than 60 percent of the 8,040 individual hours examined, each of the eight plant divestiture scenarios in Ratepayer Advocate Set One also fails the less stringent FERC Guidelines. Indeed, as shown in Table 3-4 on page 6 of Exhibit S-592, the Set One scenarios have pre- to post-merger HHI changes greater than 100, and consequently fail the FERC Guidelines, in more than 47 percent of the 3,728 "peak" hours studied and in more than 72 percent of the "off-peak" hours examined.

The FERC Guidelines define seasonal on-peak and seasonal off-peak periods as representing distinct "load levels" during which the energy supplied to those loads is treated as a separate supplied product in the screening analysis.[39] Hence, screen failures for energy supplied at any of these load levels means that the merger fails the overall screening analysis.

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

In its evaluation of Ratepayer Advocate Set Two, the PJM MMU again used the Joint Petitioners' assumptions as to the buyers of the divested fossil capacity. However, this set of scenarios assumed that the divested nuclear energy would be purchased by the next three largest existing participants in PJM East after Exelon and PSEG. The results of the PJM MMU's analyses of the scenarios in Ratepayer Advocate Set Two are presented in Tables 4-1 to 4-4 on pages 6 and 7 of *S-592*. As shown in Table 4-3 on page 5 of *S-592*, each of the scenarios in Ratepayer Advocate Set Two fails the Board's positive benefits test in every hour studied because they have pre-merger to post-merger HHI changes greater than zero. Moreover, because they have HHI changes greater than 100 in more than 41 percent of the 8,040 individual hours examined, each of the eight scenarios in Ratepayer Advocate Set Two also fails the less stringent FERC Guidelines. Indeed, as shown in Table 4-4 on page 7 of *S-592*, the Set Two scenarios have pre- to post-merger HHI changes greater than 100, and consequently fail the FERC Guidelines, in more than 25 percent of the 3,728 "peak" hours studied and in more than 55 percent of the "off-peak" hours examined.

In its evaluation of Ratepayer Advocate Set Three, the PJM MMU assumed that the buyers of both the divested fossil capacity and nuclear energy in each scenario are the next two largest current participants in PJM East other than Exelon and PSEG. As shown in Table 1-3 on page 3 of *S-592*, each of the scenarios in Ratepayer Advocate Set Three fails the Board's positive benefits test in every hour studied because they have pre-merger to post-merger HHI changes greater than zero. Moreover, because they have HHI changes greater than 100 in more than 71 percent of the 8,040 individual hours examined, each of the eight scenarios in Ratepayer Advocate Set Three fails the less stringent FERC Guidelines. Indeed, as shown in Table 1-4 on page 4 of *S-592*, the Set Three scenarios fail the FERC Guidelines because of HHI changes greater than 100 in more than 62 percent of the 3,728 peak hours studied and in more than 78 percent of the off-peak hours examined.

In its evaluation of Ratepayer Advocate Set Four, the PJM MMU assumed that the buyers of the divested fossil capacity are the next two largest existing participants in PJM (after Exelon and PSEG) but the divested nuclear energy is now assumed to be purchased by the next three largest existing participants instead of the next two largest participants as had been assumed in Ratepayer Advocate Set Three. The results of the PJM MMU's analyses of the scenarios in Ratepayer Advocate Set Four are presented in Tables 2-1 to 2-4 on pages 4 and 5 of *S-592*. As shown in Table 2-3 on page 4 of *S-592*, each of the scenarios in Ratepayer Advocate Set Four fails the Board's positive benefits test in every hour studied because they have pre-merger to post-merger HHI changes greater than zero. Moreover, because they have HHI changes greater than 100 in more than 48 percent of the 8,040 individual hours examined, each of the eight scenarios in Ratepayer Advocate Set Four also fails the less stringent FERC Guidelines. Indeed, as shown in Table 2-4 on page 5 of *S-592*, the Set Four scenarios have pre- to post-merger HHI changes greater than 100, and consequently fail the FERC Guidelines, in more than 34 percent of the 3,728 "peak" hours studied and in more than 60 percent of the "off-peak" hours examined.

c. Northern New Jersey Market.

The Northern New Jersey ("NNJ") geographic area is a "load pocket' and a highly concentrated market, according to PJM.[40] The proposed merger will further increase market concentration in the NNJ area, due mainly to the allocation of Exelon import capacity into NNJ. *JP-24* at 41. Notwithstanding, the market power concerns regarding the NNJ area, the Joint

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

Petitioners have not proposed a demonstrably effective plan to address NNJ market power issues, as set forth below and in the testimony of the Ratepayer Advocate's witnesses.

The NNJ load pocket has HHI's in excess of 3,800, indicating a highly concentrated market. *RA-5* at 59-60. Synapse testified that this is due to the dominance of PSEG's capacity in the market. *RA-5* at 60. The Joint Petitioners' witness Mr. Frame acknowledged that the NNJ area is a load pocket. *JP-6* at 26. Mr. Frame also acknowledged that screen violations would occur using the FERC guidelines because Exelon is allocated some of the import capacity into NNJ. *JP-24* at 41. However, Mr. Frame argues that the proposed merger will not have an impact on competition because Exelon does not own any generation in NNJ. *JP-24* at 41.

Although he testified that the divestiture of 100 MW of generating capacity either in NNJ or deliverable there would eliminate any merger-related NNJ screen violations, Mr. Frame's analysis of the NNJ market suffers from the same problems as his other analyses, as Synapse testified. *JP-24* at 41; *RA-16* at 26. Hence, Synapse expressed concern that the proposed divestiture of 100 MW might not be adequate and testified that, even with the divestiture of 100 MW, the post-merger NNJ energy market will be more concentrated than before. *RA-16* at 26-27. Although Mr. Frame cites PJM's NNJ offer caps as a way to prevent the exercise of market power, he cites no studies or other support for their claimed effectiveness. *JP-24* at 43. Furthermore, instead of addressing NNJ market power issues at this juncture, Mr. Frame relies on post-merger measures to address NNJ market concerns, and proposes that the Joint Petitioners' post-divestiture filing with the FERC will "include a demonstration that any competitive concerns within NNJ have been addressed." *JP-24* at 42, ln. 9-11.

In sum, the adverse impact of the merger on the NNJ market would fail the Board's positive benefits test. *RA-16* at 27. As Synapse testified, the Ratepayer Advocate respectfully submits that the Board should "work with PJM to identify potential actions to actually reduce the levels of [market] concentration" in NNJ, and not approve the proposed merger if it will increase concentration in NNJ. *RA-5* at 62, ln. 17-19.

d. Capacity Market

With respect to the capacity market, the Joint Petitioners have not presented a permanent capacity market mitigation proposal. Hence, it cannot be said that market power concerns regarding the PJM capacity market have been satisfied at this juncture. The Joint Petitioners' proposal to bid in the merged entities' Net Unforced Capacity (UCAP) position into PJM's daily ICAP market at a price of "zero" is but an interim measure.

Presently, a long-term design for the PJM capacity market has yet to be approved by the FERC. The PJM's Reliability Pricing Model ("RPM") capacity market proposal is now under review at the FERC.[41] As an interim mitigation measure, the Joint Petitioners have proposed to offer their entire "net long" position into PJM's daily capacity market at a price of zero. *JP-24* at 48. The Joint Petitioners have proposed to make a filing with the FERC to mitigate capacity market power concerns after a "new capacity paradigm is adopted for PJM." *JP-24* at 48, ln. 15-18. Therefore, concerns raised about the proposed merger's impact on capacity markets have not been fully addressed.

As Synapse testified, the Ratepayer Advocate respectfully recommends that the Board should not approve the proposed merger until it has had a reasonable opportunity to review concrete proposals from the Joint Petitioners identifying the amounts and locations of capacity that would have to be divested in order to mitigate market power concerns under the RPM proposal now before the FERC, or whatever new or revised capacity market form is ordered by the FERC. *See, RA-5* at 59.

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[41] FERC Dkt.Nos. ER05-1410-000 and EL05-148-000.

e. Mitigation/Virtual Divestiture.

Recognizing that without supply divestiture, the proposed merger would result in market power screen failures even under the less stringent FERC Guidelines, the Joint Petitioners proposed several mitigation measures. Joint Petitioner witness Mr. Frame found that, without mitigation, using the FERC Guidelines the proposed merger would yield screen violations in each of the three geographic markets he examined "during all or nearly all of the time periods studied," depending on the capacity measures used. *JP-6* at 6, ln. 9-10. However, the Joint Petitioners' mitigation plans leave unanswered questions material to the determination of their effectiveness, namely with respect to the specific generating units to be divested and their respective buyers. Additionally, the Joint Petitioners' novel "virtual divestiture" proposal and their proposals for post-merger compliance filings are fundamentally flawed. Finally, the Joint Petitioners' mitigation proposals are not based on the Board's "positive benefits" standard but, rather, on the less stringent FERC Guidelines.

Originally, the Joint Petitioners proposed to divest 2,900 MW in PJM East, including 1,900 MW of coal and mid-merit capacity, of which at least 550 MW would be coal-fired and 1,000 MW would be peaking capacity. *JP-6* at 6. The Joint Petitioners also originally proposed a "virtual divestiture" of 2,600 MW of nuclear capacity, of which at least 2,400 MW would be in PJM East. *JP-6* at 6. Under the Joint Petitioners' virtual divestiture proposal, EEG sells the energy related to the divested capacity, but retains the capacity associated with the virtually divested units. *RA-5* at 64.

The Joint Petitioners' original mitigation proposal also placed restrictions on the purchasers of the divested capacity. Under the original proposal, any firm with more than a 5 percent market share in PJM East or a PJM Pre-2004 would be ineligible to purchase divested capacity. *JP-6 Suppl.* at 7. Market participants with a market share of at least 3 percent but no more than 5 percent could purchase no more than 25 percent of the divested capacity, and no one purchaser could purchase more than 50 percent of the divested capacity. *JP-6 Suppl.* at 7.

The Joint Petitioners later revised their mitigation proposal to include an additional 1,100 MW of generating capacity, increasing the total amount of affected capacity (including "virtual divestiture") from 5,500 MW to 6,600 MW. *JP-6 Suppl.* at 6, Table 1. However, the Joint Petitioners' revised mitigation plan eliminated the restrictions on purchasers of the divested capacity. *JP-6 Suppl.* at 6. In place of the purchaser restrictions, the Joint Petitioners proposed a post-divestiture compliance filing "to show that the final results of the process do not differ materially and adversely from the Appendix A analysis submitted to FERC." *JP-6 Suppl.* at 7-8.

Significantly, the Joint Petitioners have not specified exactly which generating units will be divested and the identities of the buyers who will purchase the divested assets are not known at this time. The lack of data concerning the proposed divestiture is troubling. As Synapse testified, the characteristics of the units being divested and their buyers have a significant impact on market concentration and the ability of the merged company to exercise market power. *RA-16* at 32. Synapse testified that "[t]he location, fuel type, marginal operating costs, operating characteristics, age, and economic viability of the divested units will have a significant impact on the ability of the merged company to exercise market power in both the short-term and the long-term." *RA-5* at 65, ln. 17-20. Synapse also testified that "[t]he post-mitigation market concentration indices will be very different if the purchasers of the divested capacity are new participants in the market or already own substantial generating assets." *RA-5* at 65, ln. 23-25. The disparity in the results of the market power analyses, depending on the units and buyers, is illustrated by the range of HHI changes in Synapse's analyses of certain Joint Petitioner, Ratepayer Advocate and Board Staff divestiture scenarios. *See, RA-62* at 16-24, Tables S-1 through S-6. Hence, it is essential to know the specific purchasers and the units that they are acquiring.

The need to identify the divested units and their buyers was also recognized by the PJM MMU. In its May 24, 2005 report on the proposed merger, the PJM MMU addressed the need to identify the divested units and their buyers:

> The impact of the proposed divestitures depends on the specific units to be divested, the specific purchasers of the divested capacity and the nature of the divestiture.[42]
>
> For the locational Energy Markets [i.e., PJM East, Western Interface and Central Interface], … it is not possible to determine whether divestiture will in fact mitigate the issues without knowing the exact units and their distribution factor impacts on the identified constraints.[43]
>
> The conclusions about the required level of divestiture in the Energy Market depend on the nature of the entities purchasing the divested assets. … This is the case for the aggregate energy market and the locational energy market.[44]
>
> It is not possible to make a meaningful assessment of the effectiveness of the proposed divestiture in remedying structural market problems [in the locational energy markets] resulting from the proposed merger in the absence of the actual identification of specific units. A supplemental analysis must be performed once a definitive declaration of divested assets has been developed.[45]
>
> The conclusions about the required level of divestiture [in the capacity market] depend on the nature of the entities purchasing the divested capacity.[46]
>
> In order to determine the impact of the proposed divestiture in the regulation market, it is necessary to know the units that are to be divested and their regulation capacity.[47]

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[42] *S-5* at 4.
[43] *S-5* at 4.
[44] *S-5* at 4.
[45] *S-5* at 19, 21, 25 and 26.
[46] *S-5* at 5.
[47] *S-5* at 5.

In Part Two of its Exelon/PSEG Merger Analysis, dated October 14, 2005, the PJM MMU reaffirmed its earlier conclusions regarding the importance of identifying the specific units to be divested and the nature of the companies purchasing the divested capacity. *S-5*(b), (c). The PJM MMU noted the following with respect to the need to consider the entities purchasing the divested capacity:

> In fact, the conclusions about the required level of divestiture in the Energy Market depend on the nature of the companies purchasing the divested assets. The initial analysis assumes that the purchasing company has no capacity ownership in the relevant market. If the divested assets are sold to a company with a market share of from 16 percent to 35 percent, the proposed divestiture results in HHI levels that exceed the levels reached when the divested assets are sold to a company with a market share closer to five percent. In some cases the results after divestiture are worse than the results without divestiture. Conclusions about the required level of divestiture in the Locational energy markets also depend on the nature of the companies purchasing the divested assets.[48]

The PJM MMU reached similar conclusions with regard to the capacity and regulation markets.[49] *S-5*(b) at 4. The PJM MMU also expressed certain caveats relating to the identity of the divested units and their buyers in its evaluation of the Joint Petitioners' mitigation proposal:

> The analysis performed by the [PJM MMU] was designed to determine whether a return to pre-merger HHI levels was achievable given the candidate facilities and total volume of CT capacity to be divested… For the Eastern Interface, there was sufficient CT capacity available within the list of candidate facilities to return the post-merger HHI to pre-merger levels when such units are divested to a company with no generation assets in the market. <u>There are two critical caveats to this conclusion: effective mitigation is, and can only be, based on specific units; and that the effectiveness of mitigation depends heavily on the nature of the purchasing companies…. It is not possible to make a meaningful assessment of the effectiveness of a proposed divestiture in remedying structural market problems resulting from the proposed merger in the absence of the actual identification of specific units. A supplemental analysis must be performed once a definitive declaration of divested assets has been developed</u>.

(emphasis added.)[50]

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48 *S-5* (b) at 3.
49 *S-5* (b) at 4.
50 *S-5* (b) at 20.

In sum, the impact of the proposed merger on the relevant markets cannot be fully examined unless the specific units to be divested -- as well as the purchasers of the divested capacity -- are identified. *RA-62* at 3. The Joint Petitioners have only narrowed the field of potential units to be divested, but recognized that other units may need to be added depending on the results of their proposed post-merger review. *JP-146* at 43. However, in the absence of specific units and purchasers, or significant restrictions on purchasers, the Board should examine a wide range of possible divestiture scenarios. *RA-62* at 7-8. Moreover, the range of scenarios must be evaluated with reference to the Board's positive benefits standard.

The Joint Petitioners also propose a novel "virtual divestiture" of nuclear energy. The virtual divestiture involves the equivalent of 2,600 MW of nuclear generation. *RA-146* at 41. Under the Joint Petitioners' virtual divestiture proposal, the Joint Petitioners would retain operational control of their nuclear units while the energy output equivalent to that from the plants would be sold at the plant's PJM bus location. *RA-5* at 68-69. The Joint Petitioners would retain control over scheduling plant outages and output. The virtual divestiture of 2,600 MW of nuclear generation would involve the (1) auction of rolling three-year 100 percent load factor 25 MW blocks, (2) "through contracts" of long-term firm sales, or (3) some combination of the two. *JP-6* at 17-18.

Notably, as Synapse testified, virtual divestiture is a "novel and untested" concept. *RA-5* at 70, ln. 21. Furthermore, although the FERC approved the Joint Petitioners' virtual divestiture proposal as part of their approval of the instant merger, the FERC's virtual divestiture finding is at odds with its own requirements, as pointed out by Synapse. *RA-5* at 70. As Synapse testified, typically the FERC attributes the capacity associated with firm energy sales "to the party that has authority to decide when generating resources are available for operation." *RA-5* at 70, ln. 10-12.

Here, the Joint Petitioners would retain control over the operation of the nuclear units from which the virtually divested nuclear energy is generated.

As Synapse noted, the virtual divestiture proposed by the Joint Petitioners is an inadequate mitigation remedy due to several critical weaknesses:

- Under the proposed virtual divestiture, EEG still would maintain control over operations of the units that would generate the divested energy.
- Under the proposed virtual divestiture, EEG would have an incentive to exercise market power as that would indirectly increase the prices in the yearly nuclear auctions.
- As proposed, the virtual divestiture is not symmetric because there would be no provision for increasing the amount of nuclear energy to be divested if EEG constructs or acquires additional capacity.[51]

Therefore, as set forth in the testimony of its witnesses, the Ratepayer Advocate respectfully urges Your Honor and the Board to take the traditional view of virtual divestiture, that is, that virtual divestiture is not equivalent to actual divestiture. *See, RA-5* at 68-71; *RA-16* at 35; and *RA-62* at 19-20. Accordingly, the virtual divestiture proposed by the Joint Petitioners should not be considered as an effective mitigation measure in market power analyses.

Finally, the Ratepayer Advocate respectfully submits that Your Honor and the Board should not rely on the FERC and PJM MMU to address market power concerns in post-merger filings. Here, the Joint Petitioners propose to make post-merger filings with the FERC and the PJM MMU. *JP-24* at 49-50; *JP-146* at 42. The Joint Petitioners propose to file a post-merger filing with the FERC -- with the identities of the units and purchasers revealed – so the FERC can determine whether the divestiture creates market power problems. *JP-24* at 49-50. The Joint Petitioners also propose to make a post-merger filing with the PJM MMU, with the specific units and purchasers identified, with the intent that the PJM MMU would apply the same tests found in its February 9, 2006 report and, in turn, certify to the Board that the divestiture proposal

[51] *RA-5* at 68, ln 19, to p. 74, ln . 7.

meets those tests. *JP-146* at 42. Notably, the Joint Petitioners' post-merger PJM MMU process does not envision a challenge by the Board to the certification of the test results, nor does it provide for litigation or participation by other parties in the Board's review of the PJM MMU certification. *See,* T2910:L18-T2914:L11 (3/24/06). The proposed process appears to delegate the Board's decision-making authority to the PJM MMU.

The Ratepayer Advocate also has several significant concerns about the Joint Petitioners' proposed post-merger filings. First, the FERC and PJM MMU tests apply a standard of review which differs from the Board's standard. Whereas the Board applies the positive benefits standard, the FERC and the PJM MMU tests follow the FERC Guidelines, whereby a market may still be considered in compliance even if market concentration increases post-merger. Furthermore, for the post-merger Aggregate Energy Market submission to the PJM MMU, the Joint Petitioners commit only to passing a test where the average hourly increase in HHIs is considered. *JP-146* at 44. Moreover, the post-merger review process proposed by the Joint Petitioners limits the Board's role in the review of the PJM MMU's certification, and does not provide for participation by the other parties in the Board's post-merger review. *See,* T2910:L18-T2914:L11 (3/24/06). Furthermore, as noted herein, the use of the average HHI change proposed by the Joint Petitioners, as calculated by the PJM MMU in its February 9, 2005 report, is not consistent with how HHI analyses should be performed. *RA-62* at 4.

In short, any tests performed pursuant to the format found in the PJM MMU's February 9, 2006 report would suffer the same flaws that were identified earlier by Synapse. Also, the role of the Board in the post-merger review process would be severely limited. Moreover, as envisioned by the Joint Petitioners, other parties would not have the opportunity to participate in the process or litigate the results. Therefore, the Joint Petitioners' proposed post-merger filing with the PJM MMU should be summarily rejected as an effective mitigation measure. The Joint Petitioners' proposed post-merger process involving the PJM MMU shuts out other parties and does not provide for a meaningful review of the proposed mitigation measures.

With respect to the proposed post-merger filing with the FERC, aside from the application of a standard of review which differs significantly from the Board's, the FERC's earlier decision to approve the instant merger without a hearing raises serious questions about whether the FERC will perform a detailed post-merger review, with an opportunity for other parties to participate in a meaningful way in evidentiary hearings. In sum, the Joint Petitioners' proposed post-merger filings do little, if not nothing, to ensure that the impact of the proposed merger on competition will be addressed in a way that protects New Jersey ratepayers.

f. Strategic Bidding.

As stated in the testimony of Ratepayer Advocate witnesses David Schlissel, Robert Fagan and Bruce Biewald, the Board should be extremely concerned that EEG would be able to exercise market power even if the merger satisfied the FERC merger guidelines.[52] This is because if the gigantic new company were able to raise market prices only slightly through the exercise of the market power that comes from its dominant size, all of the minor merger-related savings could easily be lost.[53]

Given the size of the proposed merged company, the potential impact of the merged company and energy and capacity market prices in PJM East and the extremely minor merger-related savings claimed by the Joint Petitioners, it is critical for Your Honor and the Board to

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52 November 14, 2005 testimony of Schlissel, Fagan and Biewald, Exhibit RA-5 at pp. 81-88.

53 For example, in the testimony of Joint Petitioner witness William D. Arndt, the Joint Petitioners have noted that the electric merger-related savings in New Jersey would average only $12 million per year during the first four years after the merger is completed; the period emphasized by the Joint Petitioners in their merger studies (Exhibit JP-5, at page 54).

look beyond the results of Mr. Frame's idealized HHI analyses. In particular, Your Honor and the Board must examine whether or not it will be profitable for the merged company to exercise market power through strategic bidding or by physically withholding capacity from the market. This is crucial because the merger will create a situation in PJM East with a single dominant firm, even if the Joint Petitioners actually carry out the revised mitigation that they propose. In this situation, it is important to determine whether EEG, which will be the dominant firm and "market leader" in PJM East, will be able to profitably exercise market power through strategic bidding because merely looking at the usual market concentration indices for the total market (the "HHI") does not address this adequately.

No strategic bidding analyses were performed by Joint Petitioners or Mr. Frame while Synapse utilized their ELMO Model to evaluate whether EEG would be able to exercise market power by strategic bidding.[54]

As explained in their Direct Testimony, ELMO is a screening model developed by Synapse to evaluate market power potential in the electricity energy market.[55] The model is based on the supply curve concept and the potential revenue gain that participants could earn by bidding resources above their costs. The basic mechanism is that the owners of units on or below the margin can increase the market price by bidding up or withholding capacity. Then all the resources that still remain in the market receive a higher price. For any given participant, one can think of ownership of low-cost baseload resources as the motive and intermediate or peaking marginal resources as the means to exercise market power in this way. Any company that has

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54 See Exhibit BFS-8, RA-5.

55 November 14, 2005 Testimony of Biewald, Fagan and Schlissel, Exhibit RA-5 at p. 83.

both may be able to independently increase their net revenues – although all generators benefit when any one boosts the market price.[56]

In performing their market power evaluation, Synapse initially examined six Mitigation Scenarios in their HHI analyses using two sets of input assumptions. Their first set of analyses used all of Mr. Frame's input assumptions and the second set of analyses used most of Mr. Frame's input assumptions except corrected to reflect improved nuclear power plant performance capacity and economic allocation of the transmission into PJM East. In both sets of analyses Synapse used the resources as identified by Mr. Frame in his various pre and post merger cases and looked at the market power potential.[57] These analyses with the Synapse ELMO model revealed substantial market power potential in the existing PJM East energy market in which PSEG has a resource share of roughly 25 percent.[58] However, the potential for the exercise of market power increases as a result of the merger even after mitigation. This increase in the potential for the exercise of market power is represented by percentage increases in market clearing prices in the pre-merger and post-mitigation situations. For example, a 15.8 percent result in a post-mitigation situation represents a greater potential for the exercise of market power than does a 13.5 percent result in the corresponding pre-merger situation.

All of the scenarios that Synapse examined showed increases in the average energy market clearing price as a result of the exercise of market power. In the first set of analyses, which used all of Mr. Frame's input assumptions, Synapse projections of pre-merger to post-mitigation increases range from two tenths of one percent increase (for Mr. Frame's Mitigation Scenarios 1 and 3) to slightly more than one percent increase (for Synapse Mitigation Scenarios

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56 *Id.*

57 *Id*. at 83-84.

58 Exhibit BFS Table 9, November 14, 2005 Testimony, Exhibit RA-5 at p. 76.

4,5 and 6).[59] The net revenue changes (difference between market price and production costs) for the participants range from 12 percent to 16 percent depending on the Mitigation Scenario.

The results of Synapse's second set of analyses, which used corrected nuclear performance and transmission import assumptions, also showed potential increases in the potential for the exercise of market power from the pre-merger to the post-mitigation scenarios. For example, Synapse Mitigation Scenarios 4 and 5 showed potential market power revenue impacts 2.3 percent greater than the pre-merger situation. The market power revenue impact under Synapse Mitigation Scenario 6 was 1.3 percent.[60]

Synapse's ELMO modeling shows that there already is a significant potential for market power in PJM East because of PSEG's substantial market share. However, the proposed merger can be expected to make the situation worse, even with the Joint Petitioners' proposed levels of virtual and actual divestiture. The amount by which the proposed merger will increase the ability of EEG to exercise market power will depend on the identities of the parties that actually purchase this divested energy.

In his rebuttal testimony on behalf of the Joint Petitioners, Mr. Frame wrongly claims that the ELMO modeling predicts only a very small merger related price increase due to strategic bidding.[61] As discussed in Synapse's Direct Testimony, the $12 million average annual electric merger-related savings for New Jersey ratepayers claimed by the Joint Petitioners for the years 2006-2009 would be eliminated by just a 0.2 percent, or two-tenths of one percent, increase in wholesale prices from the exercise of market power.[62] Using Synapse's corrected input assumptions, the potential increases in market prices from the exercise of market power range

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59 Confidential Exhibit BFS-9, Table 5, Exhibit RA-6 at page 4.

60 Confidential Exhibit BFS-9, Table 6, Exhibit RA-6 at page 5.

61 Rebuttal Testimony of Rodney Frame, Exhibit JP-24, at page 8, line 18, to page 9, line 4, and at page 66, lines 1-16.

62 Biewald-Fagan-Schlissel Direct Testimony, Exhibit RA-5 at page 89, line 14, to page 90, line 6.

from 0.7 percent to 2.3 percent.[63] Even using all of Mr. Frame's assumptions, the potential increases in market prices from the exercise of market power range from 0.2 percent to 1.2 percent.[64] Using just the lower end of the range of these increases would fully offset the $12 million average annual electric merger-related savings that the Joint Petitioners claim for New Jersey ratepayers.

Mr. Frame claims that taking load obligations into account would eliminate the incentives to increase prices through strategic bidding.[65] However, the analysis presented in Exhibit RF-19 that Mr. Frame has prepared to demonstrate this claim is misleading and based on faulty assumptions. In fact, contrary to what Mr. Frame has assumed, it is not reasonable to expect that EEG's load serving subsidiaries PSE&G and PECO would have to pay the higher market prices for the energy they obtain – in many situations the load serving entities could have contractual arrangements of various types that would protect them from the full spot market prices. However, over time those contractual prices would change to reflect the increased market prices. Nor is it reasonable to expect that the load serving entities would be unable to pass along market price increases to their ratepayers. There may be some delay in doing so, but ratepayers would eventually pay the higher market prices. If not immediately through paying for purchases in the spot market, then later as new supply contracts are priced at the new market levels.[66]

Therefore, Synapse agrees with the figures for Increased Generator Profits from Withholding shown in Mr. Frame's Exhibit RF-19. However, Mr. Frame's figures for Increased Costs of Serving Load do not represent the real costs to the load serving entities. Rather, they would not occur because of existing supply contracts, or they would be passed onto customers as

63 *Ibid*, at page 85, lines 5-11.
64 *Ibid*, at page 84, line 22, to page 85, line 4, and Exhibit BFS-9, Table 5, at page 4.
65 Rebuttal Testimony of Rodney Frame, Exhibit JP-24, at page 9, lines 1-4, and page 60, lines 15-23.
66 Surrebuttal Testimony of Biewald-Fagan-Schlissel, Exhibit RA-16 at p. 28, lines 8-22.

market costs. For all of these reasons, Mr. Frame's conclusion that consideration of load obligations would eliminate the incentive for EEG to exercise market power is wrong.[67]

Mr. Frame opines that there is no need for simulation modeling to reflect the behavior of market participants as the results of a simulation analysis would not be useful to the Board.[68] Synapse disagrees and noted that Mr. Frame used a simulation model in testimony submitted to the Missouri Public Service Commission in February 1998 and the Mississippi Public Service Commission in August 1998. There Mr. Frame used production cost analyses to conduct a behavioral analysis which sought to assess whether a company acting unilaterally might be able to exercise market power in energy markets.[69] The simulation model that Mr. Frame used in that case was quite detailed and was able to represent transmission constraints between various locations on the grid as well as randomly occurring generating units outages on a probabilistic basis. As previously noted, Mr. Frame has misrepresented the findings and conclusions of the PJM MMU Merger Analyses. Rather than support Mr. Frame's claim that simulation modeling is not needed for the Board to evaluate the proposed merger, the PJM MMU Merger Analyses shows the need for such modeling.

Mr. Frame also criticizes Synapse's ELMO modeling, claiming that it did not model the hourly behavior of the market under a wide variety of conditions and bidding behavior correctly.[70] That criticism is misplaced as ELMO simulates the market at a number of load levels for 8,760 hours of the year. This is far more than the 10 periods examined in Mr. Frame's

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67 *Ibid*, l. 23- p. 29, l. 6.

68 Rebuttal Testimony of Rodney Frame, Exhibit JP-24, at page 58, line 19, to page 59, line 6.

69 *Report of Ameren to the Public Service Commission of Missouri on Market Power Issues*, dated February 27, 1998, at pages 64-67 and *Report to the Mississippi Public Service Commission on Retail Market Power Issues*, dated August 1998, at page 65-69. Both of these documents were provided in PSEG's response to RAR-MKT-81(b), Exhibit RA-5 at p. 28.

70 *Ibid*, at page 59, lines 16-20.

analyses.[71] Furthermore, ELMO is designed as a screening model to identify the potential for market power. The simulation analyses described in the Ratepayer Advocate's witnesses' Direct Testimony indicate the next steps that could be taken to analyze in more detail the potential impacts of the proposed merger on competition.[72] Given the results of Synapse's ELMO modeling, it is the responsibility of the Joint Petitioners to present such a simulation analysis.

Mr. Frame also claims that the use of a single resource curve representing complete units and the absence of operational limits related to unit commitment and ramping limits the applicability of the ELMO analysis and bias the results.[73] Once again, he is mistaken as ELMO does use a single supply curve and does not impose any restrictions on dispatching resources. However, this likely underrepresents the potential for exercising market power compared to a more realistic system, where competing resources might not be available or could not ramp fast enough to meet load and resource changes. The more restrictions placed on the supply options, the fewer resources are effectively available at any given time and location and, therefore, one could reasonably expect, the greater the potential for the exercise of market power.[74]

Mr. Frame also claims that generators in PJM East are frequently subject to cost-based offer caps and therefore cannot engage in the type of strategic bidding envisaged in the ELMO analysis.[75] He is again incorrect as while the existence of cost-based offer caps may limit the incentive for market participants to exercise market power, they do not eliminate this incentive. A 10 percent cap thus provides a substantial incentive because additional profit can be gained where the cap is set at 10 percent above marginal cost, relative to the situation where offers are

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71 B-F-S Rebuttal Testimony, Exhibit RA-16 at p. 30, l. 8 -12.

72 Biewald-Fagan-Schlissel Direct Testimony, Exhibit RA-5 at page 26, line 3, to page 28, line 4.

73 Rebuttal Testimony of Rodney Frame, Exhibit JP-24, at page 62, lines 2-16.

74 B-F-S Surrebuttal Testimony, Exhibit RA-16 at p. 31, l. 1 – 12.

75 *Ibid*, at page 63, lines 5-8.

closer to marginal costs. Also, there are instances when the cost capping does not apply, in particular when the binding constraint is the PJM East Interface itself.[76]

Another incorrect claim made by Mr. Frame is that Synapse's analysis effectively assumes that the PJM Eastern Interface is constrained 100 percent of the time and, therefore, ignores the price protections that customers in PJM East have during the 97.5 percent of the year when they have access to a much broader market.**[77]** Synapse did assume, as did Mr. Frame, that PJM East is the relevant market to study. Secondly, the price increases Synapse identified do not occur uniformly in all hours of the year. The 2.5 percent price increase due to market power that was found in Synapse Mitigation Scenario 4 is the average increase over the entire year. However, the increases in individual hours may be substantially higher or lower than 2.5 percent. Consequently, substantial profits can be earned by generators during only a limited number of hours in the year. Moreover, historical PJM data shows that during 2004, the price at the PJM Eastern Hub was greater than that at the Western Hub for 3,952 hours of the year. The average price difference was $8.56/MWh. Consequently, Mr. Frame's implication that the Board should only be concerned about the potential for the exercise of market power during a mere 2.5 % of the hours of the year is incorrect.[78]

Mr. Frame is also incorrect when he criticizes the ELMO modeling claiming that it failed to treat external supplies as price takers.[79] This is because the external supplies are never on the margin in ELMO. Thus, these resources are treated as price takers, not price setters. Mr.

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76 *Ibid*, p. 31, lines 16-22.
77 *Ibid*, at page 63, lines 9-21.
78 *Ibid,* p. 32, lines 1-18.
79 *Ibid*, at page 63, line 22 to page 64, line 13.

Frame's criticism is simply wrong – Synapse treats the external supplies in the manner in which he suggests they should be treated.[80]

Finally, Mr. Frame cited a number of factors which he claims cause ELMO to overstate the price impacts that are likely to result from the merger.[81] However, it must be stressed that there are assumptions that cause ELMO modeling to <u>understate</u> the price impacts that are likely to result from the merger:

- Synapse used Mr. Frame's data in which outages are represented by derated capacity rather than probabilistically. This means that Synapse ignored situations in which greater amounts of capacity than average are out of service.
- Synapse represented PJM East as a single market with no internal transmission constraints. This means that Synapse has ignored the potentially higher profits from the exercise of market power in those smaller constraints within PJM East (such as Northern New Jersey) that are sometimes binding.
- Synapse did not assume any operational limits related to unit commitment or ramping, or any operational restrictions related to grid stability requirements.
- Synapse assumed independent pricing behavior, that is, no implicit or explicit collusion among generation suppliers.[82]

g. Impact on the BGS Auction.

As was stated in the Synapse testimony,[83] the Joint Petitioners have not presented any analysis beyond several pages of narrative discussion in the Additional Testimony of Mr.

80 B-F-S surrebuttal testimony, Exhibit RA-16 at p. 32, l. 19-25.
81 *Ibid*, at page 62, line 1, to page 65, line 21.
82 B-F-S surrebuttal, Exhibit RA-16 at p. 33, lines 1-20.
83 See the November 14, 2005 testimony of Schlissel and Biewald, Exhibit RA-5 at pp. 80-81.

Frame[84] and no market power study of the BGS auctions was done.[85] Nevertheless, the Board should be concerned about the potential for EEG to exercise market power, directly or indirectly, in the BGS auctions because PSEG has supplied substantial amounts of power through the BGS auctions, both as a successful bidder and as a supplier to other successful bidders.[86]

While Exelon has not supplied a significant amount of BGS power, that might change as its commitment to using its nuclear capacity in Illinois to serving loads in its Chicago service area will no longer exist after the end of 2006. At that time, Exelon will be free to bid some or all of its 10,000 MW+ of nuclear capacity into the BGS auctions.[87] While BGS customers might benefit from this additional low-cost nuclear energy, there is also the possibility that EEG is able to exercise market power to boost BGS prices due to the availability of this additional nuclear energy, its dominance in the PJM East market, and/or its position as a supplier of natural gas to competitor power plants.

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

h. PJM Market Monitoring Unit Role.

The results of the PJM MMU Hourly Energy Market analyses do not show that the proposed merger satisfies the "positive benefits" standard[88] adopted by the Board[89]. Indeed, the

84 See the Additional Direct Testimony of Mr. Frame in JP-6 Additional.

85 Response to NJLEUC/RESA-PSEG-125, Exhibit RA-5 at p. 80.

86 For example, see the Direct Testimony of Joint Petitioner witness Mr. Frank Cassidy in JP-9, at pages 18 through 26.

87 Schlissel and Biewald testimony dated November 14, 2005, Exhibit RA-5 at p. 81, l. 1-5.

88 *NJ Board Order on Standard of Review*, dated November 9, 2005, at page 25.

results do not show that the proposed merger even satisfies the more lenient Department of Justice/Federal Energy Regulatory Commission ("DOJ/FERC") Merger Guidelines[90]. The PJM MMU used a different standard to evaluate the more than 200 scenarios requested by the parties to this proceeding, but never considered the Board standard. *T2542:L18 to T2543:L14 (3/9/06).*

The PJM MMU became involved in this proceeding at the request of the Board to independently analyze the impact of the merger on the PJM markets. *T2415:L18-23 (3/9/06).* The PJM MMU prepared reports dated May 24, 2005, June 16, 2005 and October 14, 2005 as well as performing the 220 sensitivity analyses requested by the parties after December 28, 2005. *T2417:L1-4, 14-22, T2418:L2-9 and T2421:L4-10 (3/9/06).* In the first two reports, the PJM MMU concluded that no definitive assessment regarding market power mitigation could be made since the Joint Petitioners failed to identify the specific plants to be divested or the identity of the buyers. *T2420:L16-23 (3/9/06).*

The PJM MMU used actual historical market activity data in performing its analysis, specifically data from May 1 through July 31, 2005. *T2422:L3-16 (3/9/06).* Since historical data was used and the proposed merger has not been consummated, the PJM MMU added the data from PSEG and Exelon together to simulate the merger. *T2424:L15-23 (3/9/06).* While the analysis took into account known upcoming plant retirements, it did not consider future capacity additions or increases in generation output. *T2425:L2-25 (3/9/06).* The analysis also did not take into account any other future possibilities, such as an increase in natural gas prices, impact on growth and demand or a new transmission line from PJM East into New York City. *T2533:L7-20 (3/9/06).*

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[89] *Supplemental Testimony of Robert Fagan and David Schlissel on behalf of the New Jersey Division of the Ratepayer Advocate*, dated March 17, 2006, Exhibit RA-62 at p. 1, l. 21 – p. 2, l. 1.

[90] *Id*. at p. 2, l. 6 – l. 9.

In the aggregate energy market, a generator might exercise market power by withholding, either economic withholding or physical withholding. *T2435:L5-14 (3/9/06).* Economic withholding means setting a price above a level likely to clear in the market. *T2435:L15-16 (3/9/06).* Physical withholding is not making the generating unit available to PJM, by taking an outage that is not real or keeping the unit out of the market when there is no physical reason to do so. *T2435:L25 to T2436:L5 (3/9/06).* The PJM MMU also analyzed market concentration within transmission constrained market systems identified as the Western, Central and Eastern interface markets and the key markets affected by binding transformer constraints. *T2439:L4-12 (3/9/06).* However, for this proceeding, the PJM MMU did not analyze economic withholding strategies or any other withholding strategies. *T2528:L8-12 (3/9/06).*

One way to mitigate market power in the Eastern interface locational energy market would be to apply PJM's offer capping rules, but that would require a rule change since the Eastern interface has been exempt from such rules since 1999. *T2446:L6 to T2447:L10 (3/9/06).* To change that exemption would take anywhere from two months to a year or more depending upon the approval process including the PJM membership and the FERC. *T2447:L11-20 (3/9/06).* In a perfectly competitive market, PJM would expect unit owners to offer their energy at marginal cost. *T2451:L10-12 (3/9/06).* In the past, there have been challenges to the PJM's method of offer capping and to the PJM MMU itself. *T2549:L11-16 (3/9/06).*

However, the Board cannot rely on PJM to effectively mitigate the exercise of market power by EEG because PJM is primarily limited to offer-capping suppliers at 110 percent of marginal costs, even if such an offer cap results in a greater return to the supplier than would be expected in a fully competitive market. The 10 percent adder is somewhat arbitrary and it has not been definitively shown that a lower level would not result in outcomes more closely approximating fully competitive markets. Moreover, energy offers are not capped at 110 percent of marginal cost if the only binding constraint is the PJM East interface itself. The resulting impact of the limited market power mitigation tools available to the PJM is a reduced ability to ensure that market price outcomes are competitive and that participants are not exercising market power through strategic bidding or the withholding of otherwise available capacity.[91]

In the October 14, 2005 report, three tables indicate that the proposed merger would exceed the DOJ guidelines and have a significant impact on competition.[92] *T2430:L11 to T2431:L9 (3/9/06).* Other tables suggest that the magnitude of the merger would require substantial divestiture of assets to mitigate market power in the aggregate energy market.[93] *T2432:L13 to T2435:L4 (3/9/06).* Another table shows an 850 point HHI increase in a highly concentrated market which exceeds the DOJ guidelines many times over.[94] *T2445:L11-21 (3/9/06).* Due to the relative size and mix of the existing generation owners in the Eastern interface market, the simplest way to achieve sufficient mitigation in the aggregate energy market is through plant divestitures. *T2445:L22 to T2446:L3 (3/9/06).*

Selling a generating plant to a competitor is a structural remedy to mitigate market power, whereas a behavioral remedy focuses on conduct or modified behavior by an individual entity. *T2452:L3-21 (3/9/06).* In the October report, with reference to the Eastern Interface energy market, it is stated "divestiture could result in a structurally competitive market."[95] If a competitive market relied on a behavioral remedy of EEG, the PJM MMU would monitor the behavior but only the FERC has enforcement ability. *T2453:L7-23 (3/9/06).* The MMU could call the participants and issue a "demand letter" if the offending behavior is not corrected before

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91 *November 14, 2005 Testimony*, Exhibit RA-5 at pp. 91-92.

92 Tables 3-1, 3-2 and 3-3 of the *October 14, 2005 PJM MMU report*, Exhibit S-5(b) at p. 13.

93 Tables 3-12 and 3-13 of the *October 14, 2005 PJM MMU report*, Exhibit S-5(b) at p. 17.

94 Table 3-14 of the *October 14, 2005 PJM MMU report*, Exhibit S-5(b) at p. 20.

95 The *October 14, 2005 PJM MMU report*, Exhibit S-5(b) at p. 19.

contacting the FERC. *T2455:L6 to T2456:L2 (3/9/06).* Given this required supervision, "clearly structural competitive markets are to be preferred to non-structural competitive markets." *T2458:L7-16 (3/9/06).*

However, the Board should be aware that the responsibilities and authority of the PJM MMU are not fixed. On March 31, 2006, PJM filed with the FERC an application to amend its tariff and change the Market Monitoring Plan. For example, the application seeks to remove one of the key mechanisms the PJM MMU currently has at its disposal when monitoring the competitiveness of the PJM markets, the ability to send "demand letters" to generators to discontinue actions that may be at odds with the spirit of competitive markets. This and other changes could reduce the ability of the PJM MMU to properly monitor the PJM markets – and as necessary, enforce – the PJM rules.[96]

The two markets most relevant to the BGS auction are the locational energy markets defined by the Eastern interface and the Keeney transformer. *T2463:L9-14 (3/9/06).* The former is exempt from the offer capping rules but the latter is not. *T2465:L2-19 (3/9/06).*

Electrical capacity is the capability to produce energy and a load serving entity ("LSE") in PJM has an obligation to acquire capacity equal to their load plus a reserve margin every day or face penalties. *T2466:L2-15 (3/9/06).* An LSE may generate its own capacity or acquire it by buying the rights in the market. *T2466:L20 to T2467:L7 (3/9/06).* PJM has been concerned about the adequacy of near term capacity for New Jersey and PJM East, especially as price signals are not adequate now to insure that generation is built where it is needed. *T2467:L8-21*

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[96] *PJM Interconnection, L.L.C.*, *Docket No. ER06-826*, filed March 31, 2006. As this filing was made on the last day of the hearings, the Ratepayer Advocate would respectfully ask the Court to take Judicial Notice of it pursuant to *N.J.R.E. 201(b)* and Official Notice as per *N.J.A.C. 1:1-15.2*. A copy has been provided to the Court in the Appendix and may be obtained by any other interested party by utilizing the eLibrary at www.ferc.gov and entering the Docket No. and filing date.

(3/9/06). While PJM has proposed an integrated plan to address the problem, there is no locational market for capacity in place today within PJM. *T2468:L10-25 (3/9/06).*

While the Board cannot rely upon the PJM MMU monitoring, the Board also cannot rely on the FERC to adequately address the market power implications of this proposed merger on an after-the-fact basis. The FERC's standard for review is significantly different from the Board's standard and would be inadequate to protect New Jersey customers from the consequences of the merger. Moreover, the FERC's decision to approve this merger without a hearing and without any detailed review of the Joint Petitioners' market power analysis raises serious questions about how detailed a review the FERC would make of any compliance filing by the Joint Petitioners.[97]

C. Vertical Market Power Issues

1. Electric

The new company created by the merger ("EEG") could earn additional revenues in electric markets and disadvantage electric competitors through the exercise of market power in gas markets. In an August 2005 Presentation to investors by the President of Exelon's Power Team, it was noted that in Exelon's market in the East (PJM) "natural gas prices drive power prices" and that "power prices are tracking closely to increasing fuel costs."[98] Because the merged company will have such substantial amounts of nuclear capacity, it will be able to profit from higher power prices due to increasing natural gas prices. Natural gas tends to set the marginal cost of power. Nuclear power generation cost will be substantially less. **[BEGIN CONFIDENTIAL]** [redacted]

[97] *Fagan-Schlissel Supplemental Testimony on PJM MMU Analyses*, dated March 17, 2006, RA-62 at p. 6.
[98] November 14, 2005 Testimony, RA-5, Exhibit BFS-7, at page 8 of 14.

[redacted] **[END CONFIDENTIAL]**

EEG would be able to disadvantage electric competitors through the exercise of market power in gas markets as PSEG has indicated that during 2004 it delivered natural gas to power eleven merchant plants.[100]

2. Gas

Combining Joint Petitioners' Gas Supply and Capacity Portfolios May Result in an Unacceptable Concentration of Market Power

a. Analysis of Market Power

The proposed merger of PSE&G and Exelon would combine ownership of the gas supply resources of PSE&G and PECO as well as the gas trading and retail gas businesses of PSEG and Exelon. *RA-4 at 6.* PSE&G currently serves 1.6 million retail gas customers, and PECO serves approximately 460,000 retail gas customers**.** *JP-1 at 8.* According to Joint Petitioners' calculations, the merged entity would control at least 35.6% of the pipeline capacity in the PJM East market. *RA-4 at 17, citing Hieronymus Testimony, FERC Docket No. EC05-43-000, Ex J-16.*

One analytical tool for evaluating market power is the Herfindahl-Hirschman Index ("HHI"). The Ratepayer Advocate did not prepare an HHI analysis for this proceeding; however, it has reviewed the gas market power analyses filed by Joint Petitioners' witnesses Rodney Frame (*JP-6)*, William Hieronymus **(***FERC Ex. J-16*), and John Morris (*JP-22*), as well as the HHI analysis prepared by Philadelphia Gas Works' ("PGW") witness, Dr. Paul Carpenter (*PGW-1*). Dr. Carpenter testified that there is a vertical power problem—a high degree of concentration

99 Confidential Response to RAR-MKT-87 (CONF), Exhibit RA-6 at p. 91.

100 Response to RAR-MKT-11, Exhibit RA-5 at p. 91.

of power in the upstream natural gas market as well as a high degree of concentration in the downstream electricity market. *PGW-1 at 4-5.* He stated that:

> The proposed merger of Exelon and PSEG raises significant vertical market power concerns. The merged entity will possess market power in the downstream electricity market represented by PJM East, and it will possess market power in the upstream market for delivered natural gas in the same geographic area. The degree of market power in the upstream gas market, as measured by the level and change in the HHI statistic, is sufficient to establish a presumption that the merger is "likely to create or enhance market power" under the FERC's standard for evaluation vertical mergers set out in order No. 642.

PGW-1 at 4.

Regarding the Joint Petitioners' incentive to manipulate natural gas prices, Dr. Carpenter testified that:

> The merged entity will have the ability and incentive to raise the level and volatility of natural gas prices, and thus electricity prices, in PJM East. Its ability to raise the price of natural gas derives from the merged entity's control of substantial gas transportation rights, and its discretion and flexibility to draw on those rights depending on demand conditions in the market during particular days….The merged entity would control more delivery capability…during peak winter demand periods. When demand conditions are such that pipeline transportation capacity in the region becomes heavily utilized, the merged entity will potentially have a pivotal suppler role in the gas market.

Id. at 5.

Based on its review of the gas market power testimony, discovery and cross-examination, and particularly Dr. Carpenter's testimony, the Ratepayer Advocate has concluded that the merger of PSE&G's gas business with that of Exelon could create a gas market power problem in the PJM East territory. Such a concentration of pipeline capacity under the control of a single entity might well result in a problem of vertical market power enabling Joint Petitioners to manipulate gas prices in the New Jersey market. With control of at least 35.6% of the capacity in the PJM East market, Joint Petitioners could manipulate prices, both upstream in the gas market and downstream in the electric market. Given this circumstance, the Ratepayer

Advocate recommends that Your Honor and the Board should reject the merger. If Your Honor and the Board consider approving the merger, the approval should require prior conditions of Joint Petitioners' control of the capacity market.

In their Petition and Initial Testimony, Joint Petitioners paid little attention to the issue of combined gas capacity resources. The initial filing stated simply that, "The combined company also will have a large gas distribution portfolio to complement its electric distribution business." *JP-1 at 14.* However, neither the Petition nor Joint Petitioners' witness Rodney Frame presented an analysis or discussion about the merger's specific impact on the gas market. *RA-4 at 14.* Mr. Frame admitted that his analysis focused on the "horizontal effects of the merger on wholesale electric markets" because he had concluded that the merger would not create or enhance any vertical competitive concerns." *JP-6 at 4.* Mr. Frame's lack of review of the gas market is evident in his limited analysis that the vertical aspects of the proposed merger will not present competitive problems given "the underlying competitiveness of upstream natural gas markets" and "pipeline alternatives to LDC delivery of natural gas for non-affiliated generators. . . ." *Id. at 17; RA-4 at 14.*

During the instant proceeding and the FERC and Pennsylvania Public Utilities Commission ("PaPUC") merger proceedings, Joint Petitioners made significant changes in their vertical market power analyses. *PGW-1 at 10-11.* In addition to Mr. Frame's testimony, Dr Hieronymus filed testimony and an HHI analysis in the FERC and PaPUC proceedings, concluding that "the PJM East upstream market is not highly concentrated and thus the competitive conditions in the market are not conducive to a vertical foreclosure strategy." *RA-4 at 16, citing FERC Ex. J-16 at 73.* However, Dr. Hieronymus's analysis is inadequate because he provided only summary data on pipelines flowing gas into the PJM East territory and the shares of such capacity controlled by various entities. He provided no data on market control for individual pipelines, nor did he provide information concerning control of storage capacity held by the entities with interstate transportation entitlements. *Id.* Dr. John Morris filed an upstream HHI analysis in rebuttal in this proceeding, inaccurately claiming that the merger would not create a vertical market power problem since "PSEG and Exelon do not have a large presence in the market for wholesale natural gas, nor do they own any interstate natural gas pipelines." *JP-22 at 5.*

In response to Joint Petitioners' witnesses, Intervenor PGW presented Dr. Paul Carpenter, who prepared an HHI analysis and testified that the merger of PECO's gas operations with PSE&G would result in the Joint Petitioners' controlling significant market power. *PGW-1.* Dr. Carpenter found Dr. Morris's analysis "…flawed because, like the Joint Petitioners' other upstream analyses, it significantly understates market concentration by including New York and New England capacity that will not be available in PJM East in peak demand periods. [It] compounds this error by including additional capacity on a pipeline that does not physically serve PJM East." *Id. at 11.*

The Ratepayer Advocate has reviewed Dr. Carpenter's testimony and supports his conclusions that the merger raises market power issues. In his surrebuttal in this proceeding, Dr. Carpenter concluded that:

> The proposed Exelon/PSEG merger raises significant vertical market power concerns. The merged entity would have market power in the PJM East natural gas market, and would have the incentive to use that market power to raise the level and volatility of prices in PJM East gas and electricity markets. The merger also has the potential to adversely affect outcomes in the Basic Generation Supply ("BGS") electricity auctions administered by the Board, by raising BGS auction prices. Neither the electric market mitigation the Joint Petitioners agreed to in order to secure FERC approval of their merger nor the settlement several parties entered into in Pennsylvania lessens the merged entity's vertical market power. Nor is regulation the panacea that witnesses for the Joint Petitioners claim,

> particularly as the vast majority of Exelon and PSEG's gas and electric market assets will be controlled by an unregulated entity after the merger.
>
> If the Board approves the Exelon/PSEG merger as currently proposed, the merger will have an adverse impact on competition. Therefore, the Board should either reject the merger, or order additional mitigation to eliminate the merged entity's vertical market power.

PGW-2 at 1.

The Ratepayer Advocate has not testified in this docket regarding whether the merged entity would or would not have market power as measured by an HHI analysis. *RA-14 at 5.* However, we recommend that Your Honor and the Board consider seriously Dr. Carpenter's testimony regarding the proposed merged company's having undue market power in PJM East. *Id.*

The Ratepayer Advocate does, however, disagree with Dr. Carpenter's solution to the market power problem. Dr. Carpenter recommends that, as a condition of approval, Joint Petitioners divest themselves of PECO's and PSE&G's gas assets, including the gas assets currently held and managed by PSEG ER&T. *PGW-1 at 1.* PSE&G's gas operation and its purchasing and trading affiliate, ER&T, are essential to the responsible and efficient operation of PSE&G. The Company's gas operations have been profitable for shareholders and have provided retail gas service to basic gas supply ("BGSS") customers and wholesale gas service to its own electric generation operations. In addition, ER&T has developed asset management expertise that has produced benefits to both customers and shareholders through the sharing of profits from sales of non-regulated and excess supply and capacity transactions. Divestiture of PSEG's gas unit would result in new management and new procedures that are likely to jeopardize the provision of safe, reliable and proper gas service for both gas and electric end users. Even if a purchaser does not plan to change the practices of the gas company, there would inevitably be personnel and other changes that could result in operational difficulties. If the Board chooses to approve this merger, it should look to methods other than divestiture of PSE&G's gas operations to mitigate the merged entity's adverse effect on competition resulting from vertical market power.

b. Other Gas Market Considerations.

Different gas users have different needs, and their reliance upon pipeline transportation may differ. Depending upon the supply resources utilized, local distribution companies ("LDCs") and their residential ratepayers, large commercial and industrial ("C&I") end users, and gas-fired electric generators may face very diverse market power concerns. *RA-4 at 16.* The availability of interstate gas pipeline transportation and storage capacity is limited, particularly during peak winter periods in the markets when restrictions on pipeline deliveries and excessive day-ahead gas prices occur. *Id.*

Currently, and for the foreseeable future, there is limited gas supply to meet growing gas demand. Consequently, relatively small variations in gas supply or demand can affect gas pricing. *Id*. Accordingly, an entity with a relatively small market share could influence gas prices. An entity with over 35% of the market could surely do so.

Another concern involves the growing trend for LDCs to utilize asset managers to operate some or all of their pipeline capacity. *RA-4 at 17.* ER&T already performs many of those services for PSE&G and possesses the expertise to perform asset management for other entities. With Joint Petitioners holding 35.6% or more of available capacity in the PJM East market area, any additional control of gas capacity resources, i.e., through asset management agreements, would place Joint Petitioners in a position of control wherein they could exert market power and manipulate purchases, without regulatory approval or oversight, resulting in higher than necessary pricing, to the detriment of New Jersey ratepayers. *Id.*

IX. FINANCIAL, ACCOUNTING AND CORPORATE GOVERNANCE

A. Capital Structure and Cost of Capital.

1. Introduction and Summary of Proposed Merger Conditions.

The proposed merger has a number of potential implications for PSE&G's capital structure and cost of capital. As a threshold matter, Exelon's Illinois utility subsidiary, ComEd, is involved in pending litigation which has been portrayed by the Company as a serious threat to the financial viability of ComEd, Exelon's largest utility subsidiary. The pendency of this litigation should be considered a merger "fatal flaw" until it is resolved and ComEd's financial viability is no longer threatened. *RA-9 at 11-13; RA-13 at 4-7.*

Even assuming the Illinois litigation is resolved, the proposed transaction, as currently structured, does not reflect a fair balance of shareholder and ratepayer interests. As noted elsewhere in this brief, PSEG's shareholders have already realized substantial premiums as a result of the expected benefits of the merger. The Joint Petitioners, in public statements and presentations to financial analysts, have repeatedly suggested that one of the key benefits of the merger will be capital cost reduction for the merged entities. *RA-9 at 16-17; RA-13 at 10-11.* The Joint Petitioners, however, have not quantified this expected benefit or proposed to share it with ratepayers. *RA-9 at 18; RA-13 at 10.*

Moreover, although the merger has the potential to reduce the merged entity's risk profile, it could also increase PSE&G's cost of capital due to merger-related business risks, or because Exelon may seek to move PSE&G to a more expensive capital structure with an excessive equity ratio *RA-9 at 20-21; RA-13 at 7-8.* Further, the Joint Petitioners have requested the Board's authorization for PSE&G to participate in the Exelon Utility Money Pool, which, in its present form, would allow Exelon's unregulated generation subsidiary to benefit at ratepayer expense. *RA-9 at 30-34; RA-13 at 12-13.* Finally, the merger, combined with the repeal of PUHCA, will result in the loss of important financial protections for PSE&G and its ratepayers unless the Board acts to preserve these protections.

If the Board should decide to approve the merger, the Ratepayer Advocate respectfully urges the Board to make such approval subject to the following conditions:

- The Board should not issue a Final Order permitting the merger to close until the Joint Petitioners have demonstrated that the Illinois litigation has been resolved and there is no longer a threat to ComEd's financial viability. The Joint Petitioners' proofs on these issues should be subject to review by all parties, and if necessary, further evidentiary hearings.

- The merger savings credited to ratepayers should include, at a minimum, the savings resulting from a 25-basis-point reduction in the Company's cost of equity, equivalent to approximately an $11 million reduction in the Company's revenue requirements.

- PSE&G should be required to continue as a stand-alone corporate entity that procures its own external debt capital and has its own separate bond rating.

- Should the merger increase PSE&G's cost of capital, any merger-related increase should not be reflected in PSE&G's rates.

- Any increase in PSE&G's cost of capital due to capital structure changes attributable to the merger and merger-related accounting (such as reflection of goodwill on PSE&G's balance sheet) should not be reflected in PSE&G's rates for utility service to New Jersey customers. This condition should apply to all rates charged to New Jersey retail customers, including both rates subject to the jurisdiction of the BPU and the transmission rates subject to regulation by the FERC that PSE&G's retail customers ultimately pay.

- PSE&G should not be permitted to participate in the Exelon Utility Money Pool unless Exelon's unregulated generation subsidiary is excluded as a borrower from the pool. In addition, such participation should be subject to the same conditions established by the Board for Jersey Central Power and Light Company's ("JCP&L's) participation in the First Energy money pool. Further, any Money Pool losses incurred by PSE&G should be borne by shareholders, not retail customers.

- The Board should retain certain PUHCA type restrictions on inter-affiliate loans, loan guarantees and dividends in order to assure PSE&G's financial integrity.

The reasons for the conditions are discussed in detail in the sections below.

The discussion below will also address the proposal of Staff witnesses Howard E. Lubow, Gregory S. Oetting and Dr. Robert Malko that $350 million in divestiture proceeds be infused into PSE&G to "improve" its equity ratio. *S-6(b) at 10, 13, 89-90.*[101] This proposal should be rejected, as the Staff witnesses have not presented any evidence that PSE&G's current equity ratio is inadequate.

2. Impact of Illinois Litigation.

Exelon is currently facing substantial financial exposure due to pending litigation in Illinois. As explained by Ratepayer Advocate Matthew I. Kahal, ComEd provides default electric generation service to most of its customers, under rate caps that are scheduled to expire in 2006. ComEd has proposed to provide default generation service after that time using generation supply procured through a wholesale auction process, and has further proposed full rate recovery of those supply costs. *RA-9 at 10.* The proposed procurement and rate plan was opposed by several consumer and governmental intervenors, including the Illinois Citizen Utility ("CUB") the Illinois Attorney General, and others. *Id.* The plan was approved by the Illinois Commerce Commission ("ICC") on January 24, 2006. *S-589.* Several of the parties opposing the plan expressed their intent to petition the ICC for rehearing and challenge the ICC decision in court. *Exelon Corp. 2005 Form 10K, Note 4 to Consolidated Financial Statements (Filed Feb 15, 2006) (S-588).* Applications for rehearing filed by several intervenors were denied by the ICC on March 8, 2006. As of April 25, 2006, appeals had been filed by the Illinois' Attorney General, the Cook County State's Attorney's Office, the Illinois Citizens Utility Board, and the Environmental Law and Policy Center. *Proposal to implement a competitive procurement process by establishing Rider CPP, Rider PPO-MVM, Rider TS-CPP and revising Rider PPO-*

[101] The amount of the proposed equity infusion was designated as "confidential" in the Lubow/Oetting/Malko prefiled testimony, but the amount was later included without a claim of confidentiality in the prefiled Rebuttal Testimony of Joint Petitioners' witness Mr. Young. *JP-28 at 5.*

MI, ICC Docket No. 05-0159. (Docket sheet available at: http://eweb.icc.state.il.us/e-docket/.)[102] The ComEd plan has also been opposed in the Illinois legislature. A bill that would extend the current rate freeze for three years, through the end of 2009 was introduced in the Illinois General Assembly on February 24, 2006. *Exelon Corp. Form 8-K (Feb. 24,2006).*[103]

Exelon has portrayed challenges to its procurement and rate plan as serious threats to ComEd's financial viability. According to an October 12, 2005 Memorandum of Law filed in the Cook County Circuit Court, ComEd is at risk of bankruptcy or severe financial distress if it is not able to recover the costs of procuring electric generation supply for its default customers. As the Memorandum of Law states:

> At stake is the financial viability of Com Ed and the reliability of electric service for millions of consumers in Northern Illinois.
>
> * * *
>
> ComEd cannot continue to provide reliable electric service, or survive financially, if it is forced to incur millions of dollars of costs purchasing electricity at FERC-regulated market prices that the company cannot recover from its customers. [Citation omitted.]

RA-9 at 11; Exelon Corp. Form 8-K (Oct. 14, 2005), Exhibit 99.2. ComEd's Brief in the Attorney General's Lawsuit.[104] The proposed rate freeze legislation has been portrayed in a similar light. As stated in a recent Exelon SEC filing, this legislation, if enacted and not invalidated by the courts, would "make it likely that ComEd would have to resort to the

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[102] Applications for rehearing were filed by the Illinois Citizens Utility Board, the Environmental Law and Policy Center, the Illinois Attorney General, the Building Owners and Managers Association of Chicago, Direct Energy Services, LLC, U.S. Energy Savings Corp, the Illinois Industrial Energy Consumers, and the Cook County State Attorney's Office. Your Honor and the Board are respectfully requested to take official notice of the referenced materials from the proceedings in Illinois Commerce Commission Docket No. 05-0159.

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

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

protection of the bankruptcy courts to continue as a going concern." *Exelon Corp. Form 8-K (Feb. 21, 2006).*[105]

The Board should not allow a merger to go forward until the challenges to ComEd's procurement and rate plan have been resolved. As Mr. Kahal observed, the proposed merger "is predicated on the notion that PSEG and PSE&G will be merged into a highly successful, stable and financially strong corporation," and that PSE&G's New Jersey customers will benefit as a result. *RA-9 at 11-12.* "Such assertions are at best highly questionable as long as the dark cloud of this litigation hangs over ComEd and Exelon." *Id. at 12.* Exelon management has portrayed the continuing opposition to its plan as raising questions concerning ComEd's financial survival. It would be "completely unreasonable and unwise" to allow PSE&G to merge into an organization with its largest utility subsidiary at risk of bankruptcy. *Id.* If the merger is approved, it should not be allowed to go forward until the Joint Petitioners have demonstrated that the dispute has been satisfactorily resolved and that ComEd's viability is no longer threatened. Before the merger is allowed to close, the Joint Petitioners should be required to submit proofs on this issue. Those proofs should be subject to review and comment by all parties, and, in the event of a factual dispute, further evidentiary hearings.

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

In public statements and presentations to financial analysts, the Joint Petitioners have repeatedly suggested that a cost of capital reduction will be a key benefit of the proposed merger. For example, as noted in Mr. Kahal's direct testimony, in a February, 2005 presentation to securities analysts, Exelon and PSEG management stated that the merger would result in a "Lower risk profile." *RA-9 at 16.* This theme was continued in the testimony filed by Joint

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

Petitioners in this proceeding. In his direct testimony, Mr. Rowe asserted that the merger would result in a "more diverse customer base" for the combined entities. *JP-2 at 6, quoted in RA-13 at 10.* Mr. Rowe further testified that the merger would provide financial benefits *to PSE&G*:

> 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.

Id. Mr. Ferland, in his rebuttal testimony, similarly stressed the benefits that would result from the geographic diversification of the combined entities delivery business. *JP-26 at 3-4. RA-13 at 3-4.*

The implication of such statements is clear—the Joint Petitioners are anticipating a significant cost of capital reduction as a benefit of the merger. *RA-9 at 18; RA-13 at 10-11.* The Joint Petitioners have not presented any quantification of the expected cost of capital reduction, or proposed to flow any portion of this benefit through to ratepayers. Mr. Kahal has testified that a reasonable estimate of these savings would be 25 basis points, representing a "small but meaningful" reduction in PSE&G's cost of capital. *RA-9 at 19.* This would translate into a $6.8 million annual cost of equity savings, or about an $11 million reduction in revenue requirements, based on PSE&G's $2.7 billion common equity capitalization at year end 2004. *Id.*

Joint Petitioners' witness Mr. Arndt has criticized Mr. Kahal's estimate as "arbitrary." *JP-29 at 34-35.* Joint Petitioners have not, however, presented their own quantification. As Mr. Kahal noted, "[b]y criticizing my estimate without offering an alternative, Mr. Arndt effectively argues for a 'zero savings" by default …." *RA-13 at 11.* Mr. Kahal selected 25 basis points as a "meaningful (*i.e.,* non-trivial) reduction" in PSE&G's cost of capital. In the absence of any other estimate in the record, this level of cost reduction should be included in the merger savings to be passed through to ratepayers. This annual level of savings should remain in effect until the completion of PSE&G's first post-merger rate case when its cost of capital can be established using market evidence.

4. Ratepayer Protections Against Cost of Capital Increases.

In addition to failing to propose any sharing of the expected cost of capital savings, the Joint Petitioners' proposal also includes no protections against the risk that the merger will increase PSE&G's cost of capital. The Ratepayer Advocate is proposing three conditions to provide such protections: (1) a requirement that PSE&G be required to continue as a stand-alone corporate entity that procures its own external debt capital and has its own separate bond rating; (2) a cost of capital "hold harmless," *i.e.*, a condition stating that any merger-related increase in PSE&G's cost of capital may not be reflected in PSE&G's rates; and (3) a condition specifically prohibiting PSE&G from reflecting capital structure changes attributable to the merger for ratemaking purposes. The Joint Petitioners do not appear to be objecting to the first of these conditions. *RA-9 at 23.* Thus, the following discussion will address the need for a cost of capital "hold harmless."

As Mr. Kahal explained, the "hold harmless" should protect ratepayers against two types of risk: the business risks inherent in any merger (*i.e.*, merger "execution risk"), and the risk that Exelon may seek to pursue a more expensive capital structure for PSE&G. With regard to the first type of risk, in any merger, there is a risk that the anticipated benefits will not occur or unanticipated problems may arise. As Mr. Kahal explained in his direct testimony, the literature examining the results of mergers "provides a very mixed picture concerning efficiency gains." *RA-9 at 20.* Staff witness Boris J. Steffen noted that this type of risk is particularly relevant to utility mergers. According to Mr. Steffen, S&P "has found that the credit quality of the acquiring company in a utility merger often suffers as a result of the deal," and that this occurs in part because utility mergers tend to rely heavily on synergy savings that may not materialize. *S-7 at 159, 161.* The concern expressed in the professional literature is also echoed by Joint Petitioners' witnesses Ferland and O'Flynn. In their joint prefiled testimony, Messrs. Ferland and O'Flynn acknowledge several "concerns and uncertainties" associated with the proposed merger, including "[t]the complexities involved in integrating the operations of two large companies." *JP-8 at 6.* Although there is no specific reason to believe that PSE&G's cost rate for debt and equity will increase as a result of the merger, there is nonetheless a risk that this could occur. This risk properly should be borne by shareholders, not ratepayers, particularly given the very large expected gain to shareholders on the non-regulated side of Exelon.

With regard to the second concern, there are specific reasons for concern that Exelon will attempt to move PSE&G toward a more expensive capital structure. Based on a Joint Petitioners' discovery response, PSE&G capital structure for ratemaking purposes includes 45.9 percent common equity, a common equity ratio consistent with PSE&G's current low single-A credit rating. *RA-9 at 26-27.* The same discovery response shows ratemaking common equity ratios of 66.8 percent for PECO and 58.0 percent for ComEd. *Id.* As Mr. Kahal testified, these equity ratios are "excessive." They suggest that "Exelon management is very aggressive in establishing expensive capital structure for companies that are low-risk distribution utilities." *RA-9 at 26.*

Further, the Joint Petitioners have not ruled out the possibility that they will seek a substantial common equity increase in PSE&G's ratemaking capital structure as a result of merger-related accounting. As shown on Exhibit JP-1I of the Petition, the *pro forma* capitalization for PSE&G post-merger, as of September 30, 2004, shows a common equity ratio of 62.8 percent, reflecting the Joint Petitioners' proposal to allocate an estimated $4 billion in goodwill to PSE&G's balance sheet. *RA-9 at 26, 27.* The Joint Petitioners' witness Scott S. Jennings has stated in his rebuttal testimony that the Joint Petitioners have committed to excluding goodwill from PSE&G's capital structure for ratemaking purposes—but only assuming they are granted their proposed accounting treatment for regulatory assets and liabilities. *JP-33 at 11.* As discussed below, the Ratepayer Advocate does not agree with the Joint Petitioners' proposed accounting treatment for regulatory assets. In addition, Mr. Jennings testified at the evidentiary hearing that the Joint Petitioners were not prepared to make this commitment with regard to ratemaking proceedings before the BPU. As Mr. Jennings testified, "further analysis" would be required before the Joint Petitioners could commit to excluding goodwill from PSE&G's capital structure for the purposes of establishing rates for transmission services regulated by the FERC. T372:L21 – T374:L3 (1/5/06).

Although New Jersey ratepayers do not pay FERC-regulated transmission rates directly, all electric generation suppliers must purchase transmission service. Thus, all ratepayers pay for transmission service, including both BGS customers and customers who purchase their generation service from third party suppliers. For this reason, exclusion of goodwill from the rates established by the BPU would provide only partial protection to ratepayers.

Furthermore, an increase in PSE&G's common equity for ratemaking purposes would prove very costly to ratepayers. For example, a 10 percentage-point increase in PSE&G's common equity ratio would cost ratepayers approximately $60 million annually in increased rates. *RA-9 at 27-28.*

Joint Petitioners' witness Young has raised three criticisms of the proposed cost of capital "hold harmless": (1) it is unnecessary, because the merger will not increase PSE&G's cost of capital, (2) the impact of the merger on PSE&G's cost of capital would be difficult to analyze and quantify, and (3) if there is a cost of capital increase, shareholders are entitled to collect if from customers. *JP-28 at 17-18.* These criticisms are unfounded. With regard to the first criticism, if the Joint Petitioners truly believe that the merger will not adversely affect PSE&G's cost of capital, they should have no objection to a hold-harmless condition. *RA-9 at 8.* With regard to the second criticism, operation of the proposed condition may not be simple, but it would be no more difficult than the evaluation of rate of return issues typically confronted by the Board in rate proceedings. *Id.* Indeed, during cross-examination Mr. Kahal gave an example of an analytic technique that could be used by a cost of equity witness to quantify a merger-related cost of equity premium. T443:L3 - T444:L14 (1/5/06). The Ratepayer Advocate is not proposing that PSE&G prove in every case that there is no adverse cost of capital risk premium, merely that the Board adopt a principle that the rate of return should not reflect such. Any party would be free to present evidence on that issue, along with other rate of return issues. Further, Exelon has implicitly acknowledged the feasibility of a cost of capital "hold harmless" condition by its agreement to such a condition in proceedings before the Pennsylvania Public Utility Commission. *RA-22;* T446:L18 – T448:9:L16 (1/59+/06). Mr. Young's third criticism is inconsistent with the Joint Petitioners' claim that the merger will not cause a cost of capital increase. As Mr. Kahal observed, "[i]t is improper to advocate merger 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." *RA-13 at 9.*

The proposed "hold harmless" condition would protect ratepayers from a risk that rightfully belongs to shareholders. The Board should establish as a ratemaking principle that cost of capital increases resulting from the merger will be excluded from PSE&G's rates. Further, any merger should be conditioned on a commitment by the Joint Petitioners to exclude goodwill from PSE&G's balance sheet for ratemaking purposes in all ratemaking proceedings that affect New Jersey ratepayers.

5. Participation in Exelon Utility Money Pool.

Exelon presently operates a "Utility Money Pool" in which the participants may invest on a short-term basis, and from which they may borrow available funds. Currently the participants in the money pool are the two Exelon delivery service utilities, ComEd and PECO, Exelon Business Services and Exelon Generation. In addition, Exelon Corporation participates only as a contributor of funds. *JP-4 at 16-17.* The Ratepayer Advocate, through the testimony of its witness Mr. Kahal, has recommended that PSE&G not be permitted to participate in the Utility Money Pool unless Exelon Generation is excluded as a borrower. In addition, Mr. Kahal has recommended that PSE&G's participation in the money pool be subject to the same conditions as were established by the Board for JCP&L's participation in the First Energy Money Pool. *RA-9 at 30-34.* Also, any losses on Money Pool loans should be borne by shareholders. *RA-9 at 34.* The Joint Petitioners are not opposing the latter two recommendations. *JP-28 at 7-9;* T312:L7 – T313:L19 (1/5/06); T313:L8-19 (1/5/06). The discussion below will address Exelon Generation's participation in the money pool.

As the Utility Money Pool is currently structured, PSE&G's participation would not benefit ratepayers. One of the Utility Money Pool participants, Exelon Generation, is Exelon's unregulated generation affiliate. It is clear that Exelon Generation in recent years has been the primary beneficiary of the Utility Money Pool. Ratepayer Advocate witness Mr. Kahal reviewed the month-end borrowing balances for the money pool from January 2004 to February 2005. During that period the two delivery service utilities had almost no borrowings, and were presumably the source of funds, while Exelon Generation borrowed about $200 million. *RA-9 at*

31. Exelon Business Services Corporation was also a significant borrower, with borrowings averaging about $82 million.

Allowing PSE&G to participate in a money pool with Exelon Generation as the primary borrower could prove costly to ratepayers. First, if large loans are outstanding, any decline in Exelon Generation's credit quality could increase PSE&G's risk profile. *RA-9 at 32.* Second, the Utility Money Pool with Exelon Generation as a borrower could contribute to a thicker, more expensive equity ratio for PSE&G. As Mr. Kahal explained, and as Joint Petitioners' witness Mr. Young acknowledged during his cross-examination, a loan would remain on the books of PSE&G as an asset, while funds transferred to Exelon Generation through a dividend to the holding company would reduce PSE&G's equity balance. *RA-9 at 32; RA-13 at 12-13;* T309:L22 – T311:L15. (1/5/06) Thus, the Utility Money Pool, with Exelon Generation as a borrower, could result in a thicker, more costly, equity ratio for PSE&G. *RA-9 at 32; RA-13 at 12-13.*

The Joint Petitioners claim that PSE&G's participation in the Exelon Utility Money Pool would save PSE&G approximately 5 to 10 basis points on short-term borrowings. Based on PSE&G's average short-term borrowings, the savings would amount to only $50,000 to $100,000 annually. *RA-13 at 32.* Moreover, even this small level of benefits is in question in view of the Exelon's past practice of loaning most of the available funds to Exelon Generation. *RA-13 at 12.*

For the above reasons, it would not be in ratepayers' interest to allow PSE&G to participate in the Utility Money Pool unless Exelon Generation is excluded, or is allowed to participate only as a lender. If the merger is approved, PSE&G should be prohibited from participating in the Utility Money Pool as long as Exelon Generation is permitted to participate as a borrower.

6. Preservation of PUHCA Protections.

At the time the Joint Petition was filed, Exelon Corporation was a non-exempt holding company under PUHCA and was therefore subject to a variety of requirements concerning its capital structure, financial transactions, and affiliate relationships, under the oversight of the SEC. If PUHCA had continued in effect, Exelon Electric and Gas would have been subject to those same restrictions. The Energy Policy Act of 2005, however, effectively repeals PUHCA, although some oversight responsibility has been transferred to the FERC. *RA-9 at 35.* This is an issue of concern because PSE&G's financial policies and practices, post-merger, would be controlled by an out-of-state holding company with two other utility affiliates and a much larger non-utility segment. In addition, future additional Exelon mergers or acquisitions could create an even larger and more complex organization with additional affiliates. *RA-9 at 35, 38.*

The merger, and possible future developments, creates the need for the Board to preserve certain consumer protections that would have been provided by PUHCA had it not been repealed. Mr. Kahal has recommended that any Board Order approving the proposed merger include the following capital structure-related restrictions:

- Exelon should continue to be required to maintain a minimum common equity ratio of 30 percent. This will help ensure that Exelon (the ultimate parent) retains financial strength and can serve as a source of capital for PSE&G, if needed, since PSEG can no longer serve that role.

- Other than through the Utility Money Pool (already addressed), PSE&G should not loan funds to, purchase the securities of or extend credit to either the Exelon holding company (including Exelon Energy Delivery) or any corporate affiliate.

- PSE&G shall pay dividends only from current and retained earnings, not from capital.

- PSE&G should not guarantee the debt of Exelon or any corporate affiliate or encumber its assets to provide security for Exelon or any affiliate.

RA-9 at 38. The above conditions are not intended to be an exhaustive list of all of the restrictions that the Board should implement as a result of the repeal of PUHCA; they represent only the capital-structure-related conditions that the Ratepayer Advocate has identified in the context of this proposed merger. The Ratepayer Advocate may recommend additional consumer protections as part of a rulemaking or other proceedings before the Board. *RA-13 at 9.*

The Joint Petitioners have objected to these proposed conditions as unnecessary, because they are asserted to be duplicative of areas that will remain subject to regulation by the Board and/or FERC. *JP-32 at 13.* The Ratepayer Advocate disagrees with this proposition. With regard to regulation by the Board, as Mr. Kahal explained during his cross-examination, many of the current restrictions reside in the Board's Order approving the establishment of PSE&G's current holding company, PSEG. It is unclear whether these restrictions will survive the merger, unless the Board specifically reaffirms them if and when it approves a merger with Exelon. T426:L23 - T429:L429 (1/5/06). With regard to the possibility of FERC regulation, New Jersey also has legitimate interests that require protection if the merger goes forward, independent of FERC regulation. Those interests should be protected through appropriate conditions in any Board Order approving the proposed merger,

The recommended conditions, moreover, do not appear to be inconsistent with Exelon's own expressed policies. For example, in his rebuttal testimony, Joint Petitioners' witness Mr. Young states that it is Exelon's policy to prohibit regulated affiliates from guaranteeing the debt of other affiliates, from pledging assets as security for repayment of the loans of an affiliate, or making long-term loans to affiliates. *JP-28 at 13.* This policy is the same in substance as the second and fourth of the recommended conditions listed above. T329:L9 - T331:L6 (1/5/06). The Joint Petitioners have not suggested any reason why the other two conditions would be unreasonable, only that they object in principle to the Board imposing them as a condition of the proposed merger. *JP-32 at 15-16.* The recommended conditions are necessary and appropriate to protect New Jersey ratepayers given the repeal of PUHCA. They should be included in any Board Order approving the proposed merger.

7. Staff's Proposed Equity Infusion.

Staff witnesses Lubow, Oetting and Malko have recommended that $350 million in divestiture proceeds be used to "improve" PSE&G's equity ratio. *S-6(a) at 10, 13, 89-90.* The Ratepayer Advocate opposes this Staff proposal. As Mr. Kahal testified, PSE&G currently has about 47 percent common equity and 52 percent debt. Given PSE&G's Standard and Poor's ("S&P") Business position rate of "3," the current debt ratio is comfortably within S&P's range of 50 to 55 percent for a single A credit rating. *RA-13 at 13-14.* Mr. Kahal's position is supported by the testimony of Joint Petitioners' witness Mr. Young who stated during his cross-examination that he did not have any reason to believe that PSE&G's current capital structure was not reasonable and appropriate. T308:L5-17 (1/5/06). Mr. Young further testified that he did not see any reason why the proposed merger would, by itself, alter the appropriate target debt ratio for PSE&G. T308:L18-24 (1/5/06). Messrs. Lubow, Oetting and Malko have not suggested any basis for their proposed infusion of equity other than bringing PSE&G's capital structure in line with that of ComEd. *S-6(a) at 10, 44.* The Staff witnesses have not presented any evidence to support a conclusion that PSE&G's equity ratio is inadequate, or that ComEd's presently much higher equity ratio is fair and reasonable for PSE&G ratepayers. Their proposal to add $350 million in equity to PSE&G's capital structure should therefore be rejected.

B. Proposed Regulatory Assets.

If the merger is approved, the regulatory accounting requirements resulting from the purchase method of accounting for the proposed merger will require a one-time adjustment of PSE&G's assets and liabilities to reflect their fair market values as of the date the merger closes. *JP-4 at 7; RA-8 at 4.* This one-time adjustment will result in an increase in PSE&G's balance sheet liabilities for its pension and Other Post-Employment Benefits ("OPEB" or "PBOP") expenses, and for its third-party debt. Currently these deferred costs are being recognized in rates on a gradual basis. Purchase accounting will require the recognition of these costs all at once at the time of the merger. *Id.* In addition, PSE&G will be required to recognize the fair market value of its BGS and BGSS contracts, which, based on current market conditions, are worth more than the contract prices for BGS and BGSS supply. The one-time adjustment will increase the value of these assets on PSE&G's financial books. *Id.*

The Joint Petitioners are proposing to address this issue by creating Regulatory Asset accounts to offset the adjustments to PSE&G's pension/OPEB costs and third-party debt costs, and a Regulatory Liability account to offset the adjustments to the BGS and BGSS contracts. *JP-4 at 8; RA-8 at 4-5.* Based on fair market values at September 30, 2004, the Joint Petitioners have estimated that the proposed Regulatory Asset and Regulatory Liability accounts would have the following balances:

		Amount ($millions)
Regulatory Assets:	Pension/OPEB Liabilities	$1,100
	Third Party Debt Obligations	$ 350
Regulatory Liabilities:	BGS/BGSS Contracts	$ 750

JP-4 at 14; RA-8 at 5.

The Ratepayer Advocate disagrees with this approach, as it could create a presumption that the costs implicit in the Regulatory Assets are automatically recoverable from ratepayers. The creation of Regulatory Assets is governed by Statement of Financial Accounting Standards ("SFAS") 71 "Accounting for the Effect of Certain Types of Regulation." As explained by Ratepayer Advocate witness Robert J. Henkes, creation of a Regulatory Asset "carries with it the presumption of recoverability" of the underlying costs, which could make it more difficult to take issue with the prudency and recoverability of such costs in future rate case. *RA-8 at 6.*

Further, the Joint Petitioners' proposal is inconsistent with the methodology adopted by the Board in its the Order approving the recent merger of AGL Resources, Inc. and NUI Utilities, Inc., d/b/a Elizabethtown Gas Company ("ETG"). Rather than creating a Regulatory Asset for ETG's pension and OPEB costs, the Board Order provided the following:

> ETG shall be permitted to defer costs associated with any pension or Other Post-Employment Benefits (OPEB) net assets or liabilities as of the date of the [merger] closing. ETG will continue to book the amount of pension and OPEB expenses currently authorized in ETG's rates, and will seek their recovery through the regulatory process within the Company's next base rate proceeding. In no event shall ETG recover from ratepayers any pension and OPEB expenses pursuant to this provision in excess of the pension and OPEB expenses that would have been booked in accordance with FAS 87 and FAS 106 in the absence of the merger….

I/M/O The Petition of NUI Utilities, Inc. (d/b/a Elizabethtown Gas Company) and AGL Resources, Inc. for Authority 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 Dkt. No. GM04070721, Order of Approval at 14 (Nov. 17, 2004). Thus, ETG was allowed (1) to establish a deferral account for the purpose of deferring the amount of the one-time adjustment to its pension and OPEB costs, (2) to continue to book the level of pension and OPEB costs allowed in its rates at the time of the merger, and (3) to seek continued recovery in rates in the next ETG base rate proceeding. *RA-8 at 7.*

Based on the Joint Petitioners' rebuttal testimony, they appear to have accepted the Ratepayer Advocate's position in substance. In her prefiled rebuttal testimony, Joint Petitioners' witness Kathryn Houtsma states that the Joint Petitioners are requesting the Board to issue an Order that will make it clear that "the Board will not be constrained from reviewing pension and PBOP expense just as it could have had purchase accounting not been applied, and that, for purposes of rate recovery, the Board will consider pension and PBOP expense as if purchase accounting had not been applied." *JP-32 at 11.* The proposed ordering paragraph attached as an exhibit to Ms. Houstma's testimony is virtually identical to the language used by the Board in the NUI/AGL merger Order; it would allow PSE&G to "defer" the pension and OPEB costs as of the date of the merger closing. *JP-32, Exhibit KMH-2.* This proposed language would preserve the current ratemaking treatment of PSE&G's pension and OPEB costs, without precluding future review of the prudency and recoverability of the costs implicit in the amounts deferred. *RA-14 at 4.* As Mr. Henkes explains in his prefiled direct and surrebuttal testimony, the same accounting treatment is appropriate for third party debt obligations and BGS and BGSS contracts. *RA-8 at 8; RA-14 at 5-6.*

C. Board of Directors.

Ratepayer Advocate's witness, Mr. Peterson, also raised the issue concerning the adequacy of the post-merger composition of the merged company's board of directors. Exelon's current board of directors has 13 members while PSEG's board of directors has 9 members. Post-merger the Exelon board of directors will expand to 18 members, 6 of whom would initially be PSEG legacy directors. *RA-10 at 23.* Accordingly, after the merger, Exelon will have one less director, but PSEG will have three fewer directors and only one-third of the Exelon board.

This proposal exacerbates the concern about adequate representation of PSE&G's interests on the Exelon board of directors.

To address this concern, Mr. Peterson recommended that at least three PSEG legacy directors be appointed to the Exelon board of directors for an initial term of six years rather than 3 years as the Joint Petitioners proposed. This would give the New Jersey utility and its customers at least some comfort that there are a few board members who maintain awareness of New Jersey issues and that these directors would still be on the board representing their interests for more than the relatively short initial three-year transition period. *RA-10 at 24.* The Ratepayer Advocate respectfully recommends that, should Your Honor and the Board be inclined to approve the merger, these recommendations should be adopted to help ensure that the interests of New Jersey customers and the State are adequately represented for more than a minimal period of time once the merger closes.

X. RELATED AUTORIZATIONS REQUESTED BY THE JOINT PETITIONERS

Affiliate Transactions, GSA/MSA Allocation Issues

Because the Joint Petitioners Have Not Provided an Actual GSA or MSA That Will Be Utilized After the Proposed Merger and Have Not Demonstrated That the Proposed GSA and MSA are Reasonable, the Ratepayer Advocate Respectfully Recommends Disapproval of This Aspect of the Merger Proposals.

Exelon Business Services Company ("Exelon BSC"), a first-tier subsidiary of Exelon, provides Exelon and its subsidiaries with advisory, professional, technical and other services as described in greater detail in the testimony of Ruth Ann M. Gillis, submitted as Exhibit JP-7A.[106] *JP-1 at 4.* PSEG Services is a wholly-owned subsidiary of PSEG that provides corporate support, managerial and administrative services to PSEG and its subsidiaries including PSE&G.[107] *Id. at 3.* If the merger is consummated, PSEG Services will sell all of its assets to Exelon BSC, and remain as a non-energy entity. Post-merger, Exelon BSC will be the sole "service company" of EEG. *Id. at 7.*

The activities of PSEG Services and Exelon BSC will be combined in Exelon BSC, which will continue to provide the types of services that it currently offers and will render those services to the expanded Exelon system of companies, including PSE&G, pursuant to a General Services Agreement ("GSA") (Exhibit JP-1E). In addition, like its post-Merger affiliates PECO and ComEd, PSE&G plans to enter into a second service agreement (the "Mutual Services Agreement" or "MSA") (Exhibit JP-1F) to govern affiliated interest transactions between PSE&G and the affiliated operating companies within the Exelon system of companies other

[106] Ms. Gillis' prefiled testimony, JP-7A, adopted the testimony of the Joint Petitioners' witness, Pamela B. Strobel, JP-7, which was filed with the Verified Joint Petition (JP-1). T1324:L21-25 (1/13/06).

[107] PSEG created PSEG Services in 2000. PSE&G petitioned the Board for approval of a service agreement between PSEG Services and PSE&G. The Board approved the agreement by an order dated April 22, 2004. *In the Matter of the Petition of Public Service Electric and Gas Company for Approval of a Service Agreement with PSEG Services Corporation and Transfer of Assets*, BPU Docket No. EM00040253, OAL Docket No. PUC 1187-03. *JP-7 at 11-12; RA-10 at 25.*

than Exelon BSC. The Joint Petitioners seek Board approval of the GSA and the MSA in accordance with *N.J.S.A. 48:3-7.1. Id. at 12*; T1326:L20-25 (1/13/06).

N.J.S.A. 48:3-7.1 is the statute governing the contracts between public utilities and their affiliates if expenditures for services rendered under the contract exceed $25,000. The statute provides as follows:

> The board shall disapprove such contract if it determines that such contract violates the laws of this state or of the United States, or that the price or compensation thereby fixed exceeds the fair price or fair compensation for the property to be furnished or the work to be done or the services to be rendered thereunder or is contrary to the public interest: otherwise the board shall approve such contract.

Ratepayer Advocate witness, David E. Peterson, has concluded that the Joint Petitioners' requests for approval of the proposed merger's terms concerning affiliate transactions and the service companies do not adequately protect ratepayer interests and should not be approved. *RA-10 at 4, 28-29.*

As Mr. Peterson testified, the Joint Petitioners have not even formulated the actual GSA or MSA that will govern the related transactions; so there are in fact no such agreements for Your Honor and the Board to review, let alone approve. *RA-10 at 27, 29; RA-15 at 9-10.* The Joint Petitioners repeatedly allege that the draft GSA (JP-1E) is the proposed general services agreement that will apply to the merged companies. *JP-34 at 9.* However, they have also provided contradictory statements under oath which prove that the draft agreements are not the **actual** documents under which the merged companies will actually operate.

The Joint Petitioners' witness, Ms. Gillis, admitted that the Joint Petitioners have yet to finalize the "future products and services of the combined service company" under the new GSA. *JP-34 at 2.* In discovery responses that were entered into the record at the January 13, 2006 hearing, the Joint Petitioners also confirmed this situation. *RA-47, RA-48, RA-49 and RA-50.* Ms. Gillis reviewed these exhibits and testified likewise:

> Q These four discovery responses are all generally to the same effect, that the services that would be provided to Public Service Electric and Gas by Exelon Business Services Company post merger have not currently been identified in detail?
>
> A That is true.

T1333:L9-14 (1/13/06). Ms. Gillis also admitted that the proposed GSA has not even been signed by the merging companies. *JP-34 at 9.*

The reason given for this uncertainty is the avowed inability of the Joint Petitioners to share detailed cost information because of the status of the merger review being done by the United States Department of Justice ("DOJ"). *JP-34 at 2*; T1355:L16 to T1356:L14 (1/13/06). While the Joint Petitioners' reluctance to share information may be understandable, that still places Your Honor and the Board in the untenable position of deciding the merger petition's request to approve agreements that do not yet exist. The great importance of this issue is emphasized by Mr. Peterson's testimony that, in 2004, PSE&G was billed $207.6 million by the existing services company, PSE&G Services. *RA-10 at 26.* It is unreasonable for the Joint Petitioners to expect Your Honor and the Board to approve this merger and the uncertain GSA and MSA when such a vast amount of money is at stake. The Ratepayer Advocate respectfully recommends that Your Honor and the Board reject the proposed merger and deny approval of the draft GSA and MSA attached to the Verified Joint Petition.

Furthermore, the Joint Petitioners are also uncertain as to when they may be able to finalize the necessary information for the Board to review. As Ms. Gillis testified,

> A I don't have a sense for the timing of when we will have the ability to have more complete sharing of information. . . .

T1334:L2-4 (1/13/06). While the Joint Petitioners repeatedly allege that the proposed GSA and MSA describe the types of services that Exelon BSC currently offers to its affiliates, it is still undeniable that these draft documents are not the real documents that the merging companies will use. It is entirely unreasonable for them to expect Your Honor and the Board to approve these documents and expose ratepayers to hundreds of millions of dollars each year in charges that the new services company will bill to PSE&G without customers knowing if the types of services, and the amounts charged for the services, are reasonable or unreasonable.

In addition, Mr. Peterson raised the concern that the draft GSA does not specify what allocation methods and factors will be used to charge for the actual services that PSE&G will pay for after the merger. *RA-10 at 27.* While the Joint Petitioners have promised to treat PSE&G fairly and equitably, that vague promise hardly rises to the level of certainty that New Jersey ratemaking requires. Ms. Gillis repeated this uncertainty at the evidentiary hearing.

> I am not able to give you any more specificity today with regard to the explicit services and the explicit direct charging or allocation methodologies.
> I don't have all of the inputs, if you will, today to really do that.

T1351:L25 to T1352:L5 (1/13/06).

The draft GSA also has other major problems that were identified by Mr. Peterson. It allows Exelon BSC too much discretion in the methods used to allocate common and joint costs to the affiliates, including PSE&G, and suggests that Exelon BSC can pick and choose among all the allocation ratios that are listed to be applied to a specific category of service. Mr. Peterson recommended that the allocation basis for each specific service category, even if it is merely a "composite" formula such as the Modified Massachusetts Formula, should be specified within the agreement and not be left to the discretion of the service company. That is, the GSA should contain a more clearly defined matrix of specific services provided and associated allocation method(s) for each specific service category. *RA-10 at 28-29.*

Another major problem is that, in other cases involving service company agreements, the Board has considered it important that there be incentives within the agreement for the service company to increase the relative level of directly billed charges, as opposed to allocated charges, and to limit the use of discretionary and often arbitrary allocation methods to apportion costs among participating companies. There is no commitment or incentive in the GSA, however, to increase the percentage of directly billed costs relative to those that are allocated. *Id. at 29.* This is an important defect in the GSA that Your Honor and the Board should not disregard.

The existing Exelon GSA also "does not reflect what the Board has required other New Jersey utility agreements with service companies to contain." *RA-10 at 28.* Not only does the existing GSA conflict with BPU policy on utility service company agreements, but the Joint Petitioners have also admitted that they are unwilling to abide by the recent stipulation concerning the existing services company agreement between PSE&G and PSEG Services that the utility has already signed and that has been approved by the Board.[108] It is hardly comforting for ratepayers to know that the acquiring company is so willing to repudiate a binding agreement that was only recently signed by the acquired company.

The Joint Petitioners provided a sixteen-page list of items that they could not agree to, but which are already in the current stipulation signed by PSE&G. *TR-1362 (Appendix).* While a few of the differences are minor, many of them are a major concern to the Ratepayer Advocate. Since the Board has only recently approved the stipulation, it should be clear that these are a major concern to the Board as well.

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[108] Exhibit RA-54.

One of the differences is the Joint Petitioners' refusal to agree that costs will be directly charged whenever possible and that the service company will work toward the goal of maintaining for the future a level of direct billings for PSE&G comparable to the current experience or better. *See, TR-1362 at page 2 of 17 (Appendix).* This refusal directly contradicts the Board's policy to increase the amount of charges that are directly billed rather than merely allocated, as mentioned above.

The Ratepayer Advocate respectfully submits that the refusal of the Joint Petitioners to abide by this recent agreement is another reason for Your Honor and the Board to disapprove the proposed merger. As Mr. Peterson has recommended, the Joint Petitioners should be required to "present to the parties a detailed operating plan for Exelon BSC post- merger, along with Exelon BSC's detailed proposal for billing client companies for the services it will provide post-merger. A revised GSA reflecting those services and allocation methods should be included in that presentation. The same problems exist in the proposed MSA. Therefore, the MSA should be held to the same requirements." *RA-10 at 29.*

The Joint Petitioners believe that they can cure these serious defects in their merger proposals by waiting 120 days after the merger closing to provide the parties with the necessary information to decide whether the merger is a good idea in the first place. Their plan is contained in the rebuttal testimony of Ms. Gillis (*JP-34*) on page six:

> Exelon BSC is willing to commit to the following: Exelon BSC will provide to the Board, within 120 days after closing of the merger, a report detailing the expected services to be provided to PSE&G by Exelon BSC, and the methods to be used to allocate or direct charge the cost of these services.

This is not a reasonable plan upon which merger approval can be conditioned. The Joint Petitioners' proposal falls woefully short of what is required in this matter. It is entirely unreasonable to expect Your Honor and the Board to approve the creation of such a large merged entity on the hope that, 120 days later, the merged entity will adequately inform the parties of what services Exelon BSC will provide to PSE&G and how the hundreds of millions of dollars in annual charges will be calculated and billed to the utility to be passed through to the customers. This proposal deserves to be rejected in its entirety.

Rather than adopt the Joint Petitioners' "wait and see" proposal, the Ratepayer Advocate respectfully recommends adoption of our witness's proposals as outlined above and in Mr. Peterson's testimony including the following that are spelled out on pages 30 through 33 in Exhibit RA-10. If Your Honor and the Board decide to approve this merger, the Ratepayer Advocate recommends the following preconditions be a part of that approval:

> 1) Exelon BSC costs shall be directly charged whenever practicable and possible and affirmative steps shall be taken to increase direct billings relative to current billings. PSE&G shall report about direct and indirect charges by function quarterly and respond to questions concerning such reports. In its next base rate proceeding, PSE&G shall file testimony addressing Exelon BSC charges and the bases for such charges, as well as the modifications to procedures and systems that are being made to increase direct billings.
>
> 2) No later than the end of the second calendar quarter of each year ("Reporting Year"), PSE&G shall provide the Board, Board Staff and the Ratepayer Advocate with the following reports:
>
> a. The equivalent of the SEC Form U-13-60 Report that describes Exelon BSC direct billings versus allocated costs for each operating utility company in the Exelon system. In addition, Exelon BSC shall provide a further breakdown for PSE&G, which identifies the total amounts charged, separately stating direct and indirect charges to PSE&G for each service function.
>
> b. The cost allocation percentages and supporting work papers for the Reporting Year based on the estimated plan factors for the Reporting Year. Such report shall compare these estimated plan factors and cost allocation percentages for the Reporting Year to those actual allocation factors and percentages used in the previous year and highlight all modifications, and, specifically identify those that occurred during the course of the year due to significant events based on the prior year's actual results of Exelon BSC's charges for each allocation factor for each Exelon affiliate. PSE&G shall explain any change to allocation factors to PSE&G that are more than five percentage points. PSE&G shall also make

available on request any prior months' variance reports regarding Exelon BSC's billings to PSE&G.

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

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

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

6) For assets that Exelon BSC acquires for use by PSE&G, the same capitalization/expense policies shall apply to those assets that are applicable under the Board's standards for assets acquired directly by PSE&G.

7) For depreciable assets that Exelon BSC acquires for use by PSE&G, the depreciation expense charged to PSE&G by Exelon BSC shall reflect the same depreciable lives and methods required by the Board for similar assets acquired directly by PSE&G. In no event shall depreciable lives on plant acquired for PSE&G by Exelon BSC be shorter than those approved by the Board for similar property acquired directly by PSE&G.

8) For assets that Exelon BSC acquires for use by PSE&G, the rate of return shall be based on PSE&G's authorized rate of return, unless Exelon BSC is able to finance the asset at a lower cost than PSE&G. In such cases, the lower cost financing will be reflected in Exelon BSC's billings to PSE&G, and the resulting benefit will be passed on to ratepayers.

9) Board Staff and the Ratepayer Advocate shall be assured reasonable and convenient access to the books and records of Exelon BSC and other Exelon companies that transact business with PSE&G, and supporting documentation thereof, but only to the extent relevant to transactions with PSE&G.

10) The Board and the Ratepayer Advocate will be sent copies of any and all "60-day" letters, and supporting documentation, sent by Exelon BSC to the SEC concerning a proposed change in the GSA.

11) PSE&G shall continue to submit to the Board's jurisdiction on issues regarding the New Jersey ratemaking treatment of Exelon BSC's costs that are assigned or otherwise allocated to PSE&G and borne by PSE&G customers. PSE&G shall not raise a Federal preemption defense when challenging the appropriateness of a Board ruling on a cost allocation issue concerning the GSA.

12) PSE&G shall file petitions for approval of any modifications to the GSA, including changes in methods or formulae used to allocate costs, with the Board at the same time it makes a filing with the SEC or the FERC.

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.

By adopting our recommendations concerning the GSA and MSA, Your Honor and the Board can help to avoid any erosion of the Board's regulatory authority over PSE&G in this area and the rates that the utility charges its New Jersey customers.

XI. ADDITIONAL ISSUES RAISED IN THE COURSE OF THE PROCEEDING

The Ratepayer Advocate has addressed all issues in this initial brief.

XII. CONCLUSION

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

Respectfully submitted,

SEEMA M. SINGH, ESQ.
RATEPAYER ADVOCATE

By:________________________________
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PSEG/EXELON MERGER
RPA RECOMMENDED NET MERGER SAVINGS
ALLOCATIONS TO REGULATED PUBLIC SERVICE ELECTRIC AND GAS COMPANY EBU AND GBU
($000's)

	Total 3 Years 2006-2008 (1)	EBU	GBU
1. RPA-RecommendedTotal Adjusted Gross Savings	$ 179,880		
- EBU Allocation @ 61.8% [RJH-1, p.2, L3]		$ 111,166	
- Less: EBU Transmission	(15,200) (2)	(15,200) (2)	
- GBU Allocation @ 38.2% [RJH-1, p.3, L3]			$ 68,714
2. RPA-Recommended Total CTA	$ 46,089		
- EBU Allocation @ 61.2% [RJH-1, p.2, L4c]		$ 28,206	
- Less: EBU Transmission	(9,555) (2)	(9,555) (2)	
- GBU Allocation @ 38.8% [RJH-1, p.3, L4c]			$ 17,883
3. RPA-Recommended Total Pre-Merger Initiatives	$ 5,709		
- EBU Allocation @ 61.2% [RJH-1, p.2, L5]		$ 3,494	
- Less: EBU Transmission	(457) (2)	(457) (2)	
- GBU Allocation @ 38.8% [RJH-1, p.3, L5]			$ 2,215
4. TOTAL [L1 - L2 - L3]	$ 122,894	$ 74,277	$ 48,617
5. 3-Year Average	$ 40,965	$ 24,759	$ 16,206

(1) Mr. Peterson's Exhibit__(DP-2)
(2) Exhibit JP-114 - PSE&G Electric Transmission

ATTACHMENT B

2. THE PJM MMU'S APRIL 19 AND APRIL 21, 2006 ANALYSES (CON'T.)

This sub-part further addresses the PJM Interconnection, LLC ("PJM") Market Monitoring Unit's ("PJM MMU") reports in response to the Board Staff's transcript request of March 24, 2006.[1] *See* TR-2820 (3/24/06); *S*-593. In its report issued on April 21, 2006 ("April 21, 2006 PJM MMU report"), the PJM MMU re-examined three sets of divestiture scenarios that the Joint Petitioners had earlier requested. As with the April 19, 2006 PJM MMU Report, *S-592*, these new PJM MMU analyses used eleven months of actual data, from May 1, 2005 to March 31, 2006, instead of the three months of data that the PJM MMU had used in each of its earlier studies of the scenarios requested by the Joint Petitioners, Ratepayer Advocate, Board Staff and PPL. Key results of the April 21, 2006 PJM MMU Report are summarized in Table [**B**] below:

[1] The April 21, 2006 PJM MMU Report was submitted very late in the briefing process. The Ratepayer Advocate respectfully reserves its right to further address the April 21, 2006 PJM MMU Report in its reply brief.

Table [**B**][2]

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Set	Scenario	Results Presented in	Percentage of Hours HHI Difference>0	Percentage of Hours HHI Difference>100	Percentage of Peak Hours HHI Difference>100	Percentage of Off-Peak Hours HHI Difference>100
Set One - Nuclear Divestiture Not Effective	1A	S-593 Tables 1-3 and 1-4	100%	99.98%	99.95%	100%
	1B		100%	99.89%	99.76%	100%
	1C		100%	99.73%	99.41%	100%
	1D		100%	99.98%	99.95%	100%
	2A		100%	100%	100%	100%
	2B		100%	100%	100%	100%
	2C		100%	100%	100%	100%
	2D		100%	100%	100%	100%
Set Two - Nuclear Divestiture to Two New Entrants in PJM	1A	S-593 Tables 2-3 and 2-4	100%	14.54%	5.63%	22.24%
	1B		>95%	13.56%	4.86%	21.08%
	1C		>95%	11.85%	3.76%	18.85%
	1D		>95%	13.47%	4.91%	20.87%
	2A		100%	14.10%	4.24%	22.63%
	2B		100%	14.23%	4.75%	22.43%
	2C		100%	13.31%	3.78%	21.54%
	2D		100%	13.40%	4.24%	21.31%
Set Three - Nuclear Divestiture to Multiple Buyers	1A	S-593 Tables 2-7 and 2-8	100%	31.70%	15.91%	45.36%
	1B		100%	30.17%	14.14%	44.04%
	1C		100%	25.05%	9.68%	38.33%
	1D		100%	29.39%	13.87%	42.81%
	2A		100%	32.14%	14.14%	47.70%
	2B		100%	31.94%	14.62%	46.92%
	2C		100%	30.01%	12.55%	45.11%
	2D		100%	29.66%	12.53%	44.48%

The first set of scenarios ("Set One") examined in the April 21, 2006 PJM MMU Report, *S*-593, reflects the possibility that the Joint Petitioners' proposed divestiture of nuclear energy will not be an effective mitigation measure. Each of these scenarios fails both the Board's positive benefits standard and the FERC Guidelines in every single one of the 8,040 hours examined. *S-593*, Tables 1-3 and 1-4. The proposed merger also fails the Board's positive benefits standard and the FERC Guidelines even if one

2 For Set Two, the "Percentage of Hours HHI Difference >0" figures for scenarios 1B, 1C, and 1D were derived from *S-593*, Tables 2-3 and 2-4, where scenarios 1B, 1C, and 1D resulted in minimum HHI changes of -3, -5, and -1, respectively. Although the underlying hourly data was not available from which an actual percentage of hours with "HHI difference >0" could be calculated, based on the minimum, maximum, and average HHI changes reported by the PJM MMU in its report, it is not unreasonable to assume that in at least 95 percent of the hours, the HHI difference would be greater than 0.

inappropriately and incorrectly focuses on the average pre-merger to post-merger HHI change. *S-593*, Table 1-3.

In the second set of scenarios ("Set Two") examined in the April 21, 2006 PJM MMU Report, the buyers of the divested fossil capacity are assumed to be two **new** entrants; that is, two parties that currently own **no** capacity in PJM. This is by far the most unrealistic and unlikely of the scenarios studied by the PJM MMU. However, even with this extreme assumption, each of the Joint Petitioners' scenarios fail the Board's positive benefits standard because they have pre-merger to post-merger HHI changes greater than zero in almost every hour studied. *S-593*, Table 2-3.

Moreover, because they have HHI changes greater than 100 in more than 11.85 percent of the 8,040 individual hours examined, each of the eight plant divestiture scenarios in Set Two examined by the PJM MMU (that assume that the nuclear divested energy will be purchased by two new entrants in PJM) also fails the less stringent FERC Guidelines. *S-593*, Table 2-3. Indeed, as shown in Table 2-4 on page 6 of *S-593*, even these scenarios have pre- to post-merger HHI changes greater than 100, and consequently fail the FERC Guidelines, in more than 3.76 percent of the 3,728 "peak" hours studied and in more than 18.85 percent of the "off-peak" hours examined. *See* Table [**B**] above.

The failures identified in Set Two using the FERC Guidelines -- during peak and off-peak hours -- indicate the ability to raise prices through the exercise of market power during certain hours. However, what seems like small percentage figures can be deceiving, for several reasons. First, the failures were indicated using the less stringent FERC Guidelines. Using the Board's positive benefits standard, all of the scenarios fail in 100 percent or almost 100 percent of all hours. *See* Table [**B**]. Second, as Synapse testified, the exercise of market power "tends to be asymmetrical." *RA-5* at 44, ln. 1. During "tight" market conditions, occurring even during a few hours, market power will be "much worse" than under average conditions. *RA-5* at 44, ln. 1-3. The exercise of market power over even a few "tight" hours may yield devastating results for ratepayers. Therefore, the Ratepayer Advocate respectfully submits that Your Honor and the Board need to consider that even with this relatively unrealistic scenario, where two **new** entrants to PJM buy all the virtually divested energy, the Joint Petitioners could still exercise market power over a number of tight hours and increase prices above competitive levels, resulting in higher rates for New Jersey ratepayers. Moreover, the scenarios in Set Two would not meet the Board's positive benefits standard, since HHI increases would occur in almost all hours.

Finally, in the third set of scenarios ("Set Three") examined in the April 21, 2006 PJM MMU Report, the buyers of the divested nuclear energy are assumed to be eleven parties specified by the Joint Petitioners. *S-593* at 4. In these scenarios, the proposed merger fails the Board's positive benefits standard in each one of the 8,040 hours examined because they have pre- to post-merger HHI changes greater than zero. *S-593*, Table 2-7.

Notably, each of the scenarios that assumes that the divested nuclear energy will be purchased by multiple buyers also fails the FERC Guidelines in more than 25.05 percent of the 8,040 individual hours examined. *S-593*, Table 2-7. Indeed, as shown in Table 2-8 on page 7 of *S-593*, each of these scenarios have pre- to post-merger HHI changes greater than 100, and consequently fail the FERC Guidelines, in more than 9.68

percent of the 3,728 “peak” hours studied and in more than 38.33 percent of the “off-peak” hours examined.

Thus, the new PJM MMU Reports, *S-592* and *593,* show conclusively that all of the Joint Petitioners’ and Ratepayer Advocate’s scenarios examined fail the Board’s positive benefits standard in almost every single one of the 8,040 individual hours examined. Each of the scenarios analyzed also fail the FERC Guidelines for a substantial number of hours.