Exhibit GRID2.0 (A)

BEFORE THE
PUBLIC SERVICE COMMISSION
OF THE DISTRICT OF COLUMBIA

IN THE MATTER OF THE MERGER OF EXELON CORPORATION, PEPCO HOLDINGS, INC., POTOMAC ELECTRIC POWER COMPANY, EXELON ENERGY DELIVERY COMPANY, LLC AND NEW SPECIAL PURPOSE ENTITY, LLC	**) Formal Case No. 1119**

Direct Testimony and Exhibits of Scott Hempling

On Behalf of
GRID2.0

November 3, 2014

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Introduction

A. Qualifications

Q. State your name and business address.

A. My name is Scott Hempling. I am the President of Scott Hempling, Attorney at Law LLC. My business address is 417 St. Lawrence Drive, Silver Spring, Maryland 20901.

Q. Describe your employment background, experience and education.

A. I began my legal career in 1984 as an associate in a private law firm, where I represented municipal power systems and others on transmission access, holding company structures, nuclear power plant construction prudence and producer-pipeline gas contracts. From 1987 to 1990 I was employed by a public interest organization to work on electric utility issues. From 1990 to 2006 I had my own law practice, advising public and private sector clients—primarily state regulatory commissions, and also municipal systems, independent power producers, consumer advocates, public interest organizations and utilities—with an emphasis on electric utility regulation.

From October 2006 through August 2011, I was Executive Director of the National Regulatory Research Institute (NRRI). Founded by the National Association of Regulatory Utility Commissioners, NRRI is a Section 501(c)(3) organization, funded primarily by state utility regulatory commissions. During my tenure, NRRI's mission was to provide research that empowered utility regulators to make decisions of the highest possible quality. As Executive Director, I was responsible for working with commissioners and commission staff at all 51 state-level regulatory agencies to develop and carry out research priorities in electricity, gas, telecommunications and water. In addition to overseeing the planning and publication of over 80 research papers by NRRI's staff experts and outside consultants, I published my own research papers, advised contract clients (including state commissions, regional transmission organizations, private industry and international institutions), and wrote monthly essays on effective regulation. I also taught several dozen two-day legal and policy seminars hosted by state commissions and attended by commissioners, staff and industry practitioners; and spoke frequently at industry conferences.

In September 2011 I returned to private practice, to focus on writing books and research papers, providing expert testimony and teaching courses and seminars on the law and policy of utility regulation. I am an Adjunct Professor at Georgetown University Law Center in Washington, D.C., where I teach two seminars: "Monopolies, Competition, and the Regulation of Public Utilities"; and "Regulatory Litigation: Roles, Skills and Strategies." Students study the legal fundamentals in class, then apply that learning, under my supervision, in practicums at state and federal regulatory agencies.

I have represented and advised clients in diverse state commission cases; and in federal proceedings under the Federal Power Act of 1935 and the Public Utility Holding Company Act of 1935. The latter proceedings took place before the Federal Energy Regulatory Commission (FERC), the Securities and Exchange Commission (SEC), and U.S. Courts of Appeals. As a lawyer, expert witness or Commission advisor, I have participated in 13 merger proceedings.[1] I have testified many times on electric industry matters before Congressional and state legislative committees.

My book *Regulating Public Utility Performance: The Law of Market Structure, Pricing and Jurisdiction* was published by the American Bar Association in August 2013. This is the first volume of a two-volume treatise, the second of which will address the law of corporate structure, mergers and acquisitions. My book of essays, *Preside or Lead? The Attributes and Actions of Effective Regulators*, was published by NRRI in 2010. I published a second, expanded edition in July 2013. I have written several dozen articles on utility regulation for publication in trade journals, law journals and books; and taught electricity law seminars to thousands of students from all fifty states and all industry sectors. I have spoken at many industry conferences, in the United States and in Canada, England, Germany, India, Italy, Italy, Jamaica, Mexico, New Zealand and Nigeria. As a subcontractor to the U.S. Department of State, I have advised the six nations of Central America on the regulatory infrastructure necessary to accommodate cross-national electricity transactions.

I earned a B.A. *cum laude* in 1978 from Yale University, where I majored in (1) Economics and Political Science and (2) Music, and received a Continental Grain

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[1] These proceedings include: Toledo Edison and Cleveland Electric Illuminating (1985); PacifiCorp and Utah Power & Light (1987-88); Northeast Utilities and Public Service of New Hampshire (1990-91); Kansas Power & Light and Kansas Gas & Electric (1990-91); Northern States Power and Wisconsin Electric Power Co. (1992); Entergy and Gulf States (1995); Potomac Electric Company and Baltimore Gas & Electric (1997-98); Carolina Power & Light and Florida Power Corp (1999); Sierra Pacific Power and Nevada Power (1998-99); American Electric Power and Central and Southwest (2001); Union Electric and Central Illinois Light Company (2001); Exelon and Constellation (2011-12); and Entergy and International Transmission Company (2013).

summer fellowship and a Patterson summer research grant. I earned a J.D. *magna cum laude* in 1984 from Georgetown University Law Center, where I received an *American Jurisprudence* award for Constitutional Law. I am an attorney licensed to practice in the District of Columbia and Maryland.

My resume is attached to this testimony as Exhibit GRID2.0 A-(1). More information is at www.scotthemplinglaw.com.

Q. Have you previously submitted expert testimony in other proceedings?

A. Yes. I have submitted testimony in proceedings before the state utility commissions of California, Illinois, Indiana, Maryland, Minnesota, Mississippi, New Jersey, North Carolina, Texas, Vermont and Wisconsin; before U.S. district courts in Minnesota and Wisconsin; before the Tobacco Arbitration Panel created by the "Master Settlement Agreement" between state attorneys general and major cigarette manufacturers; before a private arbitration panel in Florida relating to a municipality's proposed acquisition of an investor-owned utility's local electricity business; and before the Superior Court of Justice of Ontario, Canada. In all of these proceedings my testimony or expert report was submitted to the tribunal; in the U.S. court and Ontario matters the witnesses did not appear in person.

Q. For whom do you appear in this proceeding?

A. I appear on behalf of GRID2.0.

Q. Are you attaching any exhibits to your Direct Testimony?

A. Yes. All my exhibits, other than this Direct Testimony and my resume, are contained in a separate document entitled "Additional Direct Exhibits of Scott Hempling." All those additional exhibits are excerpts from discovery responses provided by the Applicants.

Q. What materials did you review in preparing your testimony?

A. I reviewed the Application, the testimony and exhibits submitted by Applicants' witnesses, various official financial reports filed by the Applicants (such as 10-K annual reports and PHI's Definitive Proxy Statement associated with this transaction), and discovery from this proceeding and from the Maryland Public Service Commission's 2011-2012 proceeding concerning Exelon's acquisition of Constellation.

B. Overview

Q. What is your conclusion concerning Exelon's proposed acquisition of PHI Holdings?

A. This acquisition will not be in the public interest. Here is an overview of my reasons, with cross-references to the relevant sections of my testimony.

The public interest (Part I): The public interest requires a utility that (a) provides obligatory services using the most cost-effective practices; (b) permeates its organization with a full commitment to its jurisdictions' policies; (c) has no motivations, incentives or pressures that are not aligned with its utility service obligations and its jurisdictions' policies; and (d) is fully and willingly accountable to its commissions.

Exelon's acquisition and control of Pepco would undermine each of these values. Within the post-acquisition family will exist conflicts relating to investment priorities, transaction prices, financial relationships and market structures, all as summarized next.

PHI's purchase price conflict of interest (Part II): By agreeing to sell PHI to the highest bidder (after structuring a process that pushed the bids up), PHI's Board won for its shareholders an acquisition premium more than 12 times the value of what Exelon is guaranteeing to Pepco's customers. PHI treated its franchise like a New York City taxi medallion—created by the government as a public good, converted by its owner to a private good and sold to the highest bidder. But a utility franchise is not like a taxi medallion; it is not a private commodity. A utility franchise is an obligation to serve at "lowest feasible cost."[2] Seeking the highest possible purchase price was inconsistent with that obligation. Nor did it produce the Commission-required "balancing" of shareholder and customer interests. Worse, Exelon now must recover that acquisition premium, somehow: if not from Pepco's customers (indirectly, by withholding merger savings), then from someone else's customers—or by having its shareholders absorb it. To the extent unrecovered, the premium increases Exelon's financial risk—to Pepco's detriment.

Exelon's generation conflict of interest (Part III): Because PHI's three utilities own no significant generation, their public utility obligation is to find power at the lowest possible price. Exelon, as one of the nation's largest owners of generation, seeks to sell power at the highest possible price. Commission approval would subject Pepco's customers to a conflict of interest lasting as long as Exelon lasts. And it would reverse the Commission's 1999 decision favoring divestiture of generation from physical distribution and retail electricity sales.

Exelon's type-of-business conflicts of interest (Part IV): By owning multiple types of businesses throughout the U.S., and by telling its shareholders to expect "growth," Exelon has put itself on a path of acquisitions and risk that is (a) unlimited by geographic or type-of-business, and (b) beyond this Commission's control. As Pepco's

[2] *Potomac Elec. Power Co. v. Pub. Serv. Comm'n of the D.C.*, 661 A. 2d 131, 137 (D.C. 1995).

role in Exelon diminishes (by a factor of five, compared to its role in PHI), the top-level attention given to its operations, its obligation to innovate, and its relationship with the Commission risks diminution as well. With (a) Pepco's decisionmakers being subordinated to Exelon's Board of Directors, (b) capital being scarce by definition, (c) Exelon's decisionmakers seeking ventures with higher returns and higher risks, (d) Pepco depending entirely on Exelon for equity investment, and (e) lenders taking Exelon's risks into account when setting loan terms for Pepco, Pepco will be subject to conflicts it does not currently face with PHI.

Exelon talks of "ring-fencing." But its witness acknowledges that ring-fencing only reduces—it does not eliminate—risks arising from Exelon's non-Pepco investments. Since each Exelon acquisition adds risk, and since ring-fencing doesn't eliminate those risks, the risks to Pepco are necessarily greater with the acquisition than without. The risks are greater by an increment the Commission cannot calculate, because the source of risk is not only Exelon's existing investments, but also its future acquisitions—acquisitions that are unknown and, due to the 2005 repeal of the Public Utility Holding Company Act of 1935, unlimited by law. Not only does "ring-fencing" not promise full protection against the risks it purports to protect against; it does not purport to protect—and does not protect—against any of the following: (1) Exelon-imposed limits on Pepco's access to equity capital, (2) increases in Pepco's cost of capital due to Exelon's other activities, (3) bankruptcy risk if Pepco cannot raise capital, (4) Exelon interference in Pepco's business decisions, and (5) Exelon's abuse of interaffiliate transactions.

The benefit-cost relationship (Part V): The conflicts and risks introduced by this acquisition are not justified by the asserted benefits. The lone guaranteed benefit properly attributable to the merger is $50 per customer—totaling an amount less than 1/12 the premium PHI shareholders get. Customers will forget about that $50 within weeks of receiving it. Exelon's reliability guarantees are illusory, because the Commission can impose them on Pepco without Exelon's acquisition.[3] Exelon says it will introduce Pepco to "best practices." But this is a generic category comprising aspirations rather than commitments, and having no features that Pepco could not and should not be employing on its own. And in this context, the term "best practices" is inaccurate. It might have been accurate, had PHI's criterion for selecting Exelon been "best performer" rather than "highest bidder."

Competition (Part VI): Merging Pepco with BGE eliminates each company's most formidable potential competitor in a variety of product markets. Three transactions in one—a horizontal merger, a vertical merger, and a convergence merger—this acquisition also poses risk to competition in the newly developing markets for distributed energy resources.[4] Pepco's control of "the last mile," meter data and interoperability protocols, coupled with Exelon-as-generation-owner's understandable incentive to

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[3] I mean "illusory" not in a rhetorical sense but in a literal, legal sense, as in an "illusory contract." A promise is illusory if it involves no "consideration," i.e., if one party gives nothing of value to the other party. And when a party offers as consideration something he was obligated to do anyway, there is no consideration. *Sloan v. Sloan*, 66 A.2d 799, 800-01 (D.C. 1949) (quoting *Littlepage v. Neale Publishing Co.*, 34 App.D.C. 257 (1910) ("It of course goes without saying that the promise to do a thing which the promisor is already bound to do is not a good consideration upon which to found another promise.")).

[4] The transaction is also a conglomerate merger, because so many of Exelon's holdings bear no market relationship to Pepco. But its conglomerate characteristic does not affect competition.

discourage local distributed generation and non-generation options, means that an Exelon-controlled Pepco will have motivation and opportunity to deter competitive entry.

Conditions (Part VII): I sought to design conditions that would cause the positives to sufficiently outweigh the negatives, but I failed. Part VII provides language for conditions addressing future acquisitions, interaffiliate transactions, budgeting, spending, preservation of benefits for ratepayers, competition, compliance, and future market structure. To protect the public interest, each condition is necessary, but individually and combined they are not sufficient. Some have problems of practicality and enforceability. Some Exelon has opposed in the past because they limit Exelon's wish to pursue future acquisitions without regulatory review. None of them addresses the two deepest conflicts: the acquisition premium, which gives a gain to PHI shareholders 12 times the benefit guaranteed to customers; and the internal tensions caused when a generation buyer seeking low power prices is controlled by a generation owner seeking high power prices.

I.
Principles for the Transaction: Defining and Ensuring the "Public Interest"

A. The legal standards

Q. What legal standards apply to this transaction?

A. The Commission must find that this transaction "will be in the public interest." D.C. Code sec. 34-504 provides:

> No public utility . . . shall purchase the property of any other public utility for the purpose of effecting a consolidation until the Commission shall have determined and set forth in writing that said consolidation will be in the public interest, nor until the Commission shall have approved in writing the terms upon which said consolidation shall be made.

The Commission has held that "for the proposed merger to be in the public interest, it 'must benefit the public rather than merely leave it unharmed.'"[5] The Commission also has held that

> (1) it has traditionally balanced the interests of shareholders and investors with ratepayers and the community; (2) benefits to the shareholders must not come at the expense of the ratepayers; and (3) to be approved, the merger must produce a direct and tangible benefit to ratepayers.[6]

In applying these standards to a merger, the Commission will address "the effect of the transaction" on seven subject areas:

> (1) ratepayers, shareholders, the financial health of the utilities standing alone and as merged, and the economy of the District; (2) utility management and administrative operations; (3) public safety and the safety and reliability of services; (4) risks associated with all of the Joint

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[5] Formal Case No. 1002, Order No. 12395, at p.17 (May 1, 2002) (citing Formal Case No. 951, Order No. 11075 at p.17 (Oct. 20, 1997)).

[6] *Id.*

> Applicants' affiliated non-jurisdictional business operations, including nuclear operations; (5) the Commission's ability to regulate the new utility effectively; (6) competition in the local retail and wholesale markets that impacts the District and District ratepayers; and (7) conservation of natural resources and preservation of environmental quality.[7]

For these standards to apply predictably and consistently across proposed consolidations, there must be clear policies that give guidance to investors, ratepayers, new competitive entrants and others affected by such transactions. This Part I contains recommendations for those policies, in the following order:

—the meaning of "public interest" as applied to "consolidations"
—the requirement of certainty
—the requirement of no harm
—the requirement of balancing
—the requirement of direct and tangible benefit to ratepayers
—the requirement that shareholder benefits not come at the expense of ratepayer

After addressing these points, I explain why the public interest requires having these policies in place before transactions are proposed. The remainder of my testimony then applies these policies to Exelon's acquisition of PHI.

B. The meaning of "public interest" as applied to "consolidations"

Q. How should the Commission define the public interest in the context of consolidations?

A. The public interest requires a utility that (a) provides obligatory services using the most cost-effective practices available; (b) permeates its organization with a commitment to its jurisdictions' policies, so that the motivations and incentives of the investors, executives, workers and the jurisdiction's policymakers are all aligned; and (c) is fully and willingly

[7] Order 17597 at para. 124 (2014).

accountable to the Commission because it does not have, and is not subject to, any business objectives that are in conflict with, or that have the potential to undermine, the jurisdiction's policies. A consolidation will be in the public interest only if the regulator finds that after the consolidation, its utility will satisfy these three criteria.

To make the necessary findings, a commission must articulate and carry out policies addressing four key areas: (a) permissible business activities within a utility's corporate family; (b) the types of entities that may own utilities or exercise substantial influence over them; (c) the acceptable corporate structures that connect the corporate family's members, including the acceptable types, terms and conditions of interaffiliate transactions (such as loans, guarantees of indebtedness, and sales and purchases of goods and services); and (d) the market structures that consolidations can affect. Common to these four areas is the need to avoid conflict between a utility's public service obligation and its owners' business priorities. I will discuss each area in turn.

1. Business activities

Q. What consideration should a commission give to conflict arising from the post-consolidation entity's business activities?

A. In any utility holding company, conflict can come from at least two sources. The first is business activities. A standalone utility, affiliated with no other business, serving a single local territory, experiences no conflict involving its business activities, because its sole business is its regulated business. The potential for conflict grows as the utility's business activities expand. Expansion may be in terms of geography or type of business. Geographic expansion (merging with utilities serving other areas, whether nearby or remote) can benefit customers if there are increasing economies of scale; it can hurt customers if operations are impaired by managerial remoteness or diseconomies of scale. Type-of-business expansion (merging with companies that sell services, whether utility or non-utility services, to third parties or to the utility itself) is a two-edged sword: Non-utility affiliates can support a utility (as might a subsidiary experienced in acquiring land or supply fuel); or distract it (like affiliates buying banks and hedge funds, or engaging in businesses whose interest in high generation prices conflict with the utility's interest in low generation prices).

Q. How can a commission address these conflicts?

A. A commission can address these tensions by allowing only those consolidations whose additions to complexity are compensated by sufficient benefits to the public. Corporate complexity introduces three types of risks. The first is management distraction stemming from non-utility investments. Failures force management to spend time saving or selling the losers; successes spur management to find more winners. The second is affiliate abuse, of two types: (a) The utility affiliate overpays the non-utility for services, and (b) the non-utility affiliate underpays the utility affiliate for services. These schemes harm consumers through overcharges and undercompensation. They also harm competition by granting affiliates unearned advantages.

The third risk is a weakened utility. Every month, customers pay the utility for service, usually in cash. When non-utility affiliates fail, the utility's cash flow tempts the holding company to help the bleeding businesses, by drawing dividends from the utility or reducing equity flows to the utility (the holding company being the utility's sole source of equity). And because utilities are capital-intensive, their assets are attractive collateral for third-party loans to the failing affiliates. The utility, initially strong from ratepayer support, can be weakened when its siblings sink.

2. Corporate structure

Q. What consideration should a commission give to conflict arising from the post-consolidation entity's corporate structure?

A. In a utility's corporate family, there should be at all levels, from the holding company CEO to the substation repair team, a single focus: the utility's performance for the consumer. When presented with a proposed consolidation, therefore, a commission should ask: Will ultimate control be exercised by individuals whose full focus and professional priority is on service to utility customers? Or will control be exercised by companies and executives whose objectives conflict with the consumer interest?

3. Financial structure

Q. What consideration should the Commission give to conflict arising from the post-consolidation entity's financial structure?

A. Financial structure involves the mix of equity and debt, including who holds or controls that equity and debt, and which business activities get priority when capital is scarce. How these financial features can affect the utility subsidiary is illustrated by two simple examples. First, if the utility's holding company pays for acquisitions with debt, this leveraging can cause the holding company to pressure the utility to divert cash flow from operations to the holding company; or alternatively, to limit the flow of holding company equity into the utility. Second, when a non-utility affiliate fails, investors view the holding company as more risky, raising its finance costs. The utility affiliate's equity (which comes from the holding company) then becomes more expensive. The question for a commission is whether a consolidation will increase the possibility of these events.

4. Market structure

A consolidation changes market structure—the number and types of market participants, the products they sell, their market shares and the assets they control. As Alfred Kahn has written:

> The preponderant case for mergers is that they will improve efficiency. The preponderant case against them is their possible impairment of competition, for two reasons: first, the merging companies are typically actual or potential competitors in some parts of their business, and, second, they may be enabled by joining together to deny outside firms a fair opportunity to compete.[8]

A consolidation can make a market more competitive or less competitive, resulting in increases or decreases in efficiency, cost, customer service and innovation. A commission's consolidation policy therefore must be preceded by a commission vision for the type of market structure most likely to achieve those goals. Only then can a commission assess whether a proposed consolidation assists or impedes progress toward that market structure.

* * *

Q. Summarize your opinion on how the Commission should define the "public interest" in the context of consolidations.

A. In a consolidation involving a retail utility company, the consolidating entities have private interests that are not necessarily aligned with the public interest. The target seeks the highest possible buyout price; the acquirer seeks ownership of a company that has a government-regulated monopoly over an essential service. The Commission can assess

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[8] *The Economics of Regulation: Principles and Institutions* Vol. II at p. 282 (1988).

the appropriateness of a consolidation—the consistency of these private aims with the public interest—only if it first defines the public interest, in terms of the business activities, corporate activities, financial structure and market structure. A commission cannot satisfy the public interest by merely hosting consolidation proposals and looking for incidental benefits.

C. The requirement of certainty

Q. D.C. Code sec. 34-504 requires that the Commission find that this transaction "will be in the public interest." What factors should the Commission consider in determining whether the proposed transaction meets this test?

A. Once the Commission has articulated its four-part view of the public interest (the subject of Part I.B above), it must find that the transaction "will" satisfy that definition. The statutory phrase "will be" is a requirement of certainty. The Commission's policy must make clear that "will be" does not mean "might be" or "will be, under certain circumstances that we cannot guarantee." Certainty requires, from merger applicants, deeds, not words; commitments, not aspirations.

The required certainty will not likely exist if there are motivations, opportunities and powers within the post-consolidation corporate family that are in tension with the public interest as defined by the Commission. If those tensions do exist, then the Commission must find that it is feasible to design conditions that will prevent the company decisionmakers from using their powers to act on those motivations and opportunities. If such conditions are feasible, then the Commission must also find that it has the authority to impose those conditions, along with the resources to enforce the conditions. Any gap in this set of findings converts "will be" into "might be," a result inconsistent with policy reflected in the statutory language.

One way to craft a policy that honors "will be" is to use rebuttable presumptions: presumptions rooted in logic, common sense and a commission's policy preferences. A commonsense presumption is that a utility holding company family devoted solely to the utility business will, when subject to alert regulation, perform at a quality level consistent with what a competitive market would demand. Then a consolidation that produces such a family would be presumed to satisfy the "will be in the public interest" requirement. The presumption being rebuttable, an intervenor could show that such a consolidation would not be in the public interest if, for example, (a) the post-consolidation family is too large to manage effectively, (b) economies of scale had already been exhausted at a lower size, or (c) the transaction's horizontal or vertical coupling of assets or businesses could diminish the competitive forces that would otherwise make the company accountable to its customers and its regulators.

Similarly commonsensical would be the converse presumption: that a consolidation producing a family with motivations and opportunities that conflict with the jurisdiction's objectives is a negative, because motivations and opportunities lead to actions. The applicants then must overcome the presumption, by producing evidence that the negatives caused by the conflicts "will be" erased, either through divestitures, restructuring, or conditioning. I expect Exelon to argue that it should be the intervenor's (or commission's) burden to show that internal conflicts will necessarily undermine the utility's performance. But with a presumption that conflicts can cause harm, it becomes the applicants' burden to show that notwithstanding the conflicts, the combination of conditions and benefits will sufficiently outweigh the risk of harm. The latter policy—embodying a presumption against conflict, with the burden of proving no harm on the applicants—is the policy more likely to ensure public utility service at "lowest feasible cost."

I offer this concept of rebuttal presumption concept as a policy recommendation. While the technical effect of a presumption can be a legal effect (such as the applicant's failure to carry its statutory burden of proof), the practical effect is a policy effect: a leaning toward one result and away from another result. Here, the recommended policy is to lean away from conflict and toward the absence of conflict; a leaning consistent with logic and common sense.

D. The requirement of no harm

Q. The Commission has held that a merger "must benefit the public rather than merely leave it unharmed." What factors should the Commission consider in determining whether a merger will "leave [the public] unharmed"?

A. I understand the phrase "rather than merely leave it unharmed" to mean that there must be no harm; meaning that the purpose of the required benefit is not to offset harm, but to ensure a positive result along with requiring the absence of harm.

To answer the question, we first must define "harm." There are two distinct categories of harm: status quo harm, where the transaction diminishes benefits available from the status quo; and opportunity cost harm, where the transaction causes customers to forego additional benefits.

1. Status quo harm

Q. Explain what you mean by status quo harm.

A. A consolidation involving a public utility can create at least four kinds of *status quo* harm, to the utility's consumers and to the public.

1. As the holding company's acquisitions grow, the attention paid to each utility by the holding company's top leadership—the CEO, executive team and board—necessarily diminishes. As those individuals become responsible for more businesses and more assets, a utility's specific needs fall in their priorities. Mr. Rigby would admit, I assume, that the time he spent getting the highest possible price for his shareholders diverted him from his oversight of Pepco's executives.

2. As the corporate family invests in ventures less financially secure than regulated monopoly distribution service, the investor portrait changes. Conservative investors—those who buy-and-hold patiently, seeking and expecting only stable dividends and stable share value or modest growth—no longer can treat the corporate family as a predictable place to put their money. A different type of investor enters: one seeking higher-risk, higher-return opportunities. These new investors can bring pressures on the corporate family leadership for more growth that requires more risks, thereby affecting the leadership's priorities and drawing its attention away from the core utility business. Further, bond rating agencies can no longer give consistently stable ratings based on operational performance and regulatory treatment, because the family's financial health is no longer based solely on those relatively predictable variables.

3. Utility staff with professional ambitions find that the path to advancement is not necessarily in the traditional utility activities. but instead in non-utility activities and "corporate strategy." Essential craftspeople—women and men who make things work—face more job risk because failures in the unrelated businesses can cause the utility to reduce or defer operations, maintenance and modernization. That greater job risk can reduce the attractiveness of utility employment for talented prospective employees.

4. Where the consolidation concentrates market share, eliminates competitors, or gives the incumbent utility a financial incentive to create or increase entry barriers to existing or potential markets, there is harm to the potential for competition—the force our economy relies on to improve and diversify service at reasonable prices. The harm can be direct (by allowing incumbents to raise prices, reduce quality or slow innovation without fear of losing sales to competitors) or indirect (by discouraging prospective entrants, who will view the jurisdiction as uncommitted to competition on the merits).

2. Opportunity cost harm

Q. Explain what you mean by opportunity cost harm.

A. In the public utility context, "harm" necessarily includes "failure to act cost-effectively." I say "necessarily" because a utility, having received protection from competition, must perform as if subject to competition. It must make all feasible, cost-effective efforts to reduce costs and increase quality. Diverting resources from more productive uses—incurring what economists call "opportunity cost"—fails this test.[9] If a specific merger precludes some other utility action, including some other merger, that would have yielded more customer benefits, that merger causes opportunity costs—harm. In competitive markets, transactions that involve opportunity cost have less success than transactions that do not, all else equal. Disregarding this type of harm in the merger context violates the principle that regulation should produce outcomes similar to what competition would produce.

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[9] "[T]he opportunity cost of an item—what you must give up in order to get it—is its true cost." Krugman, P. R., and R. Wells, *Microeconomics: Third edition* (Macmillan 2012).

Q. How would the opportunity cost concept apply to the consolidation context?

A. A utility merger proposal arises, directly or indirectly, explicitly or implicitly, from a competition for control. The target picks the acquirer offering the most to the target's shareholders. The chosen acquirer is not necessarily the one whose merger with the target would produce the most benefits to consumers. Selecting a wrong merger partner necessarily precludes selecting the right merger partner (from the customers' perspective). The loss of benefits due to the incorrect selection is opportunity cost; it is harm. To see it otherwise, to be indifferent to the opportunity cost, is to allow the merging companies' interests to prevail over the consumers' interest. That is not a public interest outcome.

E. The requirement of balancing interests

Q. In consolidation cases, the Commission "has traditionally balanced the interests of shareholders and investors with ratepayers and the community." What factors should the Commission consider in determining that a merger achieves the required balance?

A. To achieve the goal of "balanc[ing] the interests of shareholders and investors with ratepayers and the community," the Commission first must address the ambiguities in this phrase; specifically, the meaning of "interests" and the meaning of "balance."

1. The meaning of "interests"

Q. Discuss the ambiguity in the term "interests."

A. The Commission's phrase refers to ratepayers, shareholders and investors, and community. For these references to take policy shape in a consolidation case, the Commission will need to clarify each category. Which "ratepayers"—large or small, today's or tomorrow's, the District's, the region's, or the nation's? Which "interests"—short-term or long-term, the interest in low electricity rates or the interest in a viable supplier? Which "shareholders and investors"—buy-and-hold types or risk-takers, pension funds or hedge funds or short sellers, current or future investors? Which investor interests—this year's profits or next decade's viability? Which "community" interests—the interest in a robust physical infrastructure able to support the District's schools, hospitals, and streetlights; the interest in a mix of utility services that can support economic development (of what type—service or manufacturing?); the interest in ensuring air, water and land that future generations can use without fear of toxicity?

Next, the Commission must make clear that the interests to be "balanced" must be *legal* interests—not raw self-interests, but interests flowing from the rights and obligations created by statutory and constitutional law. A shareholder may wish to have above-average profits with below-average risks. A customer may wish to have above-average service with below-average rates. Those are self-interests; they are not public interests recognized by public utility law.

For shareholders, the legal interest is for the utility to have a reasonable opportunity to earn a fair return on capital prudently invested in assets that are used and useful in the performance of utility service. That was the constitutionally protected interest as defined by Justice Brandeis:

> The thing devoted by the investor to the public use is not specific property, tangible and intangible, but capital embarked in the enterprise. Upon the capital so invested the Federal Constitution guarantees to the utility the opportunity to earn a fair return.[10]

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[10] *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U.S. 276, 290 (1923) (Brandeis, J., concurring). I discuss this concept in detail in my *Regulating Public Utility Performance: The Law of Market Structure, Pricing and Jurisdiction* (American Bar Association 2013) at Chapter 6.B.2.

In terms of a commission's merger policy, there is a difference, then, between two types of shareholder interests: (a) the shareholder interest in a return on dollars invested by the utility to carry out its obligation to serve, and (b) the shareholder interest in a return on the dollars the shareholder paid for her stock. The former is a legally protected interest, the latter is not. Why? Because the thing "taken" for purposes of Fifth Amendment's Takings Clause (applied to the states through the Fourteenth Amendment's Due Process Clause) is the money spent by the utility to service the public, not the dollars spent by the shareholder to buy her stock. Law aside, there is a policy reason to distinguish the dollars spent by the utility from the dollars spent by the shareholder: The customer is obligated to pay the reasonable cost of service (including a fair return on the capital expended to provide that service); he is not obligated to cover private bets in the stock market. If customers were obligated to cover private bets in the stock market, rates would rise as each new stock-buyer sought a gain on her purchase.

2. The meaning of "balance"

Q. Discuss the ambiguity in the term "balance."

A. A "balance" assumes interests in conflict. If there were no conflict, a commission could satisfy all the interests; there would be no need to "balance." In utility regulation, if we limit the relevant interests to *legitimate* interests, there are no conflicting interests. Consumers' and utilities' legitimate interests—financially viable utilities staffed with sufficient expertise, ample capital available at reasonable cost, satisfied customers who pay their bills on time, prudent performance, no waste, reasonable prices and reasonable returns—these interests are consistent and mutually reinforcing. Conflict—and thus the need to balance—arises only from illegitimate aims: the cost-causer seeking to shift costs, the shareholder seeking above-average returns for below-average risk, the customer seeking above-average service for below-average prices. It is true that customers and shareholders can have a conflict over, say, where within the zone of reasonableness the authorized return on equity should lie; but the regulator gets to a legally sustainable answer not by "balancing" but by achieving two legitimate ends: by setting the number high enough to attract the necessary equity capital (thus satisfying the legitimate shareholder interest) but no higher (thus satisfying the legitimate customer interest).

Since legitimate interests are not opposing interests, and the Commission does use the term "balance," how might we define the term? I suggest the Commission view "balancing" as articulating the common interest among the affected entities, that common interest being the public interest, and then creating policies that eliminate the divergence of self-interest from the public interest. That way, each actor's expectations and actions are aligned with the public interest.

F. The requirement of direct and tangible benefit to ratepayers

Q. The Commission has stated that a merger must produce a "direct and tangible benefit to ratepayers." What factors should the Commission consider in determining whether a consolidation satisfies this standard?

A. To give meaning to the quoted phrase, the Commission must consider the directness of the benefit, and the sufficiency of the benefit. I will discuss each in turn.

1. The directness of the benefit

Q. Why should the Commission address the directness of the benefit?

A. The statute requires the Commission to determine that the "consolidation will be in the public interest." What must be the public interest is the "consolidation" itself—the act of legally coupling companies that were previously separate. Special inducements to win support are part of a strategy to win approval of a consolidation; they are not part of the consolidation itself. They may be "tangible," but they are not "direct" results of the consolidation. A benefit should count only if the consolidation is essential to its achievement, and only if it improves a jurisdictional service or lowers its cost.

I make this point not only as a statutory interpretation but as policy recommendation. When a merger is evaluated not for its intrinsic merit but for the inducements offered to make up for its lack of merit, we diverge from the purpose of regulation: to induce high-quality utility performance. A student should get an A for excelling at her schoolwork, not for planting flowers in the schoolyard. Counting non-merger inducements also invites discrimination, because the benefits flow only to some customers, usually current ones, while the merger's risks fall on all customers (including future ones).

Counting non-merger inducements as merger benefits has one more negative effect, this one far-reaching. Each state commission approval of a merger, granted in return for a benefit unrelated to utility performance, contributes to a concentration trend within our region and nationally, with the concentration supported not by economic efficiency but by government approvals based on favors that each state receives.

2. The sufficiency of the benefit

Q. How should the Commission address the sufficiency of the benefit?

A. The answer lies in the relationship between regulation and competition. Effective competition serves the public interest because it forces a never-ending search for improvements, from horses to stage coaches to street cars to buses to jet engines; from telegrams to telephones to faxes to cell phones to the internet to the world wide web. The price paid for a computer 20 years ago buys a much better computer today. If we protect a utility from competition, we need regulation to make it perform as if subject to competition.

Applying this logic to a utility consolidation: The public interest is not satisfied by a mere absence of performance decline; otherwise the public would be worse off under regulation than under competition. And if that statement is true, then nor can the public interest be defined as status-quo-plus-some-undefined-benefit, because that leaves unstated any way to assess the appropriateness of the benefit.

Q. How would you illustrate this last point?

A. Suppose the Commission required, as a condition of an electricity merger, that the local utility trim all trees monthly, and require all customer care representatives to be trilingual. This "merger benefit" obviously exceeds what the Commission could impose under the public interest standard, because it exceeds what would exist under conditions of effective competition. The public interest standard thus protects the utility from requirements that extract excess benefits, *i.e.*, benefits exceeding what would occur in a competitive market. If the public interest standard protects the utility from extraction of excess benefits (benefits exceeding what would occur in a competitive market), it must conversely protect the consumer from insufficient benefits (benefits below what would occur in a competitive market). But requiring that a merger produce only *some benefit* sets no standard; it leaves us unknowing as to whether the benefits were excessive or insufficient. A benefits package guaranteeing a per-customer payment of $50 and a suite of new reliability commitments tells us nothing about what a utility would do under competition, and therefore should do for its customers without a merger.

If a commission were to accept a merger because it offered such a benefit, the necessary inference is that the commission has one of three policies: (a) *any* amount of benefit is sufficient, regardless of how small; (b) a benefit is sufficient if the applicant is willing to offer it; or (c) a benefit is sufficient whenever the Commission says it is sufficient. Option (a) is arbitrary, Option (b) substitutes applicant self-interest for the public interest, and Option (c) is circular. All three are wrong.

Common to the three wrong answers is this: Each is subjective rather than objective. An objective standard would be the one stated above: It would require that level of benefit that competition would produce; competition, that is, to satisfy the consumer, not competition to buy the company. If alternative acquirers had to compete with each other, with the selection criterion being not the price offered to the target's shareholders but the benefits offered to the target's customers, the contestants would bid up the benefits offered, up to the point that their own costs exceeded their benefits. But as I will explain in Part II, that is not the route this transaction took.

G. The requirement that shareholder benefits not come at the expense of ratepayers

Q. The Commission has stated that in a consolidation, the "benefits to the shareholders must not come at the expense of the ratepayers." In applying this standard, what factors should the Commission consider?

A. As with the requirement of certainty discussed in Part I.C (concerning the requirement of certainty), the Commission can address this question by using presumptions. If the Applicants have displayed a conflict of interest between shareholders and ratepayers, the

Commission can rebuttably presume that "benefits to the shareholders" will "come at the expense of the ratepayers." The burden of producing evidence to the contrary would then lie with the Applicants. In the proposed transaction, there are at least three indicators of such a conflict.

1. PHI chose its acquirer based on who offered the highest price rather than which coupling would produce the most customer benefits. I am not suggesting that PHI ignored its customers; I will assume that PHI did enough "due diligence" to ensure that the chosen acquirer would meet the Commission's minimum standards for performance and might even make some improvements.[11] But price, not performance, was the deciding factor because price, not performance, was the factor PHI used to induce the bidders to compete with each other. PHI could have done the opposite: It could have established a price that was the minimum satisfactory to its shareholders, then required bidders to compete based on how much they could offer the customers. PHI chose the former approach. PHI's approach embodies a decision to have shareholders gain at the expense of consumers.

Does PHI's decision indicate some legal or moral fault on its part? Setting aside Pepco's obligation to serve at "lowest feasible cost," the answer is no, because PHI's Board was carrying out its profit-maximizing duty to its shareholders—in a context *where the Commission has not required otherwise*. That is the omission that the

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[11] "*Might* even make some improvements" is the right phrase, because nowhere in the densely detailed merger agreement is there any requirement that Exelon improve Pepco's performance. The absence of such a requirement is conclusive evidence that performance was not PHI's priority, notwithstanding Mr. Rigby's testimonial assertion that the transaction was in the customers' "best interest."

Commission now must correct. It must reject this merger because it embodies a conflict of interest that the Commission has allowed to develop. The Commission will be accused of "changing the rules in the middle of the game." But regulation is not a game; regulation is pursuit of the public interest. And if the existing rules failed this test, they must be changed.

2. Rather than acknowledging that choosing the most consumer-contributing acquirer was not his goal, Mr. Rigby testified to a proposition that was untrue: that the transaction is in the ratepayer's "best interest." Mr. Rigby could not have known, and the Commission cannot know, if the transaction is in the customer's best interest if his Board did not require the bidder to compete based on criteria germane to the customer's best interest.

3. The acquisition takes a company whose economic obligation is to find power supply at the lowest possible price, and subjects it to the control of a company whose economic incentive is to sell power supply at the highest possible price. That is a conflict of interest.

* * *

These three conflicts of interest would not "come at the expense of ratepayers" if Applicants' decisions had been disciplined by market forces, meaning market forces pressuring competitors to maximize customers' well-being. In any seller-buyer relationship there is the potential for each side to act in a way that "comes at the expense" of the other side. This potential is negated if each party has competitive alternatives, because alternatives allow each side to say to the other: "Align your self-interest with my self-interest, or I will go elsewhere." In the "merger market," this discipline is missing.

The competition to become PHI's acquirer was not based on service to the customer, because the Commission has no policy requiring that standard. As a result, the target company was free to put its shareholder interest first—at the expense of its customers.

H. The need for clarity in the Commission's merger policy

Q. Is it important for the Commission to establish its expectations for mergers with more clarity than it has done in the past?

A. Yes. Although it has issued two lengthy opinions on mergers (Pepco-BGE, and Pepco-Conectiv), the Commission has not articulated a policy that distinguishes consolidations that serve the public interest from those that do not. The District has granted Pepco protection from competition, but has not prohibited Pepco's owners from using that protection, in the context of consolidation, to seek shareholder gain at the expense of consumers.

It is especially necessary for the District to declare a clear public interest vision because there is no longer any national law that constrains the types of conflicts that an Exelon-PHI merger will produce. Over a century, our nation has experimented with varied views of the public interest in consolidations. In electricity and gas, we have traveled from (a) the free-wheeling acquisitions of scattered utility systems in the 1920s; to (b) the requirement, established by the Public Utility Holding Company Act of 1935 (PUHCA), that every holding company be confined (subject to certain exceptions) to a "single integrated public-utility system"; to (c) PUHCA's repeal in 2005; to (d) a trend in the past 30 years that has consolidated many formerly stand-alone utilities into a smaller number of holding company systems.[12] This trend, of which Exelon's acquisition of Constellation in 2012 and its proposed acquisition of PHI is a part, is not guided by any coherent national policy that distinguishes consolidations that serve the public interest from those that do not.

Q. **Why do you say there is no coherent national policy?**

A. In 2005, Congress repealed the Public Utility Holding Company Act of 1935 ("PUHCA 1935" or "the Act"). For seventy years, the Act's "single integrated public-utility system" mandate required electric and gas utilities to stick to their knitting—essential utility service to local customers. While the Act had many provisions, the key tools were these:

> Section 11(b)(1) required the SEC to break up holding company systems that owned scattered utility companies and unrelated businesses, so that after the break-ups, each system would be confined to a single "integrated public-utility system," subject to certain exceptions.
>
> Section 10(b)(1) required the SEC to disapprove any acquisition by a utility holding company, if the acquisition would "tend towards ... concentration of control of public-utility companies, of a kind or to an extent detrimental to the public interest or the interest of investors, or consumers."
>
> Section 10(c)(2) allowed only those acquisitions that "tended towards the economic and efficient development of an integrated public-utility system."

[12] The telecommunications industry has undergone its own set of changes, from Bell's vertically integrated, national monopoly for most of the 20th century; to the divestiture required by the Modification of Final Judgment in 1984, which reduced barriers to entry in long distance service and customer premises equipment; to the 1996 Act's spurring of local wireline competition, by preempting state laws barring such competition and requiring incumbent local exchange carriers to share facilities with their independent competitors while conditioning ILECs' entry into long distance markets on their cooperation in facilitating local wireline competition; to the current merger trend in which some telecommunications players are vertically re-integrating.

> Section 7(d) prohibited utility holding companies from issuing securities that, among other things, involved an "improper risk" or were "detrimental to the public interest or the interest of investors or consumers."

The purpose of these provisions was to align utilities' corporate form with their public service obligations. PUHCA 1935 accomplished this goal through the statutory concept of the "integrated public-utility system": Each utility holding company had to limit its assets and activities primarily to those necessary to provide electric or gas service to the public. The integrated system principle limited the geographic dispersion of utility properties, the mixing of utility and non-utility businesses, the layers of corporate affiliates, the types of financing within and among utility and non-utility affiliates, and the types and pricing of interaffiliate transactions, among other things.

Once the SEC completed the initial breakup of the dispersed holding company systems, electric utility mergers were relatively rare until the mid-1980s. Of the several dozen electricity mergers between 1985 and 2005, most involved the joining of utilities with adjacent or near-adjacent service territories, such as the transactions involving Toledo Edison and Cleveland Electric Illuminating, Kansas Power and Light and Kansas Gas & Electric, and Northeast Utilities and Public Service of New Hampshire; Delmarva and Atlantic City Electric; and Pepco, Delmarva and Atlantic City Electric. In these transactions, still bound by PUHCA's requirement of an "integrated public-utility system," the main regulatory efforts were to identify and allocate costs and benefits associated with savings likely to arise from greater economies of scale and scope; to protect against horizontal or vertical market power; and to ensure that the larger, post-merger entity devoted sufficient attention to local quality of service. These mergers, for the most part, did not involve the joining of remote electric facilities, or the mixing of utility and non-utility businesses.

Q. How were the Act's restrictions changed in 1992?

A. The 1992 amendments[13] permitted utility holding companies to acquire, exempt from PUHCA 1935, geographically dispersed generating companies (then known as "exempt wholesale generators"), while still owning traditional state-regulated retail utilities.

Q. What changes did the 2005 repeal bring?

A. The Energy Policy Act of 2005 removed the remainder of PUHCA 1935's limits and reviews of utility holding company acquisitions. The result was, and is, to allow without limitation holding company arrangements that involve geographically dispersed utilities and mixtures of utility and non-utility businesses. The repeal thus increased the likelihood of structural complexity, because there are no longer any federal statutory limits on geographic remoteness, the mixing of utility and non-utility business, leveraging, private buyouts, or inter-affiliate transactions. (There remains some review by the Federal Energy Regulatory Commission under Section 203 of the Federal Power Act, 16 U.S.C. sec. 824b, and under a vestige of PUHCA 1935 now called PUHCA 2005, but there is no longer an integrated public-utility system requirement and thus no longer any federal statutory limits on geographic dispersion, type-of-business scope, corporate layering, financial leveraging or interaffiliate transactions.) Corporate family structures prohibited for 75 years are now possible. There can be, therefore, subject to the minor constraints noted in the preceding parenthetical—and unless states act on their own—

[13] See Energy Policy Act of 1992, sec. 711, 15 U.S.C. sec. 79z-5a (repealed).

unlimited geographic dispersing of utilities and assets, without regard for operational efficiencies; unlimited mixing of utility and non-utility businesses; unlimited corporate layering; and unlimited debt-leveraging of utility and nonutility subsidiaries. No longer does federal law require corporate structure to align with public service obligation. "Utilities," our parents' and grandparents' "safe investment," has changed its character.

Q. What about federal antitrust law?

A. It does not address corporate complication or conflicts of interest between shareholders and consumers, which are the problems I am addressing in this Part I. I will address competition issues in Part VI.

Q. Why are these federal statutory changes relevant to this proceeding?

A. While PUHCA 1935 was in place, and assuming it was enforced properly by the SEC, a state commission evaluating a holding company merger would not have much uncertainty about the current and future business activities within the post-merger family. The Commission would know that Pepco, on joining a holding company family, would not:

1. be an affiliate of utility businesses that were not part of the same integrated public utility system;
2. be an affiliate of non-utility businesses;
3. be a part of a corporate family in which interaffiliate transactions (including transactions anywhere in the family, not just transactions to which Pepco was a party) were unbounded by rules on interaffiliate prices aimed at preventing cross-subsidies; or
4. be a part of a corporate family in which the holding company affiliates' financial structures were unreviewed by regulators obligated to protect consumers.

Since none of these circumstances were permitted under PUHCA 1935, the Commission could make a reasonable prediction about the future activities of the family which Pepco was joining. That is no longer the case. PUHCA's repeal has shifted to the states the challenge of distinguishing helpful from harmful corporate structures. State commissions now need to develop their own methods of screening merger transactions, to ensure that the entities that own or influence utility infrastructure remain accountable to regulators, consumers, investors and the public.

In the District, the absence of a clear regulatory policy contrasts sharply with the clarity of shareholder goals. That contrast explains why the Commission is now presented with a proposal that allocates to shareholders over 12 times the benefits it guarantees to ratepayers. That is why the Commission, before addressing this specific transaction, must ask and answer the central question: "What market structure and corporate structure will produce the best performance?" Without answering this question first, there is no objective context for judging this transaction, no public interest frame. The Commission is unable to compare Exelon's proposal with alternative proposals, or even know if Exelon's proposal is precluding alternatives. Only by articulating its own vision—of performance quality, of corporate structures and market structures most likely to produce that quality, and of the merger policies most likely to produce those market structures—can the Commission ensure that when consolidations are proposed, they are proposed for public interest reasons, and that they "will be" in the public interest.

Q. Why have you included this discussion of public interest principles in your testimony?

A. Should there be a challenge to the Commission's decision (whether for or against the transaction), the challenger will ask the Court of Appeals to examine the Commission's application of the phrase "public interest." The Commission will need to demonstrate to the Court that it gave meaning to the phrase. At present, the Commission has listed 7 subjects as being relevant to the public interest, but listing subjects is not the same as articulating the public interest. As I stated above, the public interest affected by a consolidation has to be a view about what combination of corporate structure, market structure, financial structure and governance structure best advances the cause for which the Commission was created: cost-effective performance by the industry it is regulating. The Court of Appeals will expect the Commission to have articulated that view, based on the record before it. My testimony assists in creating that record.

Q. Do you have another reason for offering testimony on public interest principles?

A. Yes. The City Council and the community it represents need to learn if the existing statute is producing desirable results. If the Commission rejects these proposed principles, holding either that they fall outside the Commission's discretion or that they fall within the Commission's discretion but do not warrant the Commission's adoption, the City Council will have information useful in determining whether to amend the statute to make these principles, or other principles, obligatory. I know of no other way for the City Council to obtain this information, because if the City Council asked the Commission for its positions on these standards, the Commission would likely respond that it could not commit itself for fear of prejudging this case or some future one.

Q. Do you have any other reasons for including this discussion of public interest principles?

A. Yes. Mergers affect consumers profoundly. All the inputs to industry performance, including corporate structure, cost structure, market structure, governance relationships, business mix, executive incentives, and employee incentives, are affected by a merger.

Further, each merger changes the industry chessboard, causing others to consider making new moves. A merger affects acquirers, targets, shareholders, bondholders, large customers, small customers, incumbent competitors, prospective competitors, today's citizens, and tomorrow's citizens. And a merger affects many values, including competitiveness, the environment, labor, corporate accountability, regulatory readiness.

To address all these implications, the District has a statute that gives little guidance. It establishes a standard of "public interest" but leaves it to the Commission to make that standard meaningful. The Commission cannot make a public interest standard meaningful by waiting for transactions to emerge, then saying "yes" or "no"; or "yes if some benefits are guaranteed, others are merely aspirational and no one protests." A wait-for-the-transaction approach leaves everyone—investors, consumers, competitors, workers—guessing about what transactions will pass the test. The public interest requires principles that guide actors toward the best performance. My testimony seeks to provide those principles, by deriving them from the premises of regulation itself.

II.
PHI's Conflict of Interest:
The Guarantees to Shareholders are
Worth 12 Times the Guarantees to Customers

A. Factual background: PHI's central goal was highest possible purchase price

Q. Describe the gain to PHI's shareholders from Exelon's buyout offer.

A. The purchase price represents a premium of approximately—

> "19.6% to the closing price of our common stock on April 29, 2014, the last trading day prior to the public announcement of the proposed Merger."[14]

> "29.5% to our 20-day volume-weighted average share price as of April 25, 2014, the third business day prior to the public announcement...."[15]

> 58% over the book value of the public utility assets of PHI's three utility subsidiaries.[16]

Q. What is your understanding of PHI's goal in this transaction?

A. PHI's primary goal was to get the greatest gain for its shareholders. The basis for this conclusion is PHI's actions, as PHI has described them:

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[14] PHI Definitive Proxy Statement at p.9 (Aug. 12, 2014) (hereinafter, "Definitive Proxy Statement"), available at http://www.sec.gov/Archives/edgar/data/1135971/000157104914003924/t1401350-defm14a.htm.

[15] Definitive Proxy Statement at p.9.

[16] The 58% is the result of (27.25-17.23)/17.23. The purchase price is $27.25 per share. According to PHI, "[t]he book value of PHI's common stock at 12/31/13 was $17.23 [per share]." PHI adds that "[o]ver the past three years, prior to the merger announcement, the market price of PHI's stock price has generally traded above this [book value] level, so it is not unreasonable to expect that Pepco Shareholders received an offer price above book value." See Exhibit GRID2.0 (A)-2 (Response to GRID2.0 DR 1-64). PHI's second sentence is irrelevant to calculating the premium based on book value.

> After discussion, the [PHI] Board determined, based on the indications of interest received and the discussions with the counterparties regarding their indications of interest, to continue discussions with Exelon and Bidder D to determine if PHI could reach an agreement with either of such parties, at a price and on terms, including with respect to closing certainty and regulatory commitments, that the Board believed *would achieve the best value reasonably available for PHI's stockholders* in a transaction that would be likely to close.[17]
>
> Mr. Rigby also discussed with the [PHI] Board an April 26, 2014 meeting among certain members of senior management of PHI and PHI's outside legal and financial advisors during which different possible approaches had been discussed *to seek to take advantage of the significant competition between Exelon and Bidder D to permit PHI to obtain the best possible price* and the greatest transaction certainty. He advised the Board that during this meeting senior management and the outside advisors agreed with a proposed strategy of accelerating the process to reach final agreement with Exelon, *as the bidder presenting both the highest price and best proposed contractual terms at the time*, and given the risk to the process from public disclosure or speculation regarding a potential transaction, but continuing to negotiate strongly for the best possible contractual protections around transaction certainty from both bidders and *remaining open throughout to the possibility of obtaining higher prices* from Exelon and Bidder D.[18]
>
> On April 28, 2014, the Chief Executive Officer of Bidder D called Mr. Rigby and asked *what level of price increase was necessary for Bidder D to be the highest bidder*. In response, Mr. Rigby asked for Bidder D's best and final price, and in response, Bidder D raised its bid to \$27.00 per share in cash. Following that call, on April 28, 2014, *Mr. Rigby informed Mr. Crane that Bidder D had raised its bid and asked Mr. Crane for Exelon's best and final price. In response, Exelon raised its bid* to \$27.25 per share in cash.[19]
>
> After the April 24, 2014 discussions between PHI's directors, senior management and advisors at the board meeting, at PHI's direction, Lazard informed Exelon that based on the price offered in its initial indication of

[17] Definitive Proxy Statement at p.28 (emphasis added).

[18] Definitive Proxy Statement at p.30 (emphasis added).

[19] Definitive Proxy Statement at p.31 (emphasis added).

> interest and Exelon's comments on the draft merger agreement received on April 23, 2014, Exelon's proposal was less attractive on price and transaction terms, and that Exelon should take these matters into consideration when submitting its final proposal on April 25, 2014.[20]

PHI has explained that "[t]he term 'less attractive' indicated that of the initial proposals received by PHI, Exelon's proposal relative to price and transaction terms was less than the price and transaction terms offered by one or more other parties." See Exhibit GRID2.0 (A)-3 (Response to GRID2.0 DR 1-18(A)).[21]

> During the morning of Apr. 29, 2014, ... Mr. Rigby updated the Board with respect to the increased bids made by each of Exelon and Bidder D. Mr. Rigby noted that each such counterparty had indicated to Mr. Rigby that its increased bid was its best and final offer on price, and that *based on the higher price being offered by Exelon* and the other terms in the Merger Agreement draft that Exelon had agreed to, that the purpose of the meeting was for the Board to discuss and consider a proposed transaction with Exelon.[22]

Q. Is there any evidence that PHI's goal was to obtain from competing bidders the most benefit for its utilities' (including Pepco's) customers?

A. No. At no point was PHI's goal of getting highest price for its shareholders constrained by a goal of finding the merger partner that would produce the most benefit for Pepco's customers. For example, in a section of the Definitive Proxy Statement entitled "Reasons for the Merger" (beginning at p.32), PHI lists "material factors considered by the Board in determining the desirability of the acquirer." There are 12 positive factors, and nine factors described as "a variety of risks and potentially negative factors." None of 21

[20] Definitive Proxy Statement at p.30.

[21] All exhibits cited as "Response" are responses provided by Applicants.

[22] Definitive Proxy Statement at p.31 (emphasis added).

factors involved ratepayer benefits. The positive considerations all concern benefits to shareholders, most explicitly the one stating that PHI "had conducted a competitive process and that Exelon was the highest bidder in such process." None of the negative considerations include the possible negative effects on utility customers, such as (but not limited to) the possibilities that (a) Exelon's issuance of new debt and equity to finance the purchase will ultimately make it harder for Pepco to borrow money from third parties or access equity from its new parent, (b) Exelon's control of Pepco's spending decisions will prevent Pepco from taking actions necessary to serve its customers cost-effectively; (c) Exelon's interest, as a generation owner, in high generation prices might adversely affect Pepco, which as a non-generation owner has an interest in low generation prices; or (d) Exelon's non-utility businesses, including but not limited to its nuclear activities, could adversely affect Pepco's ability to serve its customers at "lowest feasible cost." Further, the "fairness opinions" commissioned by PHI focus only on whether its shareholders are receiving sufficient value for what they are giving up.

Q. Didn't PHI conduct a "due diligence" investigation of the bidders?

A. Yes. According to the Definitive Proxy Statement (at p. 31), PHI's senior management performed a "due diligence … on Exelon and Bidder D, including with respect to regulatory relationships, reliability, operating track records and employee matters." But a due diligence investigation would focus only on those companies under consideration due to their high price offers. PHI did not search for other prospective acquirers who might perform better. Even among the limited number of companies PHI investigated, there is no sign that PHI compared and ranked them according to their ability to improve Pepco's service. And there is no sign that "due diligence" involved assuring that the chosen bidder would be the best performer.

Q. Is there other evidence that purchase price took precedence over Pepco's performance?

A. Yes. The individuals responsible for integrating post-merger operations—i.e., improving Pepco's performance—had no involvement in selecting the acquirer: "Members of the Integration Office, the Core Teams and the BATs did not participate in negotiations between PHI and Exelon over the acquisition price." See Exhibit GRID2.0 (A)-4 (Response to GRID2.0 DR 1-97 referring to Khouzami Direct. at p.17 lines 23-25). Even as of October 2014, "Exelon has not yet undertaken an in-depth review of local priorities in PEPCO's service territory." See Exhibit GRID2.0 (A)-5 (Response to OPC DR 4-23). PHI claims to have used "due diligence," but it chose a buyer who was willing to pay a multibillion dollar premium over book without "undertak[ing] an in-depth review of local priorities."

B. Regulatory principle: Highest possible purchase price conflicts with service at lowest reasonable cost

Q. Mr. Rigby says there is no conflict between "PHI shareholders wanting the highest possible price, and Pepco ratepayers wanting the best possible service." (See Exhibit GRID2.0 (A)-6 (Response to GRID2.0 DR 1-53)). What is your response?

A. His view is illogical. In the District, a public utility has an obligation to operate at "lowest feasible cost."[23] Had PHI viewed "lowest feasible cost" as its primary obligation, it would have screened prospective acquirers for their ability to meet this standard. But

[23] *Potomac Elec. Power Co. v. Pub. Serv. Comm'n of D.C.*, 661 A. 2d 131, 137 (D.C. 1995).

the Board screened acquirers based on their price offers. By not making cost-effectiveness the primary criterion, PHI necessarily failed to consider companies whose price bids would be lower but whose cost-effectiveness would be higher.

Q. What's wrong with a seller of an asset seeking the highest possible price?

A. Nothing, if all parties affected by the transaction are subject to effective competition. Consider the sale of an apartment building, in a city with plenty of apartment vacancies. The interests of the building seller, building buyer and renters are aligned. The building seller will demand the highest possible price, but the buyer will be willing to pay a price no greater than what he can recover in rentals set by competition in the rental market, because if he raises his rentals to above competitive levels, prospective tenants will rent elsewhere. So the building buyer will pay a premium no greater than the new economic value he believes he can create as the new owner. That new economic value is a public interest benefit. In a market where there is competition for the ultimate product (in this example, apartment rentals), an acquisition contest run by the acquiree, based on highest possible price, can produce a public interest result.

But monopoly utility service is not like apartment rentals. The consumers who depend on Pepco's monopoly distribution service cannot shop elsewhere. That is why the interests of the asset seller, the asset purchaser and the ultimate consumer are not aligned; that is why there is a conflict of interest between the asset seller and the ultimate consumer—between PHI and Pepco's customers. Holding out for the highest price produces an outcome different from holding out for the best performer.

Q. But doesn't regulation replicate the forces of competition?

A. Possibly, but not necessarily. Regulation, like competition, has imperfections. In the merger context, one imperfection is asymmetry of information. *See, e.g.*, Department of Justice/Federal Trade Commission *Horizontal Merger Guidelines* at section 10 ("[Merger] efficiencies are difficult to verify and quantify, in part because much of the information relating to efficiencies is uniquely in the possession of the merging firms."). It is unlikely that the Commission's staff could establish for post-merger Pepco the same performance standards that would emerge had PHI selected, competitively, the best performer rather than the highest payor. Utility companies know things regulators don't, like ways to cut costs. With this knowledge advantage, an acquirer of a utility monopoly, unlike the acquirer of an apartment building, can pay a premium and recover it by keeping rates above costs, until the regulator discovers the facts and adjusts the rates. As I will explain in Part V.B.3, Exelon has thus far resisted a simple procedure that would produce the information Commission staff would need to align rates with costs, i.e., to prevent post-merger Pepco from withholding merger savings from consumers.

Q. In the merger context, can a commission eliminate the conflict between a target company's purchase price goals and its service obligations?

A. Yes. A commission can eliminate the conflict by declaring this principle: To gain approval of consolidation, the target company must prove that it selected the acquirer that can do the most for ratepayers. That principle adds nothing to the incumbent's obligation to operate at "lowest feasible cost"; it merely applies that obligation to the merger context. We apply this very principle in selecting the suppliers for Pepco's Standard Offer Service. Nor does the principle trump the target's obligation to its shareholders to get the highest possible price, because that obligation is always subject to complying with whatever are the laws in the relevant jurisdiction.

Because the Commission has not announced that principle, PHI did the rational thing: It pursued the highest possible price rather than the best possible performer.

Q. What are Commission's options now?

A. The Commission has a choice—between allowing shareholders to gain at the expense of customers, or by aligning the interest of shareholders with the interests of customers. Approving this transaction rewards PHI (whose shareholders get the acquisition premium) for acting adversely to Pepco's customers (who are denied the best-performing acquirer). Rejecting the transaction sends the opposite signal: If Exelon wants to acquire PHI, it must win that role through a competition whose selection criterion is "lowest feasible cost." In the first choice, shareholders win and customers lose. In the second option, shareholders win if customers win. The first choice embeds a shareholder-customer conflict; the second choice aligns their interests. Those are the Commission's choices.

C. The ratio of 12:1: Shareholder and ratepayer interests are not "balanced"

Q. Does this transaction "balance" shareholder and ratepayer interests?

A. No, for two independent reasons. First, the shareholders keep all of the gain associated with the $1.2 billion premium over market value—12 times the $100 million that the consolidated entity has guaranteed to its customers.[24] The gain is much larger—and more relevant—when measured from book value. An excess of purchase price over book value is, technically, a windfall, *i.e.*, an amount not within the shareholders' legitimate expectations. Shareholders' legitimate expectation is to receive the net present value of the stream of earnings calculated as a reasonable return on the prudent investment (i.e., book value) made by the utility in assets necessary to serve the public. As I quoted in Part I.E.1:

> The thing devoted by the investor to the public use is not specific property, tangible and intangible, but capital embarked in the enterprise. Upon the capital so invested the Federal Constitution guarantees to the utility the opportunity to earn a fair return.[25]

The gain PHI shareholders will receive bears no relationship to this amount.

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[24] According to Exelon's response to OPC DR 3-7 (Exhibit GRID2.0 (A)-7):

> For purposes of this response, the acquisition premium embedded in the purchase price was determined based on the difference in the closing share price for PHI on April 29, 2014 of $22.79 per share (representing the PHI per share price prior to the deal announcement) compared to the Exelon offer price of $27.25 per share. Based on the number of PHI shares outstanding as of June 30, 2014, Exelon currently estimates the acquisition premium in PHI market capitalization would be approximately $1.2 billion. This was determined based on an estimated purchase price of approximately $7 billion ($27.25/share for 251 million shares at June 30, 2014) compared to an estimated market capitalization of approximately $5.7 billion ($22.79/share for 251 million shares). Please note that these amounts are estimates based on the number of shares outstanding and per share premium offered by Exelon compared to the per share price prior to the announcement of the PHI acquisition."

[25] *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U.S. 276, 290 (1923) (Brandeis, J., concurring).

The excess of purchase price of book value is also a windfall for a distinct reason. Pepco and its affiliated utilities—the assets Exelon believes are worth the premium—are valuable to Exelon (and thus worth the price PHI is demanding) not because of managerial skill or investor risk-taking. The target utilities' value to Exelon is due to their historic and continuing control of a service territory whose customers' monthly payments for an essential service are a given. This control itself is a given because the District government (and that of Maryland and Delaware) allows only the incumbent utility to provide that service. The value of utility franchises—which are what Exelon is buying from PHI, along with the utilities' assets—lies primarily in the exclusive privilege to provide service to captive customers at rates that must satisfy statutory and constitutional standards. Since each utility has historically been compensated for the service it has provided, at rates lawfully designed to cover its reasonable expenditures plus a fair return on investment, any additional payment now is a windfall—a payment above legitimate expectations. Allocating to shareholders a value created by government action rather than competitive success is not "balancing" the interests of shareholders and ratepayers.

III.
Exelon's Conflicts of Interest: Pepco Needs Low Generation Prices While Exelon Needs High Generation Prices; Pepco Needs Stability While Exelon Intends to Expand

A. Factual background

1. Pepco

Q. Describe PHI's business emphasis.

A. PHI is "predominantly a 'pipes and wires' distribution utility company." Crane Direct Testimony p.18 l.13. All three PHI utility subsidiaries concentrate on transmission, distribution and default supply of electricity within their assigned service territories. (Delmarva also distributes and supplies natural gas.) PHI's mission statement is the essence of local, customer-focused service:

> PHI's business objective is to be a top-performing, regulated power delivery company that delivers safe and reliable electric and natural gas service to its customers and through its regulatory proceedings, earns a just and reasonable rate of return on, and receives timely recovery of, its utility investments.

PHI 10-K at p.5 (2013). Within the PHI family, the three utilities are responsible for 95 percent of PHI's operating revenues. Pepco's revenues account for nearly half of that amount.[26] Thus, nearly all of PHI's profitability depends on pleasing utility regulators, especially this Commission. As PHI's 10-K (2013 states (at p.27): "PHI's profitability is

[26] Per PHI's 10-K for 2013, total PHI operating revenues were $4.666 billion. Of that amount, Pepco had $2.026 billion, Delmarva $1.244 billion, and Atlantic City $1.202 billion, totaling $4.472 billion for the three utilities.

largely dependent on its ability to recover costs of providing utility service to its customers and to earn an adequate return on its capital investments."

PHI's non-regulated business is the Pepco Energy Services, which "provid[es] comprehensive energy management solutions and developing, installing and operating renewable energy solutions." PHI 10-K at p.5 (2013). Its activities remain close to home, substantively speaking, and its contribution to PHI's total is small.

2. Exelon

Q. What role would Pepco play if PHI is acquired by Exelon?

A. With this transaction, Pepco would become one of over 20 subsidiaries spread over multiple industries and regions. Whereas today PHI's regulated utility operations contribute nearly all of PHI's earnings, after the acquisition Exelon's regulated utility operations would contribute only "60% and 65% of Exelon's pro forma 2015 and 2016 earnings, respectively." O'Brien Direct Testimony at 12. As for Pepco, this transaction would cause Pepco to shrink in importance to its holding company by a factor of 5: Today, Pepco's contribution to holding company revenues is 43%; after the transaction, 8.2%.[27] And as explained in Part III.C below, Pepco's shrinkage is not capped, because Exelon makes no promise to remain static; Exelon has told its shareholders it intends to grow. Absent a condition requiring that Pepco's share of total holding company earnings remain above a stated level (or establishing the Commission's power to limit Exelon's

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[27] Per the companies' 2013 10-Ks: Exelon's 2013 operating revenue was $24.9 billion. PHI's 2013 operating revenue was $4.67 billion—19% of Exelon's. Pepco's operating revenue was $2.03 billion—43% of PHI's. After the transaction, Pepco's 43% of PHI's 19% is 8.2%.

future acquisitions), there is no limit to how small Pepco can become relative to the total holding company.

B. Exelon's generation interests conflict with Pepco's service obligations, Commission precedent and Commission policy objectives

1. Exelon's stake in generation

Q. Describe Exelon's stake in generation.

A. Exelon's affiliates own 33,138 MW in generation plant, as follows: nuclear (17,263), fossil (12,165), and renewable (including hydroelectric) (3,710). Exelon's 2013 10-K, pp.9-10. In addition to their own generation, Exelon's affiliates have long-term power purchase contracts amounting to 9,426 MW. Exelon's investment in Constellation Energy Nuclear Group (CENG) consists of 1,999 MW. Exelon's current stake in generating resources totals 44,563 MW.

Q. How does Exelon describe its generation and other fuels-related businesses?

A. In its 2013 10-K at p.7, Exelon states:

> [Exelon] Generation operates as an integrated business, leveraging its owned and contracted electric generation capacity to market and sell power to wholesale and retail customers. Generation's customers include distribution utilities, municipalities, cooperatives, financial institutions, and commercial, industrial, governmental, and residential customers in competitive markets. Generation also sells natural gas and renewable energy and other energy-related products and services, and engages in natural gas exploration and production activities.

Exelon also engages in risk management services and natural gas exploration and production activities. These activities occur in the Mid-Atlantic, Midwest, New England, New York, ERCOT and other regions.

2. The reversal of Commission precedent on generation divestiture

Q. In terms of their business interest in generation, describe the difference between PHI and Exelon.

A. The PHI family owns almost no bulk generation. Exelon controls 44,563 MW—and makes no commitment to forego future generation acquisitions. This transaction therefore reverses the financial interests of the holding company controlling Pepco. As a buyer of electric power for its default customers, Pepco wants low generation prices. As an owner of generation, Exelon wants high generation prices. As Exelon has stated:

> The rate of expansion of subsidized low-carbon generation such as wind and solar energy in the markets in which [Exelon] Generation's output is sold *can negatively impact wholesale power prices*, and in turn, Generation's results of operations.

Exelon 2013 10-K at p. 85 (emphasis added).

> [N]ational regulation or legislation addressing climate change through an RPS [renewable portfolio standard] could also increase the pace of development of wind energy facilities in the Midwest, which could put *downward pressure on wholesale market prices for electricity from [Exelon] Generation's Midwest nuclear assets*, partially offsetting any additional value Exelon and Generation might derive from Generation's nuclear assets under a carbon constrained regulatory regime that might exist in the future.

Exelon 2013 10-K at p.52 (emphasis added).

> "Power Market Recovery Upside" is a term that Exelon uses frequently in its investor presentations. Exelon Generation, Exelon's competitive power generation and power and gas supply business unit, actively monitors power, gas, capacity and other commodity markets throughout the country. Since the recession, wholesale power prices have been driven lower due to many factors, most notably by lower demand for electricity as well as less expensive natural gas (which often sets power prices in Exelon Generation's markets). Exelon, as well as other power generators and independent analysts, believe that power prices are in the process of recovering (or moving upward) as natural gas prices move up, demand increases and coal-fired power plants exit the market. However, such factors are not always believed to be reflected adequately in the future

> price of power. If such events do occur, Exelon Generation would see its profitability increase as it could sell its power at a higher price. In other words, it would realize upside to its currently projected profitability. Thus, we believe that power markets have the ability to recover more than they have to date and that such additional recovery would result in upside for Exelon Generation.

Exhibit GRID2.0 (A)-8 (Response to DCG DR 1-10, referring to an April 30, 2013 presentation, Slide 11 of which was entitled "Transition Economics are Attractive").

Q. How does this difference in business interest, between PHI and Exelon, relate to the Commission's existing policy on a utility's stake in generation?

A. Approving this transaction would reverse the Commission's policy preference for generation divestiture. In 1999, when seeking Commission approval to divest its generation, Pepco cited the benefits of "elimination of market power concerns associated with the existence of vertically integrated electric utilities in a competitive retail market; and ... earlier access to the benefits associated with a competitive marketplace."[28] The Commission echoed the point:

> [T]he sale of PEPCO's generation assets eliminates market power concerns that derive from the existence of a vertically integrated utility in an evolving competitive market for generation supply. With PEPCO substantially out of the generation business, there will be less motivation for the Company to act as an inhibitor to the development of a competitive generation market in the District. Thus, once retail access is underway, the prospect that District ratepayers will reap the benefits of a competitive marketplace is greatly enhanced.[29]

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[28] *In the Matter of the Investigation into Electric Service Market Competition and Regulatory Practices*, Formal Case No. 945, 1999 D.C. PUC LEXIS 56 (Dec. 30, 1999) at text accompanying n.32 (Commission's summary of Pepco's position).

[29] *Id.*, 1999 D.C. PUC LEXIS 56, at *33.

3. The potential conflicts with Commission policy objectives

Q. Besides reversing Commission policy on divestiture, does this transaction create conflicts with Commission or District policy objectives?

A. Yes. As a buyer of electric power, Pepco's interest is in procuring low-cost sources. As owners and traders of generation, Exelon's affiliates want high-priced sales. This difference in business goals can cause conflict in five policy areas: transmission access to lower cost generation supplies, wind and solar displacing nuclear and fossil, distributed energy resources, retail competition, and Standard Offer Service. I will discuss each in turn.

a. Transmission access to lower cost generation supplies

Q. Is there a potential for conflict between Exelon's generation investments and the District's interest in transmission access?

A. Yes. Over the past thirty years, policymakers in the electricity, gas and telecommunications industries have known that a corporate family that controls competitive assets and monopoly facilities (the latter sometimes called "bottleneck facilities" or "essential facilities") has an incentive and opportunity to exploit those monopoly facilities to enhance the profitability of the competitive assets. Starting even before FERC's landmark Order No. 888[30] and continuing through its

[30] *Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities, Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, Order No. 888, 75 FERC ¶ 61,080 (1996), *order on reh'g*, Order No. 888-A, 78 FERC ¶ 61,220, *order on reh'g*, Order No. 888-B, 81 FERC ¶ 61,248 (1997), *order on reh'g*, Order No. 888-C, 82 FERC ¶ 61,046 (1998), *aff'd in relevant part sub nom.* Transmission Access Policy Study Group v. FERC, 225 F.3d 667 (D.C. Cir. 2000), *aff'd sub nom.* New York v. FERC, 535 U.S. 1 (2002).

Order No. 1000,[31] FERC has tried to remove this incentive and opportunity in the context of the relationship between generation and transmission. Because Pepco owns no generation, and has an obligation to find the least cost power for its citizens, it has an interest in boosting transmission access to low-cost power sources, and ensuring that such transmission access is itself low-cost.

As a generation owner, Exelon does not have the same interest. Its stake in high generation prices means it will not favor transmission actions or policies that make generation available to buyers like Pepco at lower prices. Thus when Pepco needs transmission to access low-cost power sources, Exelon will have the business motivation (and the corporate governance power, as explained in Part III.D below) to prevent or constrain Pepco's actions, whether those actions are building transmission, entering into transmission purchase arrangements, or pressing for regional transmission policies that plan and promote transmission.

Q. Are there examples of an Exelon tendency to oppose efforts to increase transmission access or lower its cost?

A. Yes. Among other features, Order No. 1000 injected competition into the market to build and own transmission facilities. It did so by removing from transmission owners' FERC tariffs their "right of first refusal" to build certain regional transmission facilities. That "right of first refusal" was, in effect, a right to block others from competing to build

[31] *Transmission Planning and Cost Allocation by Transmission Owning and Operating Public Utilities*, Order No. 1000, 136 FERC ¶ 61,051 (July 21, 2011); Order No. 1000-A, 139 FERC ¶ 61,132 (May 17, 2012); Order No. No. 1000-B, 141 FERC ¶ 61,044 (Oct. 18, 2012), *aff'd, South Carolina Public Service Commission v. FERC,* No. 12-1232 (D.C. Circuit (Aug. 15, 2014).

transmission and supply transmission service. My understanding is that Exelon's three utilities opposed this feature of Order No. 1000. That opposition continues, in another form. The regional transmission organization, PJM, has submitted to FERC revised tariffs that removed the incumbents' right of first refusal. Exelon's utilities opposed PJM's filing, as illustrated by this statement (Exelon 2013 10-K at p.96):

> ... [C]ertain of the PJM transmission owners including ComEd, PECO and BGE (collectively, the PJM Transmission Owners) submitted a filing asserting that their contractual rights embodied in the PJM governing documents continue to justify their right of first refusal to construct new reliability (and related) transmission projects and that the FERC should not be allowed to override such rights absent a showing that it is in the public interest to do so under the FERC's "Mobile-Sierra" standard of review. This is a heightened standard of review which the PJM Transmission Owners argued could not be satisfied based on the facts applicable to them. On March 22, 2013, FERC issued an order ... (1) rejecting the arguments of such PJM Transmission Owners that the PJM governing documents were entitled to review under the Mobile-Sierra standard, (2) accepting most of the PJM filing, removing the right-of-first refusal from the PJM tariffs; and (3) directing PJM to remove certain exceptions that it included in its compliance filing that FERC found did not comply with Order No. 1000. *FERC's order could enable third parties to seek to build certain regional transmission projects that had previously been reserved for the PJM Transmission Owners, potentially reducing ComEd's, PECO's and BGE's financial return on new investments in energy transmission facilities....*

The italicized sentence capsulizes the problem: Exelon is resisting competition in the market for new transmission facilities because that competition could reduce its profit. There is, therefore, a direct conflict between the District's interest in lower transmission costs, and the Exelon utilities' interest in maintaining transmission profit. The same conflict applies to the underlying transmission planning process. Pepco will need transmission that links population centers with low-cost power supplies. But if low-cost power supplies compete with Exelon's existing generation or future-acquired generation, Exelon's incentive will be to oppose that transmission. And as explained in Part III.D below, Exelon will have the governance power to keep Pepco from pressing for these policies. Pepco's silence, ordered by Exelon, will leave the Commission without the guidance it needs—and expects—from Pepco to take appropriate positions in the regional planning process. The District will lose a knowledgeable voice—a voice whose economic interests has aligned with the District's—in the very Order 1000 planning process FERC has created to give the District a voice.[32]

b. Wind and solar displacing nuclear and fossil

Q. Is there a potential for conflict between Exelon's generation investments and the District's interest in wind and solar energy?

A. Yes. As an owner of nuclear and fossil generation, Exelon views the expansion of wind and solar as inconsistent with its interests:

> The rate of expansion of subsidized low-carbon generation such as wind and solar energy in the markets in which Generation's output is sold can negatively impact wholesale power prices, and in turn, Generation's results of operations.

Exelon 10-K p.85.

Q. But don't Exelon's subsidiaries invest in renewable energy; and if so, how can you say that their interests are opposed to those sources?

A. In various media Exelon has stated its "commitment" to renewable energy. But those statements do not remove the conflict; they highlight it. Exelon's investments in or purchases of renewable energy are not acts of charity; they exist either because a state law or order has required the investment or purchase, or because Exelon sees a profit

[32] I have detailed Order 1000's benefits to states in a series of papers available at http://www.scotthemplinglaw.com/research-papers.

opportunity is diversifying its generation assets. The facts remain that (a) Exelon's mix of conventional and renewable generation will be based on its perception of what mix will maximize its profit, and (b) Exelon sees itself as primarily a nuclear and fossil generator for profit:

> Regulatory and legislative developments related to climate change and RPS [renewable portfolio standards] may also significantly affect Exelon's and Generation's results of operations, cash flows and financial positions. Various legislative and regulatory proposals to address climate change through GHG emission reductions, if enacted, could result in increased costs to entities that generate electricity through carbon-emitting fossil fuels, *which could increase the market price at which all generators in a region, including [Exelon] Generation, may sell their output, thereby increasing the revenue Generation could realize from its low-carbon nuclear assets*. However, national regulation or legislation addressing climate change through an RPS could also increase the pace of development of wind energy facilities in the Midwest, *which could put downward pressure on wholesale market prices for electricity from Generation's Midwest nuclear assets,* partially offsetting any additional value Exelon and Generation might derive from Generation's nuclear assets under a carbon constrained regulatory regime that might exist in the future.

Exelon 2013 10-K at 52 (emphasis added). Exelon may respond that its opposition to wind and solar is not to those sources themselves, but to the subsidies of them. But I know of no instance where Exelon has warned its investors of the opposite—that continuing government subsidies of nuclear and fossil fuel, including the absence of "national regulation or legislation addressing climate change," could lower the value of Exelon's investments in renewable energy.

c. Distributed energy resources

Q. Is there a potential for conflict between Exelon's generation investments and the District's interest in distributed energy resources?

A. Yes. District policies that encourage consumers to develop low-cost, distribution-level substitutes for generation-dependent utility service are in direct conflict with Exelon's self-interest. Exelon has said so, bluntly:

> The Registrants are potentially exposed to emerging technologies that may over time affect or transform the energy industry, including technologies related to energy generation, distribution and consumption. Some of these technologies include, but are not limited to further shale gas development or sources, cost-effective renewable energy technologies, broad consumer adoption of electric vehicles and energy storage devices. Such developments could lower the price of energy, could affect energy deliveries as customer-owned generation becomes more cost-effective, could require further improvements to our distribution systems to address changing load demands and could make portions of our electric system power supply and transmission and/or distribution facilities obsolete prior to the end of their useful lives. *Such technologies could also result in further declines in commodity prices or demand for delivered energy.* Each of these factors could materially affect the Registrants' results of operations, financial position, and cash flows through, among other things, reduced operating revenues, increased operating and maintenance expenses, and increased capital expenditures, as well as potential asset impairment charges or accelerated depreciation and decommissioning expenses over shortened remaining asset useful lives.

Exelon 2013 10-K at p.44 (emphasis added). I will discuss this issue more explicitly in Part VI, in response to Applicants' testimony asserting that the transaction will not impair competition.

d. Retail competition

Q. Is there a potential for conflict between Exelon's generation investments and the District's interest in retail electricity competition?

A. Yes. Competition works when customers can choose suppliers, and then switch among them (subject to appropriate conditions and fees) to seek the most favorable arrangements. But customer switching is not in the interest of generation owners, as Exelon explains (Exelon 2013 10-K at 51, emphasis added):

> [Exelon] Generation's business may be negatively affected by competitive electric generation suppliers. ... Because retail customers where Generation serves load can switch from their respective energy delivery company to a competitive electric generation supplier for their energy needs, planning to meet Generation's obligation to provide the supply needed to serve Generation's share of an electric distribution company's default service obligation is more difficult than planning for retail load before the advent of retail competition. Before retail competition, the primary variables affecting projections of load were weather and the economy. With retail competition, another major factor is retail customers switching to or from competitive electric generation suppliers. *If fewer of such customers switch from its retail load serving counterparties than Generation anticipates, the load that Generation must serve will be greater than anticipated, which could, if market prices have increased, increase Generation's costs (due to its need to go to market to cover its incremental supply obligation) more than the increase in Generation's revenues. If more customers from its retail load serving counterparties switch than Generation anticipates, the load that Generation must serve will be lower than anticipated, which could, if market prices have decreased, cause Generation to lose opportunities in the market.*

Pepco's present position as distribution service supplier and Standard Offer Service (SOS) supplier, unaffiliated with a generation owner, means it has no generation investment at risk when customers switch. Pepco thus can be responsive to Commission efforts to increase customer choice, and can encourage choice with its own actions. But with Exelon as its owner, Pepco will be controlled by a company whose interests are explicitly adverse to customer switching. As is the case with transmission policy (discussed above in Part III.B.3.a), the proposed merger risks dampening or eliminating a voice the Commission can use to advise on how to make customer switching responsible and cost-effective.

I recognize that Exelon has stated that (a) it supports customer switching to alternative electric generation suppliers, and (b) its acquisition of Constellation's competitive retail operations provides another outlet for Exelon to "grow its business in competitive markets." Exelon 2013 10-K at p.84. Certainly in markets where Exelon's affiliates compete for retail sales, it will support customer switching (at least, switching to Exelon's affiliates). But Exelon will not necessarily support switching in markets where the switching is away from an incumbent utility Exelon controls. The risk is that Exelon will use its control of its distribution utilities to make switching difficult in the markets where difficulty serves its business objectives.

e. Standard Offer Service

Q. Is there a potential for conflict between Exelon's generation investments and the District's interest in cost-effective Standard Offer Service for retail electricity customers?

A. Yes. Exelon intends to continue competing to supply power for the SOS that Pepco provides. Joint Application at para. 32. Having a supplier that corporately controls the buyer is the definition of conflict of interest. Exelon recognizes the problem, but merely promises not to break the law: "Exelon agrees that it and its subsidiaries and affiliates will be bound by those procedures to the extent applicable following the closing of the Merger" (referring to District of Columbia's Affiliate Code of Conduct, 15 D.C.M.R. sec. 3900 *et seq.*). Application at para. 32. Because the obligation to comply exists without Exelon's "agreement," that "agreement" literally has no value. What would have value is an Exelon commitment to create in-house procedures—training, personnel assignments, supervision, inducements to ensure compliance and consequences for non-compliance—that guarantee zero tolerance for non-compliance. I am not saying that Exelon must commit here to paying employees $1 million per whistle-blow or fine non-compliers $1 million per violation—although both measures would raise the probability of full compliance. But Exelon has committed to nothing—other than causing a conflict problem that the Commission eliminated in 1999 when it approved Pepco's divestiture of generation.

Q. What about Pepco's continuing role as SOS provider?

A. The Applicants state that "Pepco will continue to provide SOS to its customers in the District." Joint Application at para. 32. Similarly, Mr. Gausman assumes that Pepco will continue to provide SOS service even as Exelon Generation competes to provide Pepco with SOS generation. Supp. Dir. at p.6. The assumption implicit in these statements, that Pepco has a lock on the SOS role that others might perform better, should cause the Commission concern. Mr. Gausman states (Supp. Dir. at p.4) that "[t]o date, Pepco has not experienced any issues with the integrity of the SOS process." But "to date," Pepco has not been controlled by an entity that has a stake in high generation prices. So the "integrity" of the past has no bearing on the integrity of the future. As mutual funds repeatedly say, past performance is no guarantee of future performance.

Q. If the Commission approves the transaction, what do you recommend as a way to limit the risk that Pepco's control by a generation owner will undermine the integrity of SOS service?

A. The best way to avoid a conflict of interest is not to have a conflict of interest. The Commission therefore should make clear that Pepco's continuing role as the SOS provider is not a foregone conclusion; that the Commission will hold a competition to determine who will provide the best SOS service at the lowest cost. That way, the negative attributes that Pepco will bring to the role, due to its control by a generation owner, will be netted against its positive attributes in a head-to-head comparison in which the public interest will prevail. There is no rationale for giving Exelon and PHI everything they ask for—Exelon's control of the District's retail electricity franchise, PHI shareholders' acquisition premium, and the continuing role of SOS monopoly—without anyone else having a chance to provide SOS service.

Exelon and Pepco might object that the transition to a new SOS provider would be difficult. I question whether it would be as difficult as (a) integrating thousands of employees in over 20 companies spread from Illinois to Virginia; (b) erecting the multiple walls between competitive and non-competitive functions that we will need to prevent Exelon and Pepco from self-dealing; and (c) designing, and paying for, the additional Commission monitoring that will be necessary to prevent Exelon from influencing the SOS process and, more generally, to prevent Exelon's generation and other business risks from harming Pepco's financial well-being.

Mr. Gausman offers this (Supp. Dir. at 6): "It has never been alleged that Conectiv Energy's [the owner of PHI's two other utilities, Delmarva Power & Light and Atlantic City Electric] participation in the District SOS auction process negatively impacted local competition." The issue is not what was alleged; the issue is what has happened. Mr. Gausman gives no evidence to support his confidence. He does not say that anyone has investigated whether Conectiv's participation affected competition negatively—such as whether anyone has interviewed prospective suppliers to see if their interest in participating was deterred by Conectiv's participation, or what the consequences were for PHI's (or its affiliates') employees who broke the rules. He offers no evidence that prior to the Exelon-PHI agreement, he extracted from Exelon a set of internal behavioral rules that give him confidence that no misbehavior can possibly occur.

Q. Are there other concerns about Standard Offer Service?

A. Yes. If the Commission approves the merger, it will need to adjust the role Pepco plays in the District's SOS working group. Pepco can no longer play the role of the independent provider of poles-and-wires-and-SOS service. Pepco must appear in the name of the entity that controls it—Exelon. I recently visited BGE's headquarters to keynote a session on demand response. On the large main wall of the entry hall, and again the meeting room, were banners proclaiming "**BGE—An Exelon Company**." That is how Pepco should participate in the working group: as "**Pepco—An Exelon Company.**" Further, in the working group the Exelon-controlled Pepco should participate only as an information provider, not as a position-taker. Otherwise there is risk of Exelon using its control of Pepco to influence the SOS process. And if there is a concern that this restriction treads on Exelon's First Amendment right to petition the government, let Exelon say so. Then we will know we have a problem—to be remedied only by removing Pepco as a representative of the SOS provider's perspective. Someone else will have to fill that role.

* * *

These five examples—transmission access to lower cost generation supplies, wind and solar displacing nuclear and fossil, distributed energy resources, retail competition and Standard Offer Service—illustrate the conflicts arising from Exelon's control of Pepco. When the Commission needs to design a request for proposals for generation, or press for changes in PJM's organized markets and transmission planning to get lower generation or transmission prices, or establish demand response and energy efficiency programs, or help consumers switch among suppliers, it no longer can rely on Pepco for objective advice: not because Pepco will be dishonest, but because it will be conflicted.

C. Exelon's emphasis on "growth" can distract from Pepco's obligation to serve

1. Exelon's acquisition is motivated by "growth" in size and profitability, not growth in ability to serve the District

Q. What is your understanding of Exelon's reasons for pursuing this acquisition?

A. Unlike PHI, which before now appeared to be satisfied with its three-utility, single-region investment base, Exelon is focused on expansion, at multiple levels of the electric industry:

> Management *continually evaluates growth opportunities* aligned with Exelon's existing businesses in electric and gas distribution, electric transmission, generation, customer supply of electric and natural gas products and services, and natural gas exploration and production activities, leveraging Exelon's expertise in those areas.[33]
>
> Exelon's financial priorities are to maintain investment grade credit metrics at each of Exelon, Generation, ComEd, PECO and BGE, and to return value to Exelon's shareholders with a sustainable dividend throughout the energy commodity market cycle and through *earnings growth from attractive investment opportunities*.[34]
>
> [Exelon] Generation's electricity generation strategy is to pursue opportunities that provide generation to load matching and that diversify the generation fleet by *expanding Generation's regional and technological footprint*. Generation leverages its energy generation portfolio to ensure delivery of energy to both wholesale and retail customers under long-term and short-term contracts, and in wholesale power markets. Generation's customer-facing activities foster development and delivery of other innovative energy-related products and services for its customers. Generation operates in well-developed energy markets and employs an

[33] Exelon's 2013 10-K at p.88 (emphasis added).

[34] Exelon 10-K (2013) at p.84 (emphasis added).

> integrated hedging strategy to manage commodity price volatility. Its generation fleet, including its nuclear plants which consistently operate at high capacity factors, also provide geographic and supply source diversity. These factors help mitigate the current challenging conditions in competitive energy markets.[35]

Q. What about Exelon's intent to provide new services for its customers?

A. It is true that Exelon has expressed a desire to provide "innovative energy-related products and services for its customers." Exelon's 2013 10-K at p.84. That desire should come as no surprise. Growth means obtaining new customers; one normally obtains new customers by providing new value (unless one obtains those customers the way Exelon obtained BGE's customers and proposes to obtain Pepco's customers—by buying the company that is the exclusive provider to those customers). But a utility's legal obligation, and the public interest I described in Part I, concerns value to the customers in the utility's existing territory, not customers in someone else's service territory. As I will discuss in Part III.C.2, there is tension between providing value to existing customers and constantly emphasizing a goal of finding new customers. That is the essential difference between PHI and Exelon. PHI was satisfied to serve the customers it has; Exelon invites investors to bet on a company that seeks to serve more than it has. In any event, there is nothing in the Joint Application or Applicants' testimony that commits Exelon to providing, or that even mentions providing, "innovative energy-related products and services for its customers."

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[35] Exelon 10-K (2013) at p.84 (emphasis added).

Q. How do financial community observers view Exelon's acquisition actions?

A. The financial community's statements indicate that it viewed Exelon's acquisition of Constellation as follows: (1) the acquisition was a strategic move to benefit Exelon's shareholders, not an operational effort to benefit BGE's ratepayers; (2) traditional utility operations were not the holding company's priority—except as an asset that diversifies its risk; (3) continued acquisitions of unregulated businesses (viewed positively by the financial community because of the reduced regulatory review of these acquisitions) were a possibility; and (4) those acquisitions of unregulated businesses will raise Exelon's risk exposure. Consider these comments about Exelon in 2011:

> Management's business strategy appears to be three-pronged: expanding the company's clean generation portfolio through its nuclear uprate program, enlarging alternative energy investments through wind development projects (and potentially solar projects), and in the medium term investing in new technologies such as electric vehicles and the smart grid. While the utilities primarily focus on growing rate base and earning a reasonable return, they are also playing a role in competitive markets by investing in transmission. Yet, Exelon has indicated that *its core power strategy does not preclude the potential for acquisitions, especially in assets that can potentially reduce the company's exposure to natural gas and offset the business risk profile of its wholesale generation business*. With nuclear generation accounting for nearly 140 terawatt hours (TWh) of the company's 150 TWh total generation in 2010, *Exelon is the most exposed of its peers to a decline in natural gas prices, which would drive down its margins*. In our opinion, *acquisition of retail power operations is consistent with Exelon's strategy because these operations offer a natural hedge against natural gas exposure*.[36]

[36] See Exhibit GRID2.0 (A)-8.1, Standard & Poor's, *Research Update: Ratings Are Affirmed On Exelon Companies On News It Will Merge With Constellation; Constellation Is On CW Positive* 3-4 (2011), attached as Ex. KLA-1 to the Direct Testimony of Karie L. Anderson before the Maryland Public Service Commission (May 25, 2011) (emphasis added).

> While acknowledging the *strategic benefits of linking a company that is long on generation resources with a company that is long on customer load*, Moody's believes that the combined entity will *still be exposed to earnings and cash flow volatility due to a large unregulated business platform* whose financial performance is influenced by market determined commodity pricing levels. We also believe that *completion of this transaction increases the likelihood that EXC will remain more focused on maintaining its leadership position among unregulated power companies*. As the largest unregulated generation company in terms of production and the largest retail energy supplier in North America, we calculate that the company's unregulated operations will collectively represent at least 65% of the combined operations during periods of low power prices and likely represent at least 80% of consolidated results when more robust power generation margins exists. As such, we believe that *it will be very challenging for EXC to easily transform the company's business mix into one that is materially more balanced across regulated operations given the sheer size of the existing unregulated footprint*. Moreover, given the competitive position that this merger reinforces, we believe that management, along with the board, *will be more inclined in the future to pursue acquisitions of additional unregulated properties as a natural extension of an existing strategy*, *particularly given the more streamlined and less challenging regulatory approval requirements that tend to accompany unregulated acquisitions*.[37]

These 2011 observations provide context for understanding Exelon's reasons for acquiring PHI. (PHI's reason for being acquired is the acquisition premium. No other reason appears on the record.) Acquiring PHI helps Exelon balance the risk of its generation portfolio, by adding to that portfolio a steady flow of revenue and earnings from customers who have no choice but to buy physical distribution service from PHI's utilities. Nowhere does the Moody's or Standard and Poor's, looking forward in 2011,

[37] See Exhibit GRID2.0 (A)-8.2, Press Release, Moody's Investors Service, "Moody's Reviews Exelon and Exelon Generation for Possible Downgrade; Affirms Constellation, Outlook Positive" (Apr. 28, 2011), attached as Ex. KLA-3 to Anderson Testimony before the Maryland Public Service Commission (emphasis added).

view future acquisitions as motivated by a desire to bring improvement to Exelon's utilities.

Q. Why is it necessary for the Commission to understand Exelon's reasons for this acquisition?

A. Exelon is not a static company. What the Commission will be approving is not today's Exelon. It is that Exelon, plus the unknown future acquisitions Exelon makes as it "pursues growth."

2. The result of Exelon's "growth" is less accountability to the Commission

Q. Does Exelon's "growth" strategy have implications for its accountability to the Commission?

A. Yes. Mr. O'Brien has stated (Direct Testimony at 12) that after the transaction, Exelon's regulated utility operations would contribute "60% and 65% of Exelon's pro forma 2015 and 2016 earnings, respectively." I assume he cites this percentage because (a) he thinks it is high, and (b) a high percentage means that Exelon will show a high degree of concern for its utilities and their regulators. There are two problems with this reasoning. First, 60-65% is much lower than the nearly 100% that applies to PHI.[38] Second, Exelon makes no commitment to maintaining that percentage. In fact, I expect that Exelon's rebuttal witnesses will resist my proposed condition that the Commission retain the power to limit future acquisitions—a power the Commission could use to maintain the 60-65% figure that Mr. O'Brien wants the Commission to accept. (Exelon opposed such

[38] And much higher than the *8.2% role Pepco will play in Exelon*, as I explained previously (referring to 2013 operating revenues). Mr. O'Brien's selectivity in number presentation is a disappointing beginning to a relationship that needs candor at its core.

a condition when I proposed it as a witness for the State of Maryland in the Maryland Commission proceeding on Exelon's acquisition of Constellation.)

Mr. Crane has acknowledged that Exelon wants to reduce the effect on its bottom line of decisions by any one regulatory jurisdiction. This reduced effect helps Exelon to achieve the strategic objective of "diversify[ing] . . . regulatory risk." Exelon Corp., Registration Statement at 64 (Form S-4) (June 27, 2011) (excerpt included as Exhibit GRID2.0 (A)-9). As Exelon acquires more utilities in more jurisdictions, its bottom-line need to please any one set of regulators declines; with each utility acquisition, the holding company can better absorb Commission decisions that are unsatisfactory to the shareholders. If Exelon has less at stake in pleasing a commission, that commission will have to work harder to ensure Pepco's accountability.

Q. What do you mean by a commission having to work harder to ensure Pepco's accountability?

A. The purpose of regulation is to ensure performance—in this case, Pepco's performance in carrying out its obligation to serve. Successful utility performance depends on three things: The commission must set clear expectations; the utility must have an internal culture that commits all employees, managers and executives to meeting those expectations; and the commission must assign clearly the consequences for meeting or failing to meet those expectations. Success on each of these dimensions requires a productive relationship between utility and commission.

Q. What do you mean by a productive relationship between utility and commission?

A. The utility-regulator relationship is typically thought of as arms-length: The utility's rights and obligations come from statutes and commission issuances; the utility and its regulator are not partners, co-workers or colleagues. But a successful utility-regulator relationship, one that produces high-quality performance at relatively low transaction cost, requires more than legal compliance by the utility. It requires elements of any productive working relationship: professionalism on both sides; respect for each entity's institutional mission; a continuous search for the commonalities between the separate institutional goals; and the credibility and trust that grows from communicating with facts, logic and law rather than other methods of persuasion.

It is difficult for a regulator to force a utility to improve. A commission cannot create the utility's internal culture, or replace the CEO and top managers with people sharing the commission's vision. A commission can try to induce behavior through financial rewards and penalties, but these are blunt tools. The financial rewards tend to be either generic (as in performance-based ratemaking that rewards cost-cutting between rate cases); or be associated with specific actions (such special inducements—positive or negative—for energy efficiency, transmission construction, fuel purchases or generation performance). Penalties, furthermore, are problematic where the incumbent utility is the service territory's only realistic option: An instance of imprudence might justify a large cost disallowance, but if that disallowance weakens the utility's ability to improve, the commission could view it as counterproductive. For these reasons, a productive utility-regulator relationship must be more than a formal arms-length relationship; it must be rooted in mutual commitments to the public interest defined consistently by each side. With Pepco's contribution to the revenues of its holding company dropping from 43% to 8.2%, the Commission needs to assure itself that the diminution in Pepco's contribution to its holding company will not adversely affect the necessary working relationships.

D. "Local control'" gives way to Exelon's power to control

Q. Does the proposed transaction reduce Pepco's independence?

A. Yes. The transaction will change Pepco's ownership, from PHI and its shareholders to Exelon and its shareholders. In this section I will describe the reality of Exelon's hierarchical structure, and its effects on budgeting, spending, and policy positions.

1. Hierarchical control

Q. After the acquisition, will Exelon have hierarchical control of Pepco?

A. At least indirectly, yes. As sole shareholder of PHI, Exelon will elect PHI's Board members. PHI, as sole shareholder of Pepco, will elect all of Pepco's Board members. (The exception is vacancies between shareholder meetings; for those vacancies, the Board will fill the vacancy). The Boards of each company, in turn, appoint the company's executive officers. See Exhibit GRID2.0 (A)-10 (Response to GRID2.0 DR 1-62). Exelon's path to controlling Pepco may have several steps, but along these steps there are no obstructions. Indeed, Exelon already has exercised that control, as demonstrated by this dialogue from Exelon's Response to GRID2.0 DR 1-63 (see Exhibit GRID2.0 (A)-11):

> Q. How can you state that Exelon is the best company to control Pepco when Exelon has made no commitment and provided no information about which Pepco executives will remain?
>
> A. Exelon has named four PHI or subsidiary executives to date. The corporate integration process is underway and additional management selections will be determined as the process continues. Please refer to Joint Applicants' Response to GRID2.0 DR 1-78.

It is true, as Mr. O'Brien explained (see Exhibit GRID2.0 (A)-12 (Response to GRID2.0 DR 1-73)), that while Exelon Corporation "may request or recommend that the PHI

Board of Directors take action or refrain from taking action, ... Exelon will not have legal power to order the PHI Board of Directors to take action or refrain from taking action." But, he continues, "the PHI Board of Directors may establish requirements for approval by the Exelon Board of Directors or an Exelon officer, in addition to any required approval of the PHI Board of Directors, for specified actions of PHI." When Exelon needs to control PHI and Pepco, it has the power to do so.

Q. Explain how hierarchical control can be exercised through reporting relationships.

A. Mr. O'Brien is "responsible for the activities of Exelon's regulated transmission and distribution businesses…." O'Brien Direct Testimony at p.1 lines 7-8. That means that Pepco's executives will be reporting to Mr. O'Brien. A reporting relationship is a hierarchical relationship. The executive receiving reports on "best practices" is more than a facilitator of communication; he approves and orders actions. Mr. O'Brien will have the power to mold individual utility decisions into something that serves the purposes of his own superiors—the Exelon executives whose strategies and plans remain undisclosed.

In descriptions of Exelon's relationship to Pepco's decisions, what often appears is the word "review," as in "Ms. Blue will 'review' requests of Mr. Green." No Applicant witness has defined the term "review." Is this a collegial, peer review? Or is it a hierarchical review? The Commission should be concerned that, as obvious as is Exelon's hierarchical control, it resists acknowledging in simple terms the legal and practical truth: that Exelon has the legal power to control all decisions, by appointing Board members and top executives, and by approving budgets.

Q. Won't there be Pepco executives on various committees and Boards?

A. So Exelon says, but it makes no legal commitment. And even if, through a Commission condition, there exists an Exelon obligation to put Pepco executives on various committees and boards, that does not diminish Exelon's power to control results—by whom Exelon chooses and what instructions Exelon gives to the chosen executive. Committee membership gets someone a voice; it does not transfer control. And there is a practical question as to how vigorously any committee member will contest Exelon plans that are adverse to Pepco. Will they be the Commission's whistleblower, or will they want to be seen as a "team player," where the team is owned by Exelon? This uncertainty does not contribute to the public interest.

Q. What kinds of Pepco decisions will be subject to Exelon's ultimate legal control?

A. All of them, unless and until Exelon commits otherwise. (And by "commits" I don't mean "good faith" statements by current executives; I mean legally enforceable commitments that bind all future executives until the Commission rules otherwise, with consequences sufficiently direct and severe that compliance is certain.) Pepco's operational independence should be a given: where to trim trees, whom to buy wholesale power from, what type of demand response programs to offer. But there are other Pepco decisions, necessary to its public service obligations, which Exelon will be motivated to control because they affect Exelon's financial picture. Examples include:

a. when to file for rate increases or rate decreases;

b. how to make the tradeoff between reliability and cost, *e.g.*, when to build more distribution or transmission or make more capital expenditures on demand management;

c. whether to add to profit-earning rate base instead of making less profitable but possibly more efficient decisions, like reducing demand;

d. when to access capital markets to borrow money for public service investments, from whom to borrow money and what interest rate to seek;

e. when to pay dividends to its parent, in what amounts; and

f. what to say to ratings agencies when they request information on earnings potential, cash flow and the regulatory environment.

Under PHI's ownership, Pepco's decisions in these areas are largely independent of objectives that conflict with Pepco's service obligations. But as one of many Exelon subsidiaries, Pepco will be subject to the influences and orders of Exelon executives, who may have conflicting objectives.[39] I will next give examples of conflicting objectives in the areas of budgeting, spending, and policy positions.

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[39] A document entitled "Commonwealth Edison Company: Corporate Governance Principles" (see Exhibit GRID2.0 (A)-13 provided in response to DCG DR 1-15 Attachment A, all emphases added) purports to "establish greater independence in the management and direction of ComEd." I assume it will be a template for Exelon's relationship with PHI and its subsidiaries, because Exelon provided it in response to a request that Exelon "explain whether and, if so, to what extent Exelon will have any influence upon the selection of the four Exelon representatives of the PHI board." The document states that

> the ComEd bylaws may be amended by the ComEd board or by Exelon, as ComEd's majority shareholder. The *ComEd board may not amend provisions of the ComEd's bylaws that are enacted by action of the ComEd shareholders*.

ComEd's shareholder is Exelon. And the document then adds:

> *Exelon and ComEd have placed limits on the extent to which the ComEd board can act on matters without Exelon's approval*. [footnote omitted] Under the Exelon and ComEd delegations of authority, some actions that might ordinarily be authorized solely by the ComEd board also require

2. Budgeting

Q. What concerns should the Commission have regarding Exelon's influence over Pepco's budgets?

A. Exelon has said it will not block Pepco spending deemed necessary by the Commission (see Exhibit GRID2.0 (A)-14 (Response to GRID2.0 DR 1-39)):

> It is Exelon's view and practice to ensure appropriate levels of capital are made available to provide safe, reliable and economic service to customer. Whether or not capital is deemed necessary by Exelon, Exelon's utility companies or the Commission, Exelon will ensure the capital is available.

The question is whether and how the Commission can ensure that Exelon's actions conform to this statement, since Exelon can control Pepco's own judgments about what capital is "necessary." For example, Exelon states (see Exhibit GRID2.0 (A)-15 (Response to OPC DR 6-3)):

> The preparation of budgets for Exelon and its subsidiaries is a collaborative process between Exelon management and management of each subsidiary. The resulting subsidiary budgets are submitted to the subsidiary boards of directors, and the consolidated budget for Exelon is submitted to the Exelon Board of Directors for approval. Under the Delegations of Authority for Exelon and its subsidiaries, the Board of

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> approval or review by the Exelon board (or the appropriate Exelon board committee or Exelon officer under Exelon delegations of authority).

And further:

> Decisions of the ComEd board will not be subject to further approval of the Exelon board of directors or its committees, except in those cases where Illinois law, the ComEd bylaws, *the ComEd corporate governance principles, the ComEd or Exelon delegations of authority, or other appropriate Exelon corporate actions require approval of ComEd's shareholders, the Exelon board, or a committee of the Exelon board* before an action authorized by the ComEd board can be implemented. The ComEd board may from time to time create committees, standing or special, in consultation with the Exelon Corporate Governance Committee.

> Directors of Exelon Corporation has final approval authority over the consolidated budget for Exelon and its subsidiaries.

This passage makes clear that the "preparation" is "collaborative" but the "final approval" is hierarchical. And the term "collaborative" cannot here mean "each participant has equal say" when one of the collaborators has power over the other. In each Exelon description of the budgeting process, hierarchy is evident. Consider these four examples:

a. In the above quote, the budget preparation is "collaborative," but the collaborators (Pepco executives and Exelon executives) will relate to each other hierarchically.

b. Separately, Exelon says that Pepco will create its own budget unilaterally, but the budget then will be reviewed by the controlling executives at Exelon (see Exhibit GRID2.0 (A)-16 (Response to DCG DR 1-19)):

> Pepco's management will develop its annual capital budget. The budget will be reviewed by Exelon Utilities' CEO, Exelon's CEO and the Executive Committee of Exelon and approved by the PHI Board of Directors, in addition to any approval required by the Exelon Board of Directors under its delegations of authority.

In this second example, there would at least be a documentary path reflecting Pepco's unilateral recommendations, followed by revisions by Exelon—a path that would allow the Commission and others to track any adverse influence by Exelon on Pepco's decisions. In contrast, the first quote implies that Pepco's independent views might never appear on a document, since the hierarchic collaboration (apologies for the oxymoron) comes first.

c. Exelon states "Pepco management will be able to 'respond to local conditions' with actions that require additions to the Pepco budget without obtaining approval from PHI, EEDC or Exelon, directly or indirectly." See Exhibit GRID2.0 (A)-17 (Response to GRID2.0 DR 1-44, citing response to DCG DR 1-23 (Exhibit GRID2.0 (A)-18)). But if Pepco needs extra equity capital to "respond to local conditions," it will need to persuade Exelon.

d. Yet another version of the internal relationship describes Pepco's management not as collaborators or initiators, but as people that merely "provide input" (Application at 17):

> Pepco's local management will continue to have the authority and responsibility to provide input into the development of Pepco's capital and operating and maintenance ("O&M") expense budgets and implement the approved budgets. While Pepco's budgets will be reviewed by Exelon's CEO and Executive Committee, they would have to be approved by the PHI board of directors.

The variation in these four versions of the Exelon-Pepco budgeting relationship is what makes Exelon's commitment to "local control" a commitment that will vary as Exelon deems desirable.

Q. How should the Commission address concerns about budgeting?

A. The foregoing passages tell us that that there is no decision that Pepco or PHI could make, that could not be prevented, overruled or blocked by Exelon, whether through "review," "collaboration," or ignoring "input." When Exelon's capital needs, including but not limited to Pepco's, exceed the amount of capital that the market is willing to make available to Exelon on reasonable terms, Pepco's needs will have only a voice—one that can be ignored, compromised or outvoted. Should the Commission approve this transaction, a necessary condition is that Pepco management create its budgets unilaterally, free of any Exelon influence, and submit them to the Commission for approval, before they go upwards to Exelon. Only that way can the Commission be sure that the District's priorities become Exelon's priorities.

3. Spending

Q. Will Pepco have control over its spending decisions?

A. Exelon has made no such commitment. Whoever in the Exelon corporate family has authority to approve Pepco budgets and spending will have an obligation to Exelon's shareholders to compare Pepco's needs with other holding company needs and, in the case of insufficient capital for all needs, choose winners and losers. Those decisions would override any business judgment that Pepco Board members might make independently. Nothing filed by Exelon in this proceeding commits Exelon to accept and finance capital needs expressed by Pepco. Pepco is not in control of spending; Exelon is. Pepco may be free to decide that tree-trimming should occur once every three years rather than once every five years. But if, to carry out that plan, Pepco needs to hire more employees and buy more trucks, Pepco will be subject to spending limits Exelon imposes.

Exelon might argue that there is no conflict between Exelon's goals and Pepco's service obligations, because Exelon's overarching goal—to earn returns for its shareholders—compels it to ensure that Pepco has adequate resources to comply with its obligations. This argument's generality ignores the merger's specific tensions. When Pepco seeks to comply with its service obligations, there is a range of business practices available, from best-in-class to franchise-losing failure. Different levels of attention and investment, by Pepco and by Exelon, can produce results at different points on this spectrum. To satisfy its shareholders, Exelon must maintain Pepco's performance somewhere on that spectrum other than franchise-losing failure, so that Exelon still realizes a return on its investment in Pepco. Where on that spectrum Pepco will land will depend on how Exelon perceives Pepco's profit potential relative to the potential of all its other investments, existing and prospective. There is no assurance that there will never be conflicts between Exelon's non-utility and utility needs, conflicts that give Exelon reason to favor its non-utility activities in ways that move Pepco's performance on that spectrum negatively.

Q. How can the Commission address this concern?

A. The Commission can correct this loss of Pepco independence by conditioning its approval (if there is an approval) on a directive that if the Commission orders Pepco to make an expenditure requiring spending exceeding an Exelon-set budget cap, Exelon will ensure that Pepco has the money to spend. Pepco can of course seek judicial review of a Commission order, but Exelon must make available the funds necessary to comply with that order.

4. Policy positions

Q. Will Pepco be free to take policy positions that differ from Exelon's?

A. I don't see how, given Exelon's ownership of Pepco; further, Exelon has made no guarantee on this point. As an example, Mr. O'Brien's rebuttal testimony in the Exelon-Constellation case before the Maryland Commission (at p.17)[40] admitted that BGE will not be free to pursue its customers' priorities in the PJM stakeholder process. Before

[40] See Exhibit GRID2.0 (A)-18.1, O'Brien Rebuttal Testimony from Exelon-Constellation case, 10/12/2011.

taking any PJM position, said Mr. O'Brien, BGE must achieve a "consensus" with the representatives of all of Exelon's business units—units that include sellers with commercial interests different from BGE's buyer interests. If the same practice applies to Pepco, and if Pepco fails to achieve a "consensus" with Exelon executives who control Pepco, Exelon can cause Pepco to silence itself, or even to pursue Exelon's preference in the PJM discussions. With so much of wholesale market policy in flux, it is not in the District's interest to lose Pepco's buyer-side voice.

More generally, in his Maryland rebuttal testimony (at pp. 16-18), Mr. O'Brien always used words that avoided acknowledging a hierarchical relationship. BGE's Board appointments will be made by BGE "in consultation with" Exelon. Exelon will "review" BGE's business plan. The BGE Board will "work with" the Exelon-controlled EDOC (the Energy Delivery Oversight Committee). BGE's executive compensation will be set by the BGE Board "in consultation with" Exelon. These general terms obscure the legal fact: Exelon's preferences will prevail when Exelon wants them to. That is the power that ownership gives the owner. Exelon and its witnesses can correct this paragraph if it reflects a misunderstanding. But the only useful correction will be this statement:

> "On pain of having the acquisition unwound, Exelon will never constrain Pepco's decisions, and annually the executives of each relevant company will certify under oath that no constraint has occurred."

Otherwise the Commission must assume that Pepco's owner will do what owners do: Exercise control.

5. Conclusion on Pepco's independence

Q. Should Pepco's loss of independence be a concern for the Commission?

A. Yes. Even if the Commission were comfortable with Exelon's stated procedures on governance and delegation, Exelon can change them without permission or even notification: "It is therefore Mr. O'Brien's understanding that permission of a regulatory authority is not required for change in the PHI or Pepco delegations of authority." See Exhibit GRID2.0 (A)-19 (Response to GRID2.0 DR 1-70). Exelon can say what it says about its intent not to control Pepco's decisions, but it has the legal power, indirectly at least, to do so. Until it backs up its intent not to control with a legal withdrawal of its power to do so, its intent is irrelevant. The Commission cannot rely on it.

IV.
Pepco's Exposure to Exelon's Business Risks: Known and Unknown

A. Exelon's generation faces multiple risks

Q. What type of risks affect Exelon's generation investments?

A. Exelon has acknowledged risk to its generation business in least four categories: operational risk, climate change risk, risk from low-cost shale, and nuclear-specific risk.

1. Operational risk

Q. What has Exelon said about operational risk?

A. In its 2013 10-K at p.50, Exelon states:

> The Registrants' businesses are capital intensive and require significant investments by Generation in energy generation and by ComEd, PECO and BGE in transmission and distribution infrastructure projects. These operational systems and infrastructure have been in service for many years. Older equipment, even if maintained in accordance with good utility practices, is subject to operational failure, including events that are beyond the Registrants' control, and may require significant expenditures to operate efficiently. The Registrants' results of operations, financial condition, or cash flows could be adversely affected if they were unable to effectively manage their capital projects or raise the necessary capital. Furthermore, operational failure could result in potential liability if such failure results in damage to property or injury to individuals....

2. Climate change risk

Q. What has Exelon said about climate change risk?

A. As an owner of 12,165 mW of fossil generation plants, Exelon has described a distinct risk (Exelon 2013 10-K at p.33):

> Despite its focus on low-carbon generation, Exelon believes its operations could be significantly affected by the possible physical risks of climate change and by mandatory programs to reduce GHG emissions. See ITEM 1A. RISK FACTORS for information regarding the market and financial,

> regulatory and legislative, and operational risks associated with climate change.

3. Economic risk from low-cost shale

Q. What has Exelon said about the risk to its generation investments from low-cost shale?

A. Exelon has noted that the development of low-cost shale gas sources could lower the value of its embedded generation investment. See Exelon 2013 10-K at p.44.

4. Nuclear-specific risk

Q. How will this transaction change Pepco's relationship to nuclear power?

A. PHI has no affiliation with nuclear power. The acquisition will leave it controlled by one of the nation's largest owners of nuclear power plants. As Exelon has stated (Exelon 2013 10-K at p.9):

> [Exelon] Generation has ownership interests in eleven nuclear generating stations currently in service, consisting of 19 units with an aggregate of 17,263 MW of capacity. Generation wholly owns all of its nuclear generating stations, except for Quad Cities Generating Station (75% ownership), Peach Bottom Generating Station (50% ownership) and Salem Generating Station (Salem) (42.59% ownership), which are consolidated on Exelon's financial statements relative to its proportionate ownership interest in each unit.
>
> [Exelon] Generation's nuclear generating stations are all operated by Generation, with the exception of the two units at Salem, which are operated by PSEG Nuclear, LLC (PSEG Nuclear), an indirect, wholly owned subsidiary of PSEG.
>
> In 2013 and 2012, electric supply (in GWh) generated from the nuclear generating facilities was 57% and 53%, respectively, of [Exelon] Generation's total electric supply....

> Constellation Energy Nuclear Group, Inc. Generation [a subsidiary of Exelon] also owns a 50.01% interest in CENG, a joint venture with EDF [Electricite de France]. ... CENG owns and operates a total of five nuclear generating facilities on three sites, Calvert Cliffs, Ginna and Nine Mile Point. CENG's ownership share in the total capacity of these units is 3,998 MW. ...

Q. What has Exelon said about risks specific to its ownership and operation of nuclear plants?

A. Owning and operating nuclear power plants, which can be subject to rule changes, breakdowns and accidents, is a source of multiple risks. See Exelon's 2013 10-K at p.14: "Generation is subject to liability, property damage and other risks associated with major incidents at any of its nuclear stations, including the CENG nuclear stations."

Q. Are there other nuclear-related risks?

A. Yes. In the quote presented immediately above, Exelon lists the risks we know about. There are also risks—unknown risks—concerning nuclear waste. Exelon is legally responsible for the toxic waste caused by its production, but no one has determined what will be the legal means of disposing of that waste permanently. That is Exelon's gamble: that someday, somehow, somewhere, someone will take care of its waste, without unanticipated cost to Exelon:

> Nuclear Waste Disposal. There are no facilities for the reprocessing or permanent disposal of SNF [spent nuclear fuel] currently in operation in the United States, nor has the NRC licensed any such facilities. Generation currently stores all SNF generated by its nuclear generating facilities in on-site storage pools or in dry cask storage facilities. Since Generation's SNF storage pools generally do not have sufficient storage capacity for the life of the respective plant, Generation has developed dry cask storage facilities to support operations.
>
> As of December 31, 2013, Generation had approximately 59,900 SNF assemblies (14,400 tons) stored on site in SNF pools or dry cask storage....All currently operating Generation-owned nuclear sites have on-site dry cask storage, except for Clinton and Three Mile Island. Clinton

> and Three Mile Island will currently lose full core reserve, which is when the on-site storage pool will no longer have sufficient space to receive a full complement of fuel from the reactor core, in 2015 and 2023, respectively. Dry cask storage will be in operation at Clinton and is expected to be in operation at Three Mile Island prior to the closing of their respective on-site storage pools. On-site dry cask storage in concert with on-site storage pools will be capable of meeting all current and future SNF storage requirements at Generation's sites through the end of the license renewal periods and through decommissioning.

Exelon 2013 10-K at pp.13-14. And what happens after decommissioning? Exelon doesn't say. All that Exelon can say is that Exelon Generation "has reduced its financial exposure to these risks through insurance and other industry risk-sharing provisions. See 'Nuclear Insurance' within Note 22 of the Combined Notes to Consolidated Financial Statements for details." Exelon 2013 10-K at p.14. Exelon does not say, because it lacks the information and foresight to say, by how much Exelon has "reduced its financial exposure." Nor can Exelon tell us whether these risk-reducing options, vague as they are, will be available for the full period during which Pepco will be owned by Exelon. Ultimately, Exelon's source of insurance against these risks is itself : "[Exelon] Generation is self-insured to the extent that any losses may exceed the amount of insurance maintained or are within the policy deductible for its insured losses. Such losses could have a material adverse effect on Exelon's and Generation's financial condition and results of operations." 2013 10-K at p.14.

Q. Can Exelon's nuclear risk affect Pepco?

A. Yes. If Exelon's nuclear losses "could have a material adverse effect on Exelon's and Generation's financial condition and results of operations," a financially damaged Exelon could reduce its equity financing of Pepco. Further, lenders concerned that Exelon's troubles will affect Pepco could then view Pepco as less creditworthy, and raise the cost of new loans to Pepco. In fact, Exelon has acknowledged that "[a]t least one Exelon utility subsidiary witness, prior to electric restructuring, identified 'nuclear risk' associated with utility nuclear operations as one component among the array of business risks, including 'regulatory risk' and other forms of risk, that form the risk profile of a utility company." See Exhibit GRID2.0 (A)-20 (Response to GRID2.0 DR 1-42(B)).

B. Exelon can increase its risks, through acquisitions unlimited by geographic or type-of-business boundaries

Q. Beyond the operational, climate change, shale gas and nuclear power risks associated with its current generation investments, can Exelon increase its risks?

A. Yes. As I explained in Part I.H, the 2005 repeal of the Public Utility Holding Company Act of 1935, coupled with the absence of any acquisition limits in District of Columbia law, leaves Exelon free to acquire more companies without geographic or type-of-business limit. Consistent with this open field, "[Exelon] Generation continuously looks to invest in new business initiatives and actively participate in new markets. These include, but are not limited to, unconventional oil and gas exploration and production, residential power and gas sales, solar and wind generation, and managed load response." Exelon 2013 10-K at p.63.

Exelon's acquisition activities will not necessarily be confined to generation. Just as Exelon is seeking to buy PHI only two years after buying Constellation and BGE, two years from now Exelon could be buying Southern California Edison, or gold mines, or utilities in Ukraine. My reference to gold mines and Ukraine is intentionally hyperbolic. The Commission should challenge Exelon to commit to *some* limit on its future acquisitions, or to accept a condition requiring Commission approval of those future acquisitions. If on rebuttal Exelon says "How absurd; we would never buy a utility in

Ukraine," the conversation needs to continue: Then what else will you commit not to buy? For what acquisitions will you commit to get Commission approval first? The Commission must also address how to make such a commitment legally and practically binding, since there are no clear District statutory provisions granting the Commission authority over Exelon's activities outside the District. In the Maryland Commission proceeding on Exelon's acquisition of Constellation, Exelon opposed any condition requiring state commission permission before making additional acquisitions. (And Exelon is not asking the Commissions in Illinois or Pennsylvania for permission to acquire PHI.) Concerning opportunities to make future and unlimited acquisitions, Exelon has not demonstrated a commitment to "local control."

The lack of limits on acquisitions is a public interest concern, because these future acquisitions involve real risk, as Exelon has acknowledged (Exelon 2013 10-K at p.63):

> Such initiatives may involve significant risks and uncertainties, including distraction of management from current operations, inadequate return on capital, and unidentified issues not discovered in the diligence performed prior to launching an initiative or entering a market. As these markets mature, there may be new market entrants or expansion by established competitors that increase competition for customers and resources. Additionally, it is possible that FERC, state public utility commissions or others may impose certain other restrictions on such transactions.

Ms. Lapson also recognized that the level of concern for Pepco's well- being is related to both the size of Exelon's non-regulated activities, and the lending community's perceptions of Exelon's creditworthiness:

> Two indicators would provide guidance that there is reduced need for strenuous ring fencing provisions that are proposed for the initial period. First, *does the Exelon group still contain a large non-utility merchant energy/power generation business*. Companies change their business portfolios over time; for example several years ago, Pepco Holdings Inc. was the parent of a power generation and merchant energy business that is

> no longer part of the PHI group. A further indicator is *whether the credit ratings of Exelon Corp. are equivalent to or higher than the current ratings (and not on a negative watch*.

See Exhibit GRID2.0 (A)-21 (Response to AOBA DR 2-10 (emphasis added)). Separately, however, she asserts that "D.C. ratepayers do not face any material or quantifiable risk due to the proposed merger, considering the ring-fencing and other measures proposed by the Joint Applicants and the separate corporate structure of Exelon's unregulated businesses." See Exhibit GRID2.0 (A)-22 (Response to OPC DR 14-51). I will address the problems with ring-fencing, and Ms. Lapson's views, shortly in Part IV.C below.

Q. Concerning Exelon's future acquisitions, what do you recommend to this Commission?

A. I recommend that this Commission not end up like the Pennsylvania and Illinois Commissions, watching from the sidelines while the company that controls their utilities gradually changes its character and size through additional acquisitions occurring outside their jurisdictional review. Pepco and its customers receive no visible benefit from Exelon's risk-taking. The Commission therefore should ask: How will the mix of business activities within the post-merger entity, including all of its utility and non-utility affiliates, presently known and future unknown, affect the quality and cost of service provided by Pepco to District customers? The problem is that there is no way to answer this question in the abstract. If the Commission approves this transaction, it should require that any future change to the post-merger entity's corporate structure, subject to some *de minimis* rule, require Commission review and approval. To impose no condition would mean that the Commission is indifferent to whether Exelon acquires any other business, anywhere, with the Commission having no say in the shape, size, risk picture, ownership or control of Pepco's new family. Commission indifference is not in the public interest.

C. "Ring-fencing" leaves Pepco exposed to five new risks

Q. What do Applicants propose to protect Pepco from Exelon's business risks?

A. Applicants recognize that the merger causes risks, but ask the Commission to accept "ring-fencing" as the solution:

> The Joint Applicants do not believe that DC ratepayers face any material or quantifiable risk due to Exelon's and PHI's decision to merge, *considering the ring fencing and other measures* proposed by the Joint Applicants and the separate corporate structure of Exelon's unregulated businesses.

See Exhibit GRID2.0 (A)-23 (Response to OPC DR 3-2 (emphasis added)). See also Khouzami Direct Testimony at pp. 8-13 (discussing ring-fencing).

I readily acknowledge that where there is risk, some fencing is better than no fencing. But the public interest question is whether, taking into account risks and risk-protection, the merger makes the risks to Pepco's customers higher or lower. The answer is "higher." As I will explain in this Part IV.C, the phrase "ring-fencing," like "low-fat ice cream," overstates its effect, for two reasons. First, ring-fencing does not purport to remove, and does not remove, five risks the merger brings to Pepco: holding company-imposed limits on Pepco's access to equity capital, increases in Pepco's cost of equity and debt capital, certain bankruptcy risks, Exelon's interference in Pepco's business decisions, and interaffiliate transaction abuse. Second, while merger increases the types of risks that ring-fencing is supposed to address, ring-fencing does not address those effects fully—as Exelon acknowledges. That means that, on a net basis, the merger-plus-ring-fencing leaves Pepco with more risks, not fewer risks, compared to no merger. More risks rather than fewer risks is not consistent with the public interest.

1. Limits on Pepco's access to equity capital

Q. Does ring-fencing prevent the possibility that Exelon's acquisition of Pepco will reduce Pepco's access to equity capital?

A. No. Today PHI is Pepco's source of equity. PHI has lower risk than Exelon because PHI has no generation risks. The acquisition takes PHI out of the equity markets, leaving Pepco completely dependent on Exelon for equity. As Exelon takes on more business risks (adding to the risks associated with nuclear generation and fossil generation), any financial problems Exelon experiences necessarily affect Pepco's access to and cost of equity. Exelon has acknowledged this reality (Exelon 2013 10-K at p.43):

> Sustained low market prices or depressed demand and over-supply could adversely affect Exelon's and [Exelon] Generation's results of operations and cash flows, and such impacts could be emphasized given [Exelon] Generation's concentration of base-load electric generating capacity within primarily two geographic market regions, namely the Midwest and the Mid-Atlantic. These impacts *could adversely affect Exelon's and Generation's ability to fund other discretionary uses of cash such as growth projects or to pay dividends*. In addition, such conditions may no longer support the continued operation of certain generating facilities, *which could adversely affect Exelon's and Generation's results of operations through increased depreciation rates, impairment charges and accelerated future decommissioning costs which may be offset in whole or in part by reduced operating and maintenance expenses*. A slow recovery in market conditions could result in a prolonged depression of or further decline in commodity prices, including low forward natural gas and power prices and low market volatility, *which could also adversely affect Exelon's and Generation's results of operations, cash flows and financial position*. In addition to price fluctuations, Generation is exposed to other risks in the power markets that are beyond its control and may negatively affect its results of operations. (Exelon and Generation) Credit Risk....

Q. But doesn't ring-fencing protect Pepco from Exelon's "financial stress"?

A. Not if the result of that financial stress is to leave Pepco with insufficient access to equity. In describing ring-fencing's role, Ms. Lapson states (Supp. Dir. at 10): "[T]he protected company [in this instance, Pepco] should not be exposed to a risk of defaulting on its own obligations or of losing liquidity due to the financial stress or bankruptcy of its parent or affiliates (assuming that the protected company is sound on a stand-alone basis)." Ms. Lapson states also (Supp. Dir. at 11) that "the protected subsidiary should maintain independent access to liquidity sources and the ability to fund itself on its own."

These statements, accurate in isolation, do not address the situation where Exelon, due to either its own financial stresses or its investment priorities, is unable or unwilling to provide sufficient equity capital to Pepco—equity capital that Pepco cannot get anywhere else. Nor does ring-fencing prevent the cost of the Exelon-supplied equity from rising. And ring-fencing does not prevent Exelon from imposing spending caps on Pepco, to preserve capital for other Exelon priorities or to deal with Exelon's "financial stress."

Ms. Lapson states (Supp. Dir. at p.11) that "there should be controls limiting the ability of the parent or affiliates to draw resources or assets from the protected company, or to transfer liabilities and debt to the protected company." She is correct, and the proposed ring-fencing measures provide that protection. But those measures omit the logical companion: requirements that the parent provide the utility with the equity capital necessary to enable the utility to carry out its legal obligations at the lowest feasible cost to ratepayers.

2. Increases in Pepco's cost of capital

Q. Does Exelon acknowledge that its ring-fencing proposal cannot prevent increases in Pepco's cost of capital?

A. Yes. Because securities laws require disclosure of negatives, Exelon has acknowledged that ring-fencing leaves gaps:

> These [ring-fencing] measures ... *may help* avoid or limit a downgrade in the credit ratings of ComEd, PECO and BGE in the event of a reduction in the credit rating of Exelon. Despite these ringfencing measures, the credit ratings of ComEd, PECO or BGE could *remain linked*, to some degree, to the credit ratings of Exelon. Consequently, *a reduction in the credit rating of Exelon could result in a reduction of the credit rating of ComEd, PECO or BGE, or all three*. A reduction in the credit rating of ComEd, PECO or BGE could have a material adverse effect on ComEd, PECO or BGE, respectively.

Exelon 2013 10-K at p.46 (emphasis added). Exelon has elaborated on this point (see Exhibit GRID2.0 (A)-24 (Response to GRID2.0 DR 1-93)) (emphasis added):

> Exelon is *not saying that there is no possibility* that events elsewhere in the Exelon corporate family will affect the cost of debt to Pepco.
>
> The cost of debt to Pepco is primarily a function of the risk free (US Treasury) rate plus an issuer-specific credit spread, which is strongly influenced by ratings given to Pepco's debt by the rating agencies. The credit ratings of Pepco *may be influenced to some extent by the credit ratings of Exelon Corporation following the proposed merger, despite the ring-fencing and other measures proposed by Exelon*. The proposed ring-fencing and other measures *may help* avoid or limit a downgrade in the credit ratings of Pepco in the event of a reduction in the credit rating of Exelon Corporation, but *those ring-fencing and other measures will not completely insulate Pepco from effects of a decline in the credit rating of Exelon Corporation*.
>
> Although the ring-fencing and other measures proposed by Exelon are designed to protect PHI and its subsidiaries from consolidation in a bankruptcy proceeding for Exelon, a bankruptcy of Exelon *could affect* the credit ratings of its subsidiaries. A downgrade in the credit ratings for Pepco could result in an increase in the cost of borrowing for those companies.

Q. What do the rating agencies think of ring-fencing?

A. Exelon has acknowledged that the rating agencies do not view ring-fencing as a guarantee against risk:

> Standard & Poor's normally assigns a credit rating to a consolidated company using a variety of factors and then assigns credit ratings to the individual members of the consolidated group with reference to the consolidated credit rating. S&P then rates individual debt securities. Normally, the credit ratings assigned by S&P to a holding company's subsidiaries will be aligned with the parent company's consolidated rating from S&P; however, with effective ring fencing measures in place, S&P will allow ratings of subsidiaries to differ by as much as three "notches" on the ratings scale. In contrast, Moody's and Fitch determine the individual ratings of members of the consolidated group, including the holding company, and then *will generally assign a consolidated rating based on the aggregate of the subsidiaries*. Moody's and Fitch do not have explicit ring-fencing guidelines in their ratings practices, so the effect of a downgrade for Exelon Corporation on the Moody's and Fitch ratings of ring-fenced subsidiaries is less predictable.

See Exhibit GRID2.0 (A)-24 (Response to GRID2.0 DR 1-93 (emphasis added)). So even with ring-fencing, Exelon cannot guarantee protection; Exelon can only "expect" and "believe":

> Given the current ratings indications from S&P, Moody's, and Fitch on Exelon and PHI and their subsidiaries, Exelon *does not expect* that the merger will result in any change in the ratings of Pepco. With the proposed ring-fencing measures in place following the merger, Exelon *expects* that S&P's current corporate rating for Exelon could decline by one notch without any effect on S&P's current corporate ratings for PHI and its subsidiaries. Exelon Corporation has consistently stated that maintaining its investment grade credit rating is its number one financial priority. Exelon therefore *believes* that the risk of a credit downgrade of Pepco by reason of events affecting Exelon is remote. Further, the Public Service Commission can protect consumers against any increase in cost of utility borrowing attributable to events and circumstances affecting a parent company.

See Exhibit GRID2.0 (A)-24 (Response to GRID2.0 DR 1-93 (emphasis added)).

It is true that Pepco will have its own access to debt capital. But lenders to Pepco will care about the availability and cost of Pepco's equity capital. To the extent they see that Exelon's own risks and needs for capital could reduce the availability of equity to Pepco (and increase the cost of that equity to Pepco), those lenders will tend to raise the cost of lending to Pepco. The reason is that Pepco's access to equity, among other things, gives lenders confidence that Pepco will repay its loans. Nothing about Exelon's ring-fencing prevents this natural lender reaction. Similarly, while Pepco will have its own credit rating for debt, that rating can still be influenced by the parent's access to and cost of capital, since Pepco's ability to pay off its debts depends in part on the availability of Exelon's capital. An Exelon bankruptcy, and Exelon financial stress generally, will not be a matter of indifference to Pepco or its lenders.

Q. What about Ms. Lapson's ideas about covenants in Pepco's loan documents?

A. Ms. Lapson states (Supp. Dir. at 12):

> The loan documents and credit arrangements of the protected company should not include a covenant that its parent or affiliates will maintain a certain credit rating. A default or bankruptcy by the parent or any affiliate should not constitute an event of default for the protected company, nor should there be any provision that causes the maturity of debt of the protected company to accelerate because of the acceleration of the debt of the parent or affiliate.

These are good ideas. But they are not within the sole control of Pepco or of Exelon. They are within the control of the lender. If a prospective lender worries about risks in Exelon's corporate family, that lender can insist on the very conditions that Ms. Lapson says "should not [be] include[d]"—and neither Pepco nor Ms. Lapson nor Exelon's ring-fencing language can do anything about it.

3. Bankruptcy risk

Q. Does Exelon's ring-fencing proposal remove the risk that Exelon's' business failures could push Pepco into bankruptcy?

A. No, it does not remove that risk. The proposal prevents Exelon from using its stockholder control of Pepco to force Pepco into bankruptcy. But the proposal does nothing to prevent Pepco from facing bankruptcy because it suffers a cash or capital shortage due to Exelon's financial stresses—such as where Exelon ability to finance Pepco's equity is constrained due to Exelon's problems (including, should Exelon enter bankruptcy, the bankruptcy court's conditions on Exelon's capital flows).

Q. Does Ms. Lapson assert that due to ring-fencing, Exelon's business failures could not cause Pepco to enter bankruptcy?

A. No. Ms. Lapson recognizes the possibility that a distressed parent might cause a utility subsidiary to need to enter bankruptcy. (Lapson Supp. Dir. at 12-13) She refers to two solutions: "an independent director (or directors) on the Board of Directors [of the protected company] whose affirmative vote is required in order for the protected company to file a voluntary petition of bankruptcy or take certain other bankruptcy-related actions"; and "grant[ing] to a third-party shareholder or another form of independent a 'golden share' with voting rights to cast a deciding vote on decisions regarding filing a petition of bankruptcy or similar actions." In other words, both the independent director and the golden shareholder would have the discretion to vote for, or against, Pepco entering bankruptcy. If Exelon's failures limit cash flow to Pepco, such that Pepco cannot meet its financial obligations, nothing prevents these directors from voting to place Pepco in bankruptcy.

Ms. Lapson has stated that the "overall objective [of ring-fencing] is to enable the protected company to sustain its viability and fulfill its business and financial obligations without adverse effects relating to the financial stress of other entities within the related corporate group." Lapson Supp. Dir. at 5. But as I explained above, if Exelon's financial problems render it unable to supply equity to Pepco, or cause rating agencies to downgrade Pepco's debt so as to render Pepco unable to finance its obligations, ring-fencing does not fix this problem. Further, if ring-fencing were truly to achieve the objective of keeping Pepco out of bankruptcy should Exelon fail, the proposed ring-fencing provisions would *deny* the independent director, and the golden shareholder, the authority to vote for bankruptcy, in situations where the utility has no independent financial reason to take that step. Of course, denial of such authority would not make sense because if Pepco cannot finance its business, whether due to Exelon's failures or other reasons, filing voluntarily for bankruptcy could be Pepco's prudent course. The point is that Exelon's stresses can lead to Pepco stresses, resulting in Pepco's bankruptcy. Ring-fencing does not prevent this result, because it does not alter Pepco's financial dependency on Exelon. It is that dependency on Exelon, as opposed to Pepco's dependency on PHI, that makes this transaction risky for Pepco.

Indeed, Ms. Lapson acknowledges, as she must, that these protections could fail in their purpose. She can say only that the special purpose entity (SPE), the presence of its independent director and golden shareholder "will *greatly reduce* any possibility of a voluntary bankruptcy filing by either the SPE or PHI for any cause other than the financial distress of PHI or the SPE." Supp. Dir. at pp.19-20. Because she does not define "greatly," the SPE's value to the public interest is indeterminate. When the Commission writes its order, it must replace "greatly" with "of indeterminate value."

And Ms. Lapson's "greatly" does not change the main point: Exelon's acquisition of PHI increases, not decreases, the possibility that due to Exelon's risk-taking, Pepco will end up in bankruptcy. The Commission cannot avoid this finding, because of the following facts:

1. Exelon has more business risks than PHI does.

2. Therefore Exelon's acquisition subjects Pepco to risks that Pepco does not face when owned by PHI.

3. Ring-fencing reduces that new risk; but as Ms. Lapson properly acknowledges, it does not eliminate the new risk.

4. Therefore even with ring-fencing, Pepco is subject to more risk with the acquisition than without.

Q. If Exelon enters bankruptcy, is Pepco's entry into bankruptcy the only risk to Pepco?

A. No. Post-merger, Pepco's operations will depend on a variety of centralized support services from Exelon and its other affiliates. The Commission does not know how these support services will be disrupted or compromised if a bankrupt Exelon requires bankruptcy court approval before spending money on services to support Pepco.

4. Exelon's interference in Pepco's business decisions

Q. Does ring-fencing prevent Exelon from controlling or otherwise interfering with Pepco's activities in carrying out its public service obligations?

A. No. Ms. Lapson (Supp. Dir. at 10) states that with ring-fencing, "the protected company should have the ability to maintain its own business, resources, and solvency, unaffected by its parent or affiliates." Her term "should" is ambiguous: Is a prediction or a normative statement? What it is not is a guarantee, because the ring-fencing proposals don't achieve this objective. Pepco cannot "maintain its own business [or] resources" if its ultimate parent limits its spending, or causes Pepco to erect entry barriers to new competitors in distributed energy resources (which Exelon is motivated to do, given its investments in conventional generation, and which I will discuss in Part VI). Even if ring-fencing could provide complete protection from financial risk—which it does not, as explained in the preceding subsections—there remains the risk that Exelon's business objectives will interfere with Pepco's public service obligations.

As I discussed in Part III, Exelon (a) has business goals that conflict with Pepco's public service obligations, but (b) makes no commitment not to divert Pepco's priorities away from the Commission's priorities. Nor does Exelon commit (legally, as opposed to aspirationally) to finding the best people and the best practices, giving them the necessary resources and then "ring-fencing" those resources from diversion or distraction. Ring-fencing does not remove Pepco's risk of having its business controlled by a holding company with conflicting objectives.

5. Interaffiliate transaction abuse

Q. Does ring-fencing ensure arm's-length relationships between Pepco and Exelon's many affiliates?

A. No. Ms. Lapson states (Supp. Dir. at p.22) that "PHI will maintain arm's-length relationships with Exelon and its affiliates, including the SPE [special purpose entity] ...." This statement is true only in part. When two companies are in an arm's-length relationship, they behave as if unrelated. That means that each has competitive alternatives to the other, and each is itself subject to effective competition. In the specific context of interaffiliate transactions, I will assume that the Commission's rules will replicate an arm's-length relationship, with interaffiliate pricing rules that replicates what would exist in a competitive market. The problem is that the Exelon-Pepco relationship consists of more than interaffiliate transactions. If Exelon and PHI were in an arm's-length relationship, Exelon could not (a) impose spending limits on PHI and its subsidiaries, (b) determine unilaterally (based on various business objectives conflicting with Pepco's public service obligations) how much equity Exelon should inject into PHI (and from PHI into the utility subsidiaries), (c) dictate who sits on the boards of PHI and its subsidiaries, (d) choose the top utility executives, or (e) establish what positions PHI and its utility subsidiaries should take on regulatory issues (including, for example, the timing of rate cases or PJM's transmission priorities). Exelon and PHI are not in an arm's-length relationship, and nothing about Exelon's ring-fencing changes that fact.

The Commission does have interaffiliate transaction rules, but they work only to the extent they are heeded, and only to the extent noncompliance is detected and punished. Exelon's acquisition of PHI multiplies the number and types of interaffiliate transactions involving or affecting Pepco, including transactions where a party has an interest adverse to Pepco and its ratepayers. More transactions mean more opportunity for breaking the rules. When motivation and opportunity combine with low risk of detection, people run red lights, text while driving, and break regulatory rules.[41] Yet

[41] See, for example, Exelon 2013 10-K at p.406: "Federal Energy Regulatory Commission Investigation (Exelon and Generation). On January 30, 2012, FERC published a notice on its website regarding a non-public investigation of certain of Constellation's power trading activities in and around the ISO-NY from September 2007 through December 2008. Prior to the merger, Constellation announced on March 9, 2012,

Exelon tells us nothing about how it will deal with the risk of rule-breaking—what internal enforcement staff it will use; how that staff will be trained, compensated and promoted; who on the executive team will be held accountable for errors of underlings; and what the consequences will be for violators. Nor has Exelon determined what increase to the Commission's enforcement staff will be necessary to ensure compliance, let alone committed to fund that staff. A consolidation that increases the number and type of possible rule violations, while relying merely on the fact that rules exist, is not a public interest transaction.

Q. Do you have any specific concerns about interaffiliate transactions on the post-acquisition Exelon system?

A. Yes. The preceding answer explained the general point that Exelon's corporate complexity, and its intent to acquire more businesses, will multiple the number and types of interaffiliate transactions. I also understand that once Pepco joins the General Services Agreement (GSA), which Pepco intends to join, Exelon can force Pepco to pay for a host of services Pepco may not want, including "relationship management with the U.S. Congress and Federal agencies; corporate communications; branding; corporate events." This is my reading of Section 7 of the General Services Agreement (GSA), which is Exhibit 7 to the Joint Application. Section 7 of the GSA provides in part:

> *Whether or not requested by the Client Companies*, the Services Company may provide to all Client Companies, and Client Companies shall pay

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that it had resolved the FERC investigation. Under the settlement, Constellation agreed to pay, and has paid, a $135 million civil penalty and $110 million in disgorgement. During the year ended December 31, 2012, Generation recorded expense of $195 million in operating and maintenance expense with the remaining $50 million recorded as a Constellation pre-acquisition contingency...."

> Services Company for, "Corporate Governance Services." Corporate governance consists of those activities and services reasonably determined to be necessary for the lawful and effective management of Exelon System businesses. Corporate Governance Services may be supplied from functions such as accounting, finance, executive, strategic planning, legal, human resources/benefits, audit, corporate communications and public affairs, environmental, health and safety, *government affairs and policy*, and investor relations. (emphasis added)

Section 7 then provides (emphasis added):

> Corporate Governance Services may include, *but are not limited to*, the following: planning and project evaluation; finance and treasury; accounting and analysis; risk management; tax; shareholder and investor relations; merger and acquisition services; strategic planning; diversity; employee and labor relations; HR planning and development; compensation and benefits; legal services in the areas of securities, PUHCA, employment, regulatory, contract, litigation and intellectual property laws; legal and administrative support to the Board of Directors; environmental compliance activities; ethics and compliance programs; management services for compliance with Federal laws, regulations and other policy requirements, including *relationship management with the U.S. Congress and Federal agencies; corporate communications; branding; corporate events; charitable support*; community relations and communications to local organizations; and communications to employees.

There are several concerns with this language. The first is the notion, in the first italicized phrase, that Pepco must pay for these things whether it wants them or not.[42] Second, as indicated in the second italicized phrase, this long list of things Pepco could be paying for is not exhaustive; Exelon can add to the list at will, by amending the GSA without the approval of this Commission or any other commission (due to the repeal of

[42] Exelon has stated that Pepco is free not to sign the GSA, but that once it signs the GSA, Section 7 applies. It appears that Pepco cannot pick and choose which of these Section 7 services it will pay for. See Exhibit GRID2.0 (A)-24 (Response to GRID2.0 DR 1-9(D)): "If Pepco enters into the GSA, including Section 7, then it will be contractually obligated to pay for services received under that provision, subject to the pricing requirements set forth in the GSA."

PUHCA 1935). Third, as indicated by the third italicized phrase, some of the items whose costs Pepco will share have nothing to with Pepco's obligation to serve, but instead are a function of Exelon's political and public relations objectives. If I am misreading this document, I invite Exelon to correct me.[43]

Q. Isn't the Commission able to disallow from rates Pepco costs associated with inappropriate interaffiliate transactions?

A. Yes, provided Exelon makes clear it will not challenge such disallowance on grounds of preemption by the Federal Power Act or the repealed—but still cited in the GSA—Public Utility Holding Company Act. (I am aware of no grounds for preemption.) But after-the-fact disallowance does not protect consumers sufficiently when there is no limit on the number and type of possible transactions. Exelon has said that "the PSC retains jurisdiction over incorporation of Pepco costs into customer rates." See Exhibit GRID2.0 (A)-25 (Response to GRID2.0 DR 1-9(A) and (C)). Exelon also has said that "[t]o the extent service costs are to be borne by utility subsidiaries, the allocations are reviewed in individual rate proceedings." But contradictorily, Exelon opposes a condition, proposed in Response to GRID2.0 DR 1-10 (see Exhibit GRID2.0 (A)-26), that "Pepco shall be under no obligation to make any payment for any service under this agreement unless the

[43] The General Services Agreement is cluttered with references to the Public Utility Holding Company Act of 1935, which was repealed 9 years ago. Some of these references have legal effect, creating uncertainty concerning what forum one must go to enforce the obligations, and what legal standards will apply. One expects greater contractual care from slumlords and used car dealers. Let's hope that Pepco, in addition to exempting itself from having to pay for services it doesn't need, will insist on making the document legally relevant before signing it.

PSC first has determined that purchasing such service from EBSC [the service company] was consistent with Pepco's obligation to minimize costs for ratepayers."[44]

Why is Exelon's position contradictory? Exelon is saying that the Commission can disallow any cost after the fact, but it cannot preclude any cost before the fact; that somehow after-the-fact disallowance is part of the Commission's core authority but before-the-fact prohibition is "managing, not regulating." The reality of regulation is that if the Commission is in reactive, after-the-fact mode, costs are likely to slip through because the Commission must plow through all costs to find the ones that are problems; whereas if the Commission identifies in advance certain categories and amounts that warrant special review, and then conducts that review, it is more likely that the Commission can prevent unnecessary costs—especially in questionable categories like ""relationship management with the U.S. Congress and Federal agencies; corporate communications; branding; corporate events." Advance review also puts Exelon's service company on notice of the risk of excess costs or improper allocations, thus saving EBSC from incurring costs that might be disallowed later.

I remind the Commission that these types of costs and cost allocation were formerly subject to review by the SEC under the PUHCA 1935, making it less important

[44] Exelon's reaction to that suggested condition is: "No, there is no such condition currently applied to Pepco's receipt of services from its holding company, nor to the Joint Applicants' knowledge is there such a condition at any state utility commission. Moreover, such a condition would be unreasonably cumbersome and would effectively place the PSC in the role of managing, not regulating the utility." See Exhibit GRID2.0 (A)-25 (Response to GRID2.0 DR 1-10).

that states review them also. With PUHCA 1935 repealed, this Commission is the lone protector of District ratepayers against interaffiliate abuse.

Q. What do you recommend?

A. I recommend a separate proceeding to examine the GSA. The problem is larger than after-the-fact vs. before-the-fact review. The long list of possible costs (under the current list, plus any that Exelon can add by amending the GSA without any Commission approval) that Exelon can allocate to Pepco through the GSA will require detailed and costly Commission scrutiny. Indeed, Exelon at present has no idea what level of charges Pepco will incur under the GSA. See Exhibit GRID2.0 (A)-27 (Response to GRID2.0 DR 1-12 ("Joint Applicants have not developed ... a projection.")). If the Commission does approve this merger, it should include a condition that forbids Pepco from entering this GSA until the Commission initiates and concludes a separate proceeding that examines each element in that agreement. If the Commission is free to disallow specific costs under the GSA after the fact, then the Commission is free to determine allowable cost categories before the fact. Doing so, in a proceeding confined to issues of interaffiliate relations on the new Exelon system, will give the Commission more control of Pepco's costs than simply approving the acquisition, after which Pepco decides unilaterally to sign the GSA.

In this separate proceeding, the Commission will need to determine what additional auditing and other costs it will need to incur each year to monitor Pepco's benefits and costs under the GSA, and ensure that those additional costs are borne by Pepco and Exelon, not by the taxpayers or ratepayers, because these costs are not accompanied by any claim by Exelon that they are justified by improved or expanded corporate services. (Exelon can signal its good faith by agreeing to bear the full costs of this monitoring. Silence or opposition would send the opposite signal.) There is also the risk of Pepco bearing duplicate costs, because even as Exelon states that Pepco will join the GSA, Exelon has described no plans for eliminating corporate overlap between PHI and Exelon administrative forces. Only a distinct proceeding on corporate overhead can address these issues.

6. Recommended conditions to address the gaps in ring-fencing

Q. Does Exelon acknowledge that ring-fencing does not eliminate the risks created by this consolidation?

A. Yes. Exelon has so acknowledged, explicitly or implicitly, in five distinct ways:

1. "The SPE structure is intended only to establish "bankruptcy remoteness" for PHI and its utility subsidiaries. Other measures proposed by Exelon will protect the PHI utilities from interaffiliate transaction abuse." See Exhibit GRID2.0 (A)-28 (Response to GRID2.0 DR 1-104).

(But as discussed above, the consolidation allows interaffiliate transactions that are unlimited, while the Commission's knowledge and resources will be limited.)

2. "The SPE structure is not intended to "protect a PHI utility from increases in the cost of capital experienced by the holding company....Exelon does not believe its cost of capital or any plausible increase in its cost of capital presents any meaningful risk to the PHI utilities...." *Id.*

(But the discussion in Part IV.C.2, referencing statements by Exelon, including references to rating agencies, made clear that cost of capital risk exists.)

3. The SPE structure is not intended to "protect a PHI utility from increases in debt cost when lenders worry that insufficient equity will be available to the utility from the holding company because of the holding company's business risks." *Id.*

(See comment under #2.)

> 4. "Lenders to BGE, ComEd and PECO have not expressed concerns to Exelon about the availability of sufficient equity from Exelon. Exelon has proposed measures to insulate PHI and Pepco from risks associated with the business of Exelon. Exelon therefore does not believe that this is a meaningful risk to the PHI utilities." *Id.*

(See comment under #2. "Belief" is not evidence. Statements by rating agencies that a utility's ratings are affected by a holding company's ratings are.)

> 5. "The SPE structure is not intended to "protect a PHI utility against competition for capital within the holding company family....Exelon has no plans to impose on Pepco limits on spending for utility purposes that differ from those to which Pepco is currently subject." *Id.*

(Saying one *has* no plans is truthful, but not meaningful. Committing that one *will never make plans* is meaningful. Exelon has not made that commitment.)

Q. What if Exelon asserts that eliminating all risk is not practical?

A. Exelon would be correct. Eliminating all risk is not practical—not where Exelon has chosen to behave in ways that cause risk. And that is the point. To make this debate about the practicality of eliminating all risk implies that Exelon has some right to engage in business activities that create risk. As the prospective acquirer of Pepco, Exelon does not have that right—unless the Commission allows it. Allowing new risk to Pepco, where the source of the risk is not efforts to improve Pepco's service and lower its costs, but Exelon's desire to invest in businesses unrelated to and in conflict with Pepco's obligations, is not consistent with the public interest.

Q. What do you recommend?

A. The solution to this problem—other than disapproving the consolidation—is a condition requiring Commission permission before Exelon makes any acquisitions of a size or type that the Commission determines could harm Pepco. This is the ring-fence missing from

Exelon's "ring-fencing." It is the provision that would actually eliminate risk, or at least subject it to case-by-case limits based on methodical, fact-based assessments—assessments conducted by an unconflicted Commission rather than a conflicted Exelon. But Exelon emphatically opposed such a provision in the Constellation case before the Maryland Commission. Perhaps it will change its position here. Because resisting such a condition means insisting on the right to make unilateral decisions, unchecked by the Commission, on what future risk-adding investments to make—even while acknowledging that ring-fencing cannot eliminate the risks arising from these investments. That is not a public interest result.

The Commission also must make clear that it retains jurisdiction to require Exelon to spin-off Pepco to its shareholders if the Commission finds that Exelon's ring-fencing protections prove insufficient to protect Pepco and its ratepayers from any harm. Exelon opposed this condition also, in the Maryland proceeding on Constellation, although a settlement approved by the Maryland Commission ultimately approved a diluted version of what I had proposed in that case. To those who say such a condition amounts to a "sword of Damocles" hanging over the post-merger entity, that is the point. Just as highway drivers at 65 mph are at risk of making one wrong move, Exelon should feel that its ownership of Pepco is at risk if it acts in any manner that places Pepco at risk.

Q. Why are these structural measures—limits on acquisitions and clarification of the Commission's authority to order Exelon to spin-off Pepco—necessary, given that the Commission can disallow risk-related costs from Pepco's rates?

A. Ratemaking as a solution works only if the problem is detected, and only if the cost of disallowance is not so large as to disable the utility. Those are the limitations that make ratemaking suboptimal, compared to the structural solutions I recommended. In ratemaking, we build the utility's revenue requirements from data on costs. The accuracy of rates depends on the accuracy of data. Accuracy depends on auditing. But auditing is not like a trip to the dentist, who checks every tooth. Auditing is sampling. It cannot promise 100% coverage—especially with the Commission's limited resources and Exelon's unlimited expansion opportunities. (Again, an Exelon commitment to increase the Commission's monitoring resources would display good faith and respect for the Commission's responsibilities.)

Further, reliance on after-the-fact disallowance is limited by too-big-to-fail realities. In the competitive world, the consequences of poor business decisions fall on the decision-makers. But not always. The Commission is certainly familiar with situations in the U.S. economy involving moral dilemmas—where a company's size or national importance pressures regulators to, in effect, "put their principles aside and do what's right." In the world of regulated monopolies, the pressure to save the company exists because a service territory's well-being, and that of its citizens, depends on reliable service, and because of the common perception—not always subjected to factual testing—that there is no ready alternative to the incumbent utility. Given this inherent weakness in ratemaking as an accountability measure after the fact, the necessary public interest answer is structural conditions before the fact.

D. Experience, logic and economic theory show that the risks to Pepco are not "speculative"

Q. Are your concerns about Exelon's business risks speculative?

A. No, they are factual:

1. The Commission does not know what activities the post-merger Exelon will undertake, because there is no legal limit on the geographic or type-of-business scope of those activities. That is a fact.

2. Absent uncontested conditions established by the Commission, or uncontested Commission statutory authority, Exelon's activities will occur outside the Commission's jurisdiction and control. That is a fact.

3. Some of Exelon's business goals and strategies are in tension with Pepco's public service obligations. That is a fact.

4. The Commission does not know how small Pepco will become relative to Exelon (Pepco it will be 8.2% of Exelon's operating revenues, down from its current 43% of PHI's, based on 2013 numbers), how small is too small to ensure Pepco's accountability to the Commission, or how many unrelated affiliates are too many unrelated affiliates, before Pepco's welfare becomes too small to matter to Exelon. That is a fact.

Those who call these concerns speculative are the ones who speculate. They speculate that (a) shrinking Pepco's role in the holding company's well-being will not reduce the holding company's commitment to Pepco's well-being, (b) Exelon's unregulated business activities will not have conflicts with Pepco's service obligations, (c) business failures within the Exelon corporate family will not occur—and if they do, they will have no adverse effect on Pepco, and (d) magnifying the complexity of the regulatory task will not stress the Commission's limited regulatory resources. Exelon cannot prove these negatives.

Exelon's speculative status is underscored by its failure to limit its future activities. This merger application is an exercise in framing: It describes what the

Applicants want the Commission to see on the day of merger consummation: one company where two had been, smoothly combining its predecessors' "best practices." Exelon wants this carefully painted picture to fill the Commission's eye-space, and then copied into the Commission's opinion approving the transaction. But a merged company is not a static company; it is a trajectory. It is all that the application portrays—plus all the motivations, plans, strategies and tactics that exist within any acquisition-oriented enterprise no longer constrained by the Public Utility Holding Company Act of 1935. Exelon's next moves remain undisclosed to this Commission—just as this acquisition was not disclosed to the Maryland Commission during the Constellation case. Post-acquisition Exelon is the classic black box. To approve this black box without addressing its future contents leaves the public interest at risk.

V.
The Claimed Benefits Do Not Justify the Costs

Q. In assessing whether a consolidation will be in the public interest, what is the relevance of benefits and costs?

A. For a consolidation to be in the public interest, it must promise an appropriate level of benefits in relation to the transaction's cost. That statement raises three questions: What items should count as benefits? What items should count as costs? What is the appropriate relationship of benefits to costs?

The Applicants answer these questions unsatisfactorily. Consider the following facts:

1. For benefits, applicants offer the District a "Customer Investment Fund" (representing about $50 per District resident), reliability commitments enforceable with financial penalties, maintenance of certain existing programs and practices, compliance with District and Commission laws and rules, efforts to share "best practices," and other matters. See Exhibit 5 to the Application. But these benefits are small relative to what the shareholders of PHI and Exelon gain (a premium worth more than 12 times the "Customer Investment Fund," plus control of a government-protected franchise, respectively). And other than the $50, which Exelon based on expected "synergies" enabled by the merger, the benefits are not attributable to the merger; they are, rather, inducements to win approval.

2. Regarding costs, Applicants say there are none to the District because they will absorb all transaction costs. This position omits the risks associated with the mixing of utility and non-utility businesses; the diminution in Pepco's importance relative to its corporate family; and, as discussed in Part VI below, the uncertainty about competitive effects, especially in the nascent markets for distributed energy resources.

3. As for the appropriate relationship of benefits to costs, the Applicants say nothing explicitly; their implicit standard appears to be "some risk of harm, minor benefits"—a standard inconsistent with the competitive market forces that regulation should emulate.

Q. What is your conclusion on the transaction's benefits and costs, and how will you organize your discussion?

A. The asserted benefits are not worth the costs. Part V.A explains that because regulation must replicate the results of competition, the proper benefit-cost relationship is one that a competitive market would demand. The Applicants' proposed relationship—"some risk of harm plus minor benefits"—doesn't qualify. Part V.B then analyzes the specific benefits offered, finding them insufficient because most are non-quantified, non-committal, or not attributable to the merger. Part V.C reminds the Commission of the costs to the District associated with the mixing of utility and non-utility businesses, and addresses the inappropriateness of the acquisition premium. Part V.D recommends policies that the Commission should use, both to reject this transaction and to guide future transactions.

A. The benefit-cost relationship

Q. What is Applicants' position on the appropriate benefit-cost relationship in a utility consolidation?

A. On this central public interest question, there is no Applicant testimony. Implicit in their proposal is this benefit-cost standard: "Some risk of harm, plus minor benefits." I infer this standard from their submissions because (a) as I explained in Part IV.C on ring-fencing, the net effect of acquisition plus ring-fencing is more risk to Pepco, not less; and (b) as I explained in Part II, the benefits they guarantee are worth less than 1/12 the benefits that PHI shareholders will receive.

Q. What is your response concerning the Applicants' view of the appropriate benefit-cost relationship in a utility consolidation?

A. A standard of "some risk of harm, plus minor benefits" does not serve the public interest. Regulation should replicate the results of effective competition. If Exelon and Pepco subject to effective competition for the right to serve District customers, someone would offer the District more than "some risk of harm plus minor benefits." In the ensuing questions and answers I will address each component of the appropriate standard: the meaning of "harm," the meaning of "benefits," and the appropriate relationship between the two.

1. The meaning of "harm"

Q. How should the Commission understand "harm"?

A. In the public utility context, "harm" means "failure to act cost-effectively." Having received protection from competition, a utility must perform as if subject to competition. It must make all feasible, cost-effective efforts to reduce costs and increase quality. Diverting resources from more productive uses—incurring what economists call "opportunity cost"—fails this test.[45] Thus a proposed merger that precluded some other utility action, including some other merger, which other action would have yielded more customer benefits, by definition causes harm because it denies consumers a benefit otherwise available to them. As I explained in Part I.A, PHI did not search for the acquirer that would produce the most customer benefits; it solicited and selected the

[45] "[T]he opportunity cost of an item—what you must give up in order to get it—is its true cost." Krugman, P. R., and R. Wells, *Microeconomics: Third edition* (Macmillan 2012).

acquirer that would pay the highest premium. As a result, the Applicants cannot prove that no opportunity cost—no harm—will be caused by this consolidation.

Besides ignoring opportunity cost, Applicants also appear to define harm to include only direct, tangible harm; specifically, harm in terms of rates and reliability. But there is harm that is less direct, less tangible, but no less real—harm inherent in complicated holding company structures: the risks of excess debt, internal conflicts for capital, and pressures on local utility management to satisfy holding company goals that diverge from the utility's obligation to serve. Quantifying this harm is a challenge, but the quantity exceeds zero. Since Applicants have the burden of proving the absence of harm, their failure to quantify, and even to address this harm, leaves a gap in their proof.

2. The meaning of "benefits"

Q. How should the Commission understand "benefits"?

A. The Commission should count as benefits only those values that are uniquely attributable to the merger; *i.e.*, improvements caused by the joining of companies previously separate, improvements unattainable without the merger. Utilities do not need a merger to fund charitable organizations, to improve reliability performance, or to introduce "best practices." These types of benefits do not grow out of a coupling of companies. Hiring consultants, sharing ideas with peers, attending professional conferences, overseeing contractors, hiring excellent managers and employees, compensating based on operational improvement, all are ways to produce these results. And if Pepco is performing below a professional standard that others (such as Exelon's other utilities) are capable of meeting, PHI, and this Commission, should find out why, rather than viewing the elimination of this suboptimality as a benefit of the merger.

Counting as benefits of a merger improvements achievable without the merger is an error of logic because it confuses the Applicants' *proposal* with the Applicants' *merger*. The consolidation statute does not ask if the *proposal* will be in the public interest; it asks if the *consolidation* will be in the public interest. A consolidation is a coupling of companies. A reduction in overhead made possible by eliminating redundancy, where that elimination is possible through the consolidation, is a benefit of the consolidation. But a proposal to introduce best practices, even a binding commitment with specific promises of savings and consequences for not achieving those savings (which Exelon's proposal is not, other than its reliability feature—which itself has no connection to the merger itself because it is something the Commission could require of Pepco without the merger), is not a benefit from a consolidation unless it was not possible except through the consolidation.

In addition to this confusion between proposal and merger, a decision to count as benefits things that can occur without a merger commits violates the principle of economic efficiency. Consumers would be incurring merger costs (such as the risks associated with Exelon's non-utility businesses and the risks to distribution resources competition) to receive a benefit they could receive without incurring those costs. Making customers pay extra for something they are already supposed to receive is a form of customer abuse that would not occur in an effectively competitive market.

Q. Do other jurisdictions reject merger benefits not uniquely attributable to the merger?

A. Yes. Applying the Communications Act of 1934, the Federal Communications Commission has done so repeatedly: "[T]he claimed benefit must be transaction- or merger-specific. This means that the claimed benefit 'must be likely to be accomplished as a result of the merger but unlikely to be realized by other means that entail fewer anticompetitive effects.'"[46] That principle, repeated by the FCC in multiple cases, was applied by the FCC Staff most recently to the proposed merger of AT&T and T-Mobile. The Staff rejected benefits that the applicants claimed would result from "the adoption of each company's best business practices, including customer service best practices . . . because the improvement of specific business functions by either AT&T or T-Mobile could be achieved absent the proposed transaction."[47]

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[46] *AT&T, Inc. & Bellsouth Corp.*, 22 FCC Rcd at 5761 (quoting *EchoStar/DirecTV Order*, 17 FCC Rcd 20,559, 20,630 (2002) (citing *Ameritech Corp. & SBC Communications Inc.*, 14 FCC Rcd 14,712, 14,825 (1999) ("Public interest benefits also include any cost saving efficiencies arising from the merger if such efficiencies are achievable only as a result of the merger"))); *Comcast Corp.*, 17 FCC Rcd 23,246 (2002) (Commission considers whether benefits are "merger-specific").

FERC had taken a different approach, but has since revised it. Approving the merger of Utah Power & Light and PacifiCorp, the Commission found that "[t]he possibility of achieving a particular benefit through a contractual arrangement [i.e., without a merger] does not diminish the cost savings associated with that benefit." *Utah Power & Light Co. & PacifiCorp*, 45 FERC para. 61,095 at p. 61,229 (1988). But FERC's 1996 Merger Policy Statement eliminated the issue. FERC there recognized the "controversy over the position we have taken that benefits are to be 'counted' even if they could reasonably be obtained by means other than the merger." So, instead of "requiring estimates of somewhat amorphous net merger benefits and addressing whether the applicant has adequately substantiated those benefits," FERC requires "ratepayer protection" in the form of short-term rate freezes or decreases. *Inquiry Concerning the Commission's Merger Policy Under the Federal Power Act: Policy Statement*, Order No. 592 at text accompanying n.42, 77 FERC para. 61,263, 61 Fed. Reg. 68,595-01 (Dec. 30, 1996) (codified at 18 C.F.R. pt. 2).

[47] *Applications of AT&T Inc. and Deutsche Telekom Ag for Consent to Assign or Transfer Control of Licenses and Authorizations*, WT Docket No. 11-65, Staff Analysis and Findings 6 241 (2011), available at http://www.wirelessestimator.com/publicdocs/ATT-TMO-FCC.pdf. The FCC Staff's document is not an official Commission document; nor was it part of the official record

In applying antitrust law, the Department of Justice and Federal Trade Commission also disregard benefits achievable without a merger. Their *Horizontal Merger Guidelines* (2010) states (at Section 10): "The Agencies credit only those efficiencies likely to be accomplished with the proposed merger and unlikely to be accomplished in the absence of either the proposed merger or another means having comparable anticompetitive effects." See also *id.* at n.13: "The Agencies will not deem efficiencies to be merger-specific if they could be attained by practical alternatives that mitigate competitive concerns, such as divestiture or licensing."

Some state commissions have adopted a similar policy. In the proposed Southern California Edison-San Diego Gas & Electric merger, the California Commission rejected the applicants' claimed labor savings. Given the smaller utility's (SDG&E's) growth, "some of the efficiencies SDG&E might realize by merger into Edison may be achieved if SDG&E remains independent and becomes larger."[48] And when a merger applicant offered ratepayers 90 percent of the net proceeds from divesting a fossil fuel plant, the New York Commission disregarded this "benefit" because the Commission had full authority to determine the proceeds' disposition without any merger.[49]

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in the named Docket. It was a draft report prepared by the Staff and released to the public by the FCC Chairman. No FCC order was issued in this proceeding, because the merger applicants withdrew their proposal.

[48] *SCEcorp, Southern California Edison Co. & San Diego Gas & Electric Co.*, Decision No. 91-05-028, 1991 Cal. PUC Lexis 253, at *25.

[49] *Iberdrola, S.A., Energy East Corp., New York State Electric & Gas Corp. & Rochester Gas & Electric Corp.*, Case 07-M-0906, 2008 N.Y. PUC Lexis 448, at *10. *See also Exelon-Constellation Merger*, Order No. 84698, 2012 Md. PSC Lexis 12, at

3. The proper relationship of benefit to cost

Q. How should the Commission understand the relationship of benefit to cost?

A. When a rational person makes an investment, she seeks the highest possible return relative to other investments of comparable risk. A prospective acquirer of a utility has the same goal: a benefit/cost ratio at least as high as the most attractive alternative investments of comparable risk. And the target utility's shareholders also have that goal: In light of the investment they made, and the risks they chose to assume, are they getting the highest possible return?

Ratepayers deserve the same outcome from their regulators, because if they had competitive options they would shop to receive the greatest value for the dollars they spend. That means that a commission, when evaluating a proposed consolidation, should ask the same question investors ask: Will this transaction enable the target utility to produce a level of customer benefits reflecting the best possible relationship to cost, compared to alternative actions? This question does no more than restate the standard for regulation: Having received protection from competition, a utility must perform as if subject to competition. It must take all cost-effective actions, obtaining for its customers the best outcome in light of their costs.

No investor, no acquirer of utilities, no target shareholder, analyzes a transaction according to a standard of "some risk of harm plus minor benefits." Their standard is always "highest return relative to alternative investments of comparable risk." That is the

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*162-163 (finding the possibility of BGE adopting its post-merger affiliates business practices "too intangible to qualify as a benefit").

standard the Commission must apply for Pepco's customers, to ensure that a proposed consolidation "will be" in the public interest.

Here is another way to understand the point: What is unique about utility mergers is that they are mergers of utilities. The target company sells services that not subject to competition. Since regulation is a substitute for competition, regulation should establish the criteria for selection. In the competition to acquire the target company, if the Commission, rather than the target's shareholders, were selecting the winners, the contestants would bid up the *benefits* offered rather than the *price* offered. They would bid up the benefits offered, up to the point where their investment in the transaction was no longer attractive relative to other investments. That is the amount of benefits the Commission should expect. And if those benefits, relative to the costs and risks customers will incur to obtain those benefits, produce a better benefit-cost ratio than alternative actions available to the target company, then there will be no opportunity cost, no waste, no performance shortfalls compared to competitive outcomes. The transaction "will be" in the public interest. But this transaction lacks this characteristic, because in the absence of a Commission policy requiring the bidding to focus on customers, Exelon and PHI focused on themselves.

Q. What, then, is the difference between (a) the benefit-cost approach the Applicants apply to themselves and (b) the benefit-cost approach the Applicants propose to the Commission?

A. Like any rational investor, the Applicants applied the standard of "biggest bang for the buck." Mr. Rigby sought the highest price, and Exelon bid up to the point where it felt that its expected return on its acquisition cost represented a reasonable return relative to other destinations for its dollars. But for the treatment of ratepayers, the Applicants propose not "biggest bang for the buck," but "some risk of harm plus minor benefits." This difference in standards reverses the relationship of private interest and public interest, because it makes the Applicants' private interest the framework, within which the public interest must fit. To ensure that the consolidation "will be" in the public interest, the Commission must reverse this relationship. It must make the public interest the framework, within which the private interest must fit. The appropriate benefit-cost relationship, from the District's perspective, is the one that produces the best benefit-cost ratio for customers.

Q. Is it appropriate to establish a policy on benefit-cost relationship within this merger proceeding?

A. Yes, otherwise the Commission will be approving or disapproving a merger without a clear standard and without a clear context. It would have been better to establish the policy before a merger is proposed. And the Applicants might argue that they "relied" on whatever policy they inferred from the Commission's prior merger decisions. They would have a point; it is inconvenient to the Applicants to find out the Commission's standard after they have negotiated their terms. But avoiding Applicant inconvenience is not the Commission's obligation; ensuring that the consolidation "will be in the public interest" is.

B. Benefits: Most are non-quantified, non-committal, or not attributable to the merger

Q. How will you discuss the benefits?

A. It is logical to place the benefits into two categories: benefits that the Applicants purport to guarantee, through a promised payment into a Customer Investment Fund; and additional benefits to which they aspire but do not guarantee. In this Part V.B, I will explain that (a) the benefits backed by the guaranteed payment must be reflected in rates; (b) the asserted benefits not backed by the guaranteed payment cannot count as merger benefits because they are merely aspirational or illusory; and (c) Pepco does not need a new parent to ensure its financial strength. Lastly, I explain why the Commission must declare that Pepco's rates will be "interim subject to refund," as of the date of merger consummation, to guarantee that the benefits that do occur go to consumers.

1. The benefits backed by the guaranteed $14 million payment must be reflected in rates

Q. What is your understanding of the benefits Exelon is guaranteeing to Pepco customers?

A. Mr. Khouzami (Direct at p.20) states that "[t]he estimated savings for the PHI utilities, net of the costs to achieve the savings, will total $95 million over [the merger's] first five years." Based on that estimate, Exelon is proposing to fund a "Customer Investment Fund" of $100 million. *Id.* He adds that the annual merger-related savings for the PHI utilities will reach $43 million by the fifth year. *Id.* The Fund would amount to $50 per Pepco customer.[50] I understand the $50 per customer to be Applicants' minimum prediction of annual cost reductions that will occur by the fifth year. By guaranteeing

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[50] There appears to be some confusion between the PHI amounts and Pepco amounts, because the Application (at para. 2) appears to attribute the $43 million to the Pepco territory:

> Customers in Pepco's service territory will realize direct and traceable financial benefits from an Exelon-funded Customer Investment Fund in the amount of $43 million - equivalent to a value of more than $50 per Pepco electric distribution customer. Of that amount, $14 million would be available for the Customer Investment Fund in the District of Columbia based on the number of customers in the District, with the remainder in the Customer Investment Fund in Maryland....

this amount in the form of a first-year payment, Applicants are accepting the risk that this amount of cost reductions will not occur over that period.

Q. What should the Commission do about the money Exelon is guaranteeing?

A. I understand the desirability of allocating this amount among a mix of community projects, but I believe the proper option is to treat this amount as a rate reduction, to be spread over the period of time during which the cost reductions supporting the $14 million will occur. If the $14 million is attributable to real operational savings but the Commission allocates them to some purpose other than rate reduction while not reducing rates, the Commission would, in effect, be authorizing post-merger rates that exceed post-merger costs—a result inconsistent with just and reasonable ratemaking in a cost-based ratemaking context.

Q. Couldn't the Commission allocate the guaranteed payment to various community projects, and also reset rates to reflect post-merger cost reductions?

A. No, because that would be counting the same cost reductions twice. My answer assumes that $14 million reflects actual cost reductions, rather than an independent inducement offered to obtain approval. By accepting this separate inducement, the Commission would be implicitly articulating a policy of evaluating mergers on bases other than their integral benefits. The unseemliness of appearing to put a government privilege up for sale should be obvious. Worse, the Commission would be inviting a battle among constituents for the $14 million, with the Commission making political judgments about who should get what—judgments that fall outside the Commission's regulatory role of inducing performance from regulated utilities. Further, any allocation of merger-related cost reductions, other than pro rata to load, consumption or some other criterion supported by the Commission's statutory authority and factual findings, would constitute discrimination. Whether that discrimination will be undue would depend on the facts.

2. The other asserted benefits—those not backed by the $14 million payment—cannot count as merger benefits because they are merely aspirational, or are achievable without a merger

Q. What should be the Commission's concerns about Applicants' assertion of benefits beyond the $14 million guarantee?

A. The asserted benefits, beyond the $14 million guarantee, have one or both of the following weaknesses: Either they are accompanied by no commitment, and thus no consequences for non-achievement; or, they are not properly attributable to the merger because they are achievable by Pepco without the merger. One or both of these weaknesses apply to the categories of "best practices," synergy estimates, distribution improvements, employment savings, load growth and load management actions, conceptual categories like "bargaining power" and "economies of scale," and the notion that Pepco will benefit from Exelon's financial support. I will discuss each of these areas in turn.

a. "Best practices" remain undefined and unquantified

Q. What concerns should the Commission have with Applicants' assertions about "best practices"?

A. There are two problems. First, we don't know what they are or what they are worth:

> Exelon has not yet determined which best practices will be implemented at Pepco as no analysis has been completed at this time regarding which processes and procedures are most beneficial and best suited for implementation at Pepco.

Exhibit GRID2.0 (A)-29 (Response to OPC DR 5-39).

> ...An analysis of the best practices employed by Pepco operating utilities that Exelon may implement has not been performed. The referenced

> testimony makes clear that following the merger, Mr. Gausman is confident that Pepco will continue to meet its current and proposed reliability commitments.

Exhibit GRID2.0 (A)-30 (Response to OPC DR 3-42 (Alden and Gausman)).

> It is not possible at this time to quantify the benefits these resources [referring to Mr. O'Brien's oversight] will have on PHI and its subsidiary utilities and customers.... It is not possible at this time to quantify the impact to Exelon's shareholders and its utilities' customers. Exelon has not yet quantified the estimated impact that the Exelon Utilities resources provided to PHI as part of a successful transaction will have to Exelon shareholders and customers.

Exhibit GRID2.0 (A)-31 (Response to OPC DR 5-34).

Second, "best practices" are practices the Commission should expect of any prudent utility entitled to retain its franchise and charge Commission-set rates while receiving protection from competition. The Commission should treat best practices as a condition of Pepco's obligation to serve, not as a benefit brought by Exelon.

b. Many asserted improvements lack analytical support

Q. Should the Commission have additional concerns with the asserted benefits?

A. Yes. Many of them lack analytical support. Here are ten examples.

"Synergy" estimates in general: Mr. Khouzami (Direct Testimony at pp. 19-27 and accompanying exhibits) provides dollar figures associated with general categories of synergies. These materials refer to "Net synergy *estimates* and "*[p]reliminary estimate* of transaction cost to achieve." (See Applicants Exhibit (F)-2, pages 1/12 and 8/12, respectively.) He provides no basis on which the Commission can determine the solidity of the estimates. Indeed, it appears that the integration teams are still fashioning their plans (Response to OPC 6-7 (referencing confidential documents)):

> As the Joint Applicants are still early in the integration process, not all integration plans have been developed. Please see OPC 6-7 CONFIDENTIAL Attachment A for a complete listing of high level project plans for the Integration Core Teams. These plans are subject to change dependent upon expected timing of Merger close. The integration Business Area Teams (BATs) have also completed their team charters and project plans for the initial analysis phase.

Reliability: The indeterminate nature of these benefits is evident from Exelon's statement that it "has not identified specific programs to be offered in Pepco's service areas to date. Exelon plans to look for opportunities to accelerate the work that is already planned where possible and to improve the performance of the system through the application of best practices and processes as part of the Exelon Management Model." See Exhibit GRID2.0 (A)-32 (Response to OPC DR 4-2). Separately, Mr. Gausman's direct testimony does no more than summarize Pepco's current obligations and promise to meet them. Meeting current obligations does not count as a merger benefit. Further, Mr. Gausman's direct testimony cites no "best practices" used by Exelon that Pepco is unaware of; nor does it identify any professional ability or expertise that Mr. O'Brien will bring that Mr. Gausman or his staff does not already have. It is true that Exelon has proposed new commitments, but as I will discuss in Part V.B.2.d, the Commission could impose these standards on Pepco without a merger.

Distribution improvements: As with best practices generally, Exelon offers no specifics: "Specific changes to Pepco's vegetation management program have not been identified to date. Exelon has made no plans to stop or defer the work that is already planned and plans to look for opportunities to accelerate that work where possible and to improve the performance of the system through the application of best practices and processes as part of the Exelon Management Model." See Exhibit GRID2.0 (A)-33

(Gausman Response to OPC DR 3-34). Similar answers—there are no specifics on changes or plans—were given for distribution feeders (see Exhibit GRID2.0 (A)-34, Response to OPC DR 3-35) and undergrounding (see Exhibit GRID2.0 (A)-35 (Response to OPC DR 3-36)) and Exhibit GRID2.0 (A)-36 (Response to OPC DR 3-41)).

Distribution automation: Again, "[s]pecific changes to Pepco's distribution automation program have not been identified to date. Exelon has made no plans to stop or defer the work that is already planned and plans to look for opportunities to accelerate that work where possible and to improve the performance of the system through the application of best practices and processes as part of the Exelon Management Model." See Exhibit GRID2.0 (A)-33 (Response to OPC DR 3-34).

Employment savings: And again, "[i]t is too early in the integration process to estimate the reduction in employment in Pepco's DC operations and the associated savings subsequent to the two-year moratorium. The Applicants expect to use the integration process to combine the two organizations and to review the opportunities the combination provides to integrate departments, systems and processes across the combined enterprise. The details of the actual consolidations have not yet been determined. The Direct Testimony of Mr. Khouzami describes more fully the integration planning process under which these and other related topics will be addressed." See Exhibit GRID2.0 (A)-37 (Response to OPC DR 6-6). (The referenced passage in Mr. Khouzami's testimony does not contain details sufficient to support predictions.)

Load growth and load management: Same as for distribution automation. See Exhibit GRID2.0 (A)-38 (Response to OPC DR 3-39).

Capital expenditures: Again, "Exelon has not completed any analysis projecting the estimated cost savings in future capital expenditure budgets at PHI's utilities. The expectation is, though, as capital savings are identified and achieved, these savings would to be reinvested in other needed capital projects." See Exhibit GRID2.0 (A)-39 (Response to OPC DR 6-31). See also Exhibit GRID2.0 (A)-40 (Response to OPC DR 3-24(C) ("There have not yet been any plans identified that would abandon, scale down or defer capital projects if this merger is completed.").

Mutual support structure: Mr. Rigby states (Direct Testimony p.9 lines 13-14) that "this mutual support structure will enhance performance and lower costs." But he has no studies to support the statement. See Exhibit GRID2.0 (A)-41 (Response to OPC DR 4-22). Similarly, Mr. Crane asserts that the adjacency of BGE and Pepco will create "robust mutual support capabilities and substantially greater combined resources to respond promptly and effectively to major storms and other emergencies." But this statement is only formulaic, because "Exelon has not performed a quantitative analysis as to the benefits derived from the geographic proximity of its utilities and PHI's utilities." See Exhibit GRID2.0 (A)-42 (Response to GRID2.0 DR 1-32).

More resources: Mr. Rigby tells us (Direct Testimony p.10) that the transaction will give Pepco "access to greater resources available from a larger enterprise." But he has never suggested that Pepco does not get enough resources through its smaller enterprise. And Mr. Alden admits that the Applicants have made no "determination" about what type or amount of resources Pepco will have "greater access to." See Exhibit GRID2.0 (A)-43 (Response to OPC DR 4-25).

Bargaining power and economies of scale: Mr. Crane talks of the benefits of "increased bargaining power" and "economies of scale" (Direct Testimony at p.6 l.1). But Exelon admits it "has not made its own explicit study of the benefits of increased bargaining power and economies of scale as a general matter." See Exhibit GRID2.0 (A)-44 (Response to GRID2.0 DR 1-24(B)).

c. Pepco does not need a new parent to ensure its financial strength

Q. Does Pepco need a new parent to ensure its financial strength?

A. There is no record evidence supporting a "yes" answer to this question. I will explore the point here, though, to avoid a situation in which Exelon makes on rebuttal new arguments it did not make on direct.

Q. What would be your response to an argument that Exelon can make Pepco financially stronger by giving it better access to capital?

A. The argument would not be supported by facts or logic. Pepco has not argued in this case that it lacks had sufficient access to capital. As long as the commissions in District, Maryland, Delaware and New Jersey set retail rates appropriately, there is no reason to assume that capital will not flow to PHI and Pepco in the amounts they need. As I explained in Part IV.C.1, interposing Exelon between PHI and the equity markets creates three problems for Pepco. First, Pepco's access to equity will depend on Exelon's unilateral decisions (which will involve conflicting demands from Exelon's other family members); today, Pepco's access to equity depends on PHI, whose main businesses are utility businesses. Second, after the acquisition, equity may come to Pepco at a higher cost because Exelon's profile is riskier than PHI's. Third, the many gaps in the ring-fence, discussed in Part IV.C, still could leave Pepco's bond ratings at levels lower than they would be without the transaction. By exposing Pepco to new and unknown business risks—risks that will grow and change over time in ways the Commission, absent conditions, can neither predict nor control—the acquisition does not make Pepco financially stronger.

Q. What would be your response to an argument that the rating agencies view this transaction favorably?

A. The rating agencies' priorities do not coincide with the Commission's public interest duties. The rating agencies' focus is on a borrower's ability to repay its debts, not on the utility's ability to perform for its customers. Further, the factual basis for these ratings is limited to the Applicants' current loans and current activities, plus the Applicants' generic, non-committal statements about future plans. Positive outlooks last only as long as positive facts last. These present ratings therefore tell us nothing, and promise nothing, about Exelon's unknown future—a future that Exelon will insist in keeping unknown if it resists a condition requiring Commission approval of its future acquisitions. Extrapolating from an allegedly positive present into an indefinite future is an insufficient basis for a public interest finding.

Q. What would be your response to an argument that improvement in BGE's financial condition was attributable to Exelon's acquisition of Constellation?

A. The record has no factual support for an argument that improvement in BGE's financial condition was attributable to Exelon's acquisition of Constellation. As Exelon has stated:

> There is no reason to think that BGE's improved credit rating is a direct effect of the mere fact of "Exelon's acquisition of Constellation," but it is correct that BGE's credit ratings have improved while BGE has been owned by Exelon and been part of the Exelon Utilities family of companies.

> Improved credit ratings at BGE are the result of a combination of factors, including improved financial ratios and credit supportiveness of the regulatory jurisdiction. Standard and Poor's cited in their August 22, 2013 research update (CONFIDENTIAL Attachment A) that the upgrade reflects their expectation that BGE will sustain stronger financial measures as the company implements a strategy to reduce regulatory lag. Moody's cited in their January 31, 2014 ratings action (CONFIDENTIAL Attachment B) that the upgrade reflects the improved regulatory framework in Maryland.

See Exhibit GRID2.0 (A)-45 (Response to GRID2.0 DR 1-91 relating to direct testimony of Carim Khouzami at p. 7, lines 21-22).

d. Benefits achievable without the merger should not count as benefits from the merger

Q. Do Applicants' asserted benefits include improvements that could be achieved without the merger?

A. Yes. In Parts I.F and V.A.2, I explained why the Commission should not count as merger benefits improvements that Pepco could achieve without the merger. Applicants' list includes such items, as discussed next.

"Best practices" generally: The claimed improvements in practices are generic business practices that are not unique to these companies or attributable to the merger of two companies. Consider these statements (from Response to OPC DR 5-33) (see Exhibit GRID2.0 (A)-46):

> The utility CEOs are required to discuss challenges to drive improvement. Areas for improvement are identified and addressed in business plans. Goals are set for the upcoming year and the operational and customer metrics are set to provide incentives and rewards for improved operations at three levels of performance: threshold, target and distinguished. Incentive compensation arrangements for utility senior executives are based upon financial and operating performance against the goals, and incentive awards are based on attainment of the threshold, target or distinguished goal level. A weighting factor of 50% is assigned to operational metrics. A 25% weighting factor is assigned to meeting goals for operating and maintenance expense and capital spending.

> Periodic reviews are conducted to ensure each utility is on track to achieve its goals/objectives and that operating and capital spending is in-line with the approved budget levels. If it is determined that a particular utility may not achieve its stated operating, strategic or financial objectives, an action plan is developed in order to assist the utility in meeting its objectives. Failure to achieve the goals set for incentive compensation has the effect of reducing the compensation of the CEO and other officers of the utility.
>
> Exelon Utilities collaboratively works with each utility's management to (i) develop its business strategy and establish the appropriate performance goals (ii) ensure utilities remain on track to implement its business plan and achieve performance goals (iii) maintain clear lines of reporting on performance of each utility and (iv) formalize the process for sharing knowledge and best practices among utilities. ....

See also Response to OPC DR 5-39 (Exhibit GRID2.0 (A)-29), and OPC DR 5-46 (Exhibit GRID2.0 (A)-47) (referring to the use of "cross-company communities of practice (or peer groups"); and OPC DR 5-47 (Exhibit GRID2.0 (A)-48) (referring to "participation in benchmarking studies and industry meetings" and "internal reviews").

Each of these activities represents commonsense business practices, not unique Exelon insights. The same goes for the so-called "Exelon Management Model," which Mr. Alden describes as a program unique to Exelon whereby "best practices are shared and implemented across Exelon's utilities." Due to the Model's uniqueness, he says, "absent the Merger, Pepco could not implement similar programs that take advantage of the Exelon Management Model offerings." See Exhibit GRID2.0 (A)-49 (Response to OPC DR 4-2(D)). That a particular "model" is unique to Exelon does not mean Pepco could not produce the same results using some other "model." It is not as if the "model" is patented, or award-winning, or the subject of a Harvard Business School "model" case study. Indeed, Mr. O'Brien's response to OPC DR 4-3 (see Exhibit GRID2.0 (A)-50) describes the "model" as a series of commonsense steps: "monitoring," "assessment," "goals," "tracking and reporting," "programs," "compliance with regulatory requirements" (!), "benchmarking," "best practices," "technology," and "performance of required regulatory activities" (!).

None of these actions is beyond Pepco's ability. Indeed, Mr. Gausman stated: "Prior to April 30, 2014, Pepco already had programs, procedures, and standards in place similar to those listed in [Mr. O'Brien's testimony]." See Exhibit GRID2.0 (A)-51 (Response to OPC DR 3-12). Mr. Gausman added that "[w]ith the proposed merger comes the opportunity to evaluate and take advantage of practices used by Exelon's operating companies," but he does not suggest that Exelon has anything to offer that Pepco could not learn without the merger. Mr. Gausman also acknowledged that Pepco uses consultants to learn of best practices. See Exhibit GRID2.0 (A)-47 (Response to OPC DR 5-46). And PHI adds that "[the Company has hired consultants to advise its utility subsidiaries on best practices regarding the delivery of safe and reliable electric service. For example, the Company has hired Accenture regarding cost containment and the Company participates in the PA Consulting Group's annual studies on best practices in the utility industry." See Exhibit GRID2.0 (A)-52 (Response to GRID2.0 DR 1-66). Finally, responding to a request that PHI "provide all the reasons why you believe that learning about best practices from Exelon's utility subsidiaries is a better path to learning about best practices than using consultants," PHI gave a non-answer: "Consultants can provide important comparisons of best practices on a national scale, as well as within a group of similar utilities. Should the merger be approved, PHI will benefit from Exelon's utility subsidiaries' institutional knowledge of geographically contiguous, similar utility operations." See Exhibit GRID2.0 (A)-53 (Response to GRID2.0 DR 1-67).

Reliability guarantees: The Applicants have offered specific reliability guarantees, along with consequences for not meeting those guarantees. But no Exelon witness has suggested that these guarantees exceed anything Pepco should not be offering on its own, or exceed what Pepco should be capable of achieving on its own. Relatedly, Exelon is not able to attribute BGE's reliability improvements to the Exelon acquisition. See Exhibit GRID2.0 (A)-54 (Response to GRID2.0 DR 1-23) ("No analysis has been conducted regarding BGE's ability to realize improved reliability metrics absent the Constellation/Exelon merger whereby Exelon acquired BGE."). Because these guarantees are inducements independent of the corporate joining of Exelon and Pepco (in fact, the Commission could establish these requirements and consequences for Pepco without the merger), the Commission should not count them.

Merger savings after five years: Exelon argues that the five-year merger savings will continue beyond five years. See Exhibit GRID2.0 (A)-55 (Response to OPC DR 3-21 citing Khouzami Direct, p.21 lines 6-11). But because these savings are relative to Pepco's status quo, Exelon is assuming that Pepco's own cost structure would never change; that Pepco would never make any improvements on its own that would replicate (or exceed) improvements that Exelon attributes to the merger. The Commission, responsible for inducing continued improvement from Pepco, should not assume as a base case that Pepco would cause no improvement on its own.

Storms: The Applicants assert that the merger will allow Pepco to take advantage of the deployment of Exelon utility crews during major storm events. Application at para. 41. But Pepco could enter into a crew agreement without a merger; moreover, it is likely that this "benefit" comes at the expense of some other utility that would otherwise use Exelon's crews during a storm. There no evidence that this "benefit" is new public interest value attributable to the merger.

e. Conclusion on benefits that are merely aspirational, or are achievable without the merger

Q. Summarize your conclusions on Exelon's aspirational benefits.

A. The Commission should disregard them, for two reasons. First, they are too vague and unsupported to be counted against the risks that Pepco's ratepayers will experience from this transaction. I recognize that a benefit need not be proven to a certainty. But despite there being dozens of mergers since the mid-1980s from which the Applicants could have drawn data, Exelon has provided no evidence of improvements attributable to any merger. If Exelon has based its estimates on other merger applicants' *pre-merger estimates* (as opposed to *post-merger merger actuals*), the Commission lacks a reliable basis for projecting savings. And not only do the Applicants fail to assign any probability to these benefits' occurrence; unlike the $14 million commitment, they incur no risk of their non-occurrence.

Second, to count as benefits from a merger benefits that are achievable without a merger is to reward shareholders of low-performing companies with acquisition premiums, because acquirers can demonstrate "benefits" from the merger. If Pepco were using quill pens and roman numerals, and its acquirer promised to replace them with computers and Arabic numbers, the Commission would not count that change as a benefit; to do so would be to credit consolidation as a solution to imprudence, rather than addressing imprudence directly.

3. To ensure that all "synergy" savings reach ratepayers, any order approving the merger must declare Pepco's rates "interim subject to refund" as of the date of merger consummation

Q. Is there a risk that the merger cost reductions described by the Applicants will not be passed through to customers?

A. Yes. For merger cost reductions to be passed through to customers, post-merger rates must be aligned with post-merger costs. The Applicants and the Commission have acknowledged this proposition. What is missing, despite GRID2.0's filings with the Commission and data requests to Applicants (as discussed below), is a commitment to a mechanism to ensures this alignment, *as of the time those costs begin to vary from the costs assumed in the last rate case*. This alignment is necessary because if merger cost reductions occur before rates are changed to reflect those reductions, the prohibition against retroactive ratemaking will prevent the Commission from passing them on to customers, except prospectively from the beginning of a rate case.

There is a standard solution to this type of situation. When a commission suspects that rates exceed cost, it can declare that as of a given date (such as the date of the declaration), the utility's rates are deemed to be "interim rates subject to refund." That is what the Commission should do here. Because the integration teams will be eager to create cost savings right away, the date should be the date of merger consummation. This approach does not mean that cost reductions that begin, say, 75 days after consummation, are deemed to occur on the date of consummation; that assumption would improperly penalize the company. The Applicants' witnesses are unsure when the cost savings will occur, because they are still organizing teams and creating plans. Making the effective date the date of consummation simply gives the Commission the option of taking the time it needs to determine new rates; and then to make those new, lower rates effective as of the date that the rates are appropriate, without violating the prohibition against retroactive ratemaking.

The wrong approach is to leave Pepco free to control the timing of its rate filings. Pepco's natural incentive will be to withhold merger savings for a period of time before filing for new rates, so as to retain the benefits rather than pass them through to its customers.

Q. On this issue of Pepco controlling the timing of its filing, is there cause for concern?

A. Yes. Exelon states that "Distribution-related savings will be included in test periods in future rate cases, resulting in lower test-year costs than would otherwise have occurred." See Exhibit GRID2.0 (A)-56 (Response to OPC DR 4-29). But Exelon *does not say when it will file those future rate cases*. Further, Exelon did not give a straight answer to a direct question. OPC DR 3-7 (Exhibit GRID2.0 (A)-7) asked: "Please explain whether Exelon anticipates recovering some or all of the acquisition premium through its share of retained cost savings." The answer said: "Joint Applicants' Commitment 1, Exelon will not seek recovery in rates of any acquisition premium associated with the Merger." "Not seek[ing] recovery" of the premium means not asking the Commission to put the premium in rates directly. Exelon can recover the premium indirectly, at least in part, by implementing cost reductions while delaying a filing for new rates that would reflect those cost reductions. That is why OPC asked the question.

To say that that "[d]istribution-related savings will be included in test periods in future rate cases, resulting in lower test-year costs than would otherwise have occurred" (Exhibit GRID2.0 (A)-56 (Khouzami Response to OPC DR 4-29)) leaves control in

Exelon's hands, keeping alive the possibility that Exelon can time the rate case filing to retain the savings. Notice also that Mr. Khouzami is a Senior Vice President of BGE and Exelon's Chief Integration Officer. So questions about Pepco's rate case timing are being answered by someone who works for Exelon, not Pepco. This is not consistent with "local control."

If on rebuttal to this testimony, Exelon resists the standard solution of declaring rates "interim subject to refund," we will know that Exelon insists on controlling the timing of its rate case to preserve its ability to retain merger savings rather than pas them through to customers. A condition will be necessary.

Q. Why should the Commission make this decision now, in the merger case?

A. By declaring that rates are interim as of the date of consummation, the Commission prevents the Applicants from controlling rate case timing to withhold savings from consumers, without causing any harm to Pepco's opportunities to seek rates it wants. The action simply places the decision over who gets the merger savings with the Commission rather than with Exelon.

If the Commission does not make the declaration in this proceeding, it will leave Exelon and its investors, and Pepco's consumers and competitors, without a clear picture of Exelon's post-merger financial condition. Consumers will be suspicious that any delay in rate revision will be Exelon's indirect way to recover the acquisition premium; investors who may have been assuming that the acquisition premium will be recovered that very way will not know what to expect. The resulting uncertainty helps no one.

The Commission has said that it "will not hesitate to initiate a Pepco rate case if its future financial reports indicate such an action is warranted." Order No. 17618

(Sept. 4, 2014). This sentence misses the point. Financial reports don't issue daily, so as to reflect Pepco's cost reductions as they occur. They issue quarterly and annually, well after cost reductions might occur. Whatever the Commission learns from these reports, it is bound by the rule against retroactivity to act only prospectively—unless it has previously declared that rates are interim subject to refund. Taking that action simply holds Exelon to its commitment to provide the savings to customers. If the Commission does not act now, the burden of ensuring that savings flow to customers will depend on discretionary actions by the Office of People's Counsel or intervenors, all of whose resources are limited and none of whom will have ongoing access to Pepco's cost information. It is the Commission's obligation, not these intervenors' burden, to ensure that rates reflect cost, and that merger savings go where they belong.

4. The Commission must order full passthrough of the financial savings to ratepayers

Q. Does your solution of making rates "interim subject to refund," as of the date of consummation, apply to all merger savings?

A. For now, I intend the "interim rates" solution to apply only to the so-called "synergy savings." Synergy savings affect the company's operating costs. Since operating costs are inputs into the utility's rates, the proper treatment is to reflect the synergy cost reductions in rates, as of the dates those reductions occur. As I explained above, making rates "interim subject to refund," as of the date of consummation, gives the Commission time to collect the information on post-merger operating costs. Then it can reflect merger-caused reductions in those from the date that the reductions began, without violating the prohibition against retroactive ratemaking.

But synergy savings are not the only merger savings. A distinct category, financing savings, requires a different treatment, as discussed next.

Q. Explain the financing savings, and the necessity of a different treatment.

A. This transaction is a leveraged buyout. In a leveraged buyout, the acquirer borrows money to buy stock. That is what Exelon is doing here. To buy PHI's equity (that is, to buy out PHI's shareholders), and to pay a premium for that equity, Exelon will be using both equity and debt. Put another way, Exelon is replacing PHI's current source of equity (its departing shareholders) with a mix of equity and debt. This action increases the corporate family's leveraging—the role of debt in the family's capital structure.

Doing so produces financial savings to Exelon, because the cost of Exelon's new debt will less than the cost of PHI's current equity. But the rates PHI's utilities currently charge, and will continue to charge immediately after consummation, are based on PHI's pre-merger cost of equity (for the portion of their capital structure that was assumed by their regulators to be equity). For that portion, Exelon will be keeping the excess of (a) the equity cost as reflected in Pepco's (and the other PHI utilities') current rates over (b) the debt cost Exelon will have incurred to replace that equity. These financial savings are not "synergy savings": They do not result from jointly operating assets and businesses that were formerly operated separately. Their source is not in actions performed by Exelon's services company or by Commonwealth Edison, PECO or BGE. Their source is the difference between the cost of PHI's current equity and the cost of Exelon's new debt incurred to replace that equity.

Q. What should the Commission do about these financial savings?

A. They are a distinct reason for the Commission to reject the merger. Exelon's financial savings do not make Pepco a better performer. They do not inspire "best practices," reduce operating costs, add internal accountability, or otherwise align internal incentives with Commission priorities. And they do not represent a free lunch. Instead of making Pepco a better performer, Exelon's extra leveraging leaves Pepco controlled by a weaker company—a holding company whose financial profile carries greater risk than did PHI's. These financial savings therefore represent a distinct conflict of interest. Exelon intends to keep all the financial savings, while the ratepayers and their utilities remain dependent on the weakened company.

Q. You've recommended that the Commission reject the transaction. If the Commission instead intends to approve the transaction, how should the Commission deal with these financial savings?

A. The Commission should require the full financial savings to go to ratepayers, for three reasons. First, to require ratepayers to continue paying rates based on a pre-merger cost of equity that no longer reflects their company's actual finance costs is to violate the principle of cost-based ratemaking, allowing Exelon to earn a return from Pepco's electric business exceeding the authorized return. Allowing this excess return violates the Commission's duty to require the utility to serve at "lowest feasible cost." Second, the post-merger ratepayers will be bearing the risk of their utility being controlled by a holding company more leveraged than PHI. Symmetry of risk and reward requires that if they are bearing the risk associated with this leveraging, they should get the full measure of benefits associated with that leveraging, i.e., all financing savings. Third, allowing Exelon to keep these financing savings creates the incentive and ability to pay the acquisition premium—a premium that, as I explain in Part V.C.2 below, is inappropriate. If it is inappropriate for PHI shareholders to receive a premium above book value, then it is inappropriate to engage in the type of financing that makes that premium possible.

Whereas the flowthrough to ratepayers of the full synergy savings (other than the amount Applicants are guaranteeing) requires a rate case (because we will need more information to predict or observe the operational capital cost reductions), the flowthrough of the financial savings does not need a rate case (because the savings are known now based on Exelon's stated finance plans). Because we know the amounts now, the savings should go to the ratepayers now. If for some reason the Commission decides to await a rate case to determine the financial savings, that is one more reason to declare rates "interim subject to refund" as of the date of the merger; otherwise the Applicants would be retaining these merger savings until the Commission's next rate decision—contrary to cost-based ratemaking, contrary to its stated commitment to provide all merger savings to ratepayers and contrary to its commitment not to recover the acquisition premium from ratepayers.

If a joining of PHI's three utilities with Exelon's three utilities has operational merit, that merit should not depend on an acquisition premium; nor should it depend on the acquirer using debt to buy out PHI's shareholders. If the motivation is to create true savings and improve performance, no buyout should be necessary. The obvious alternative is a true merger, where the PHI shareholders exchange their PHI stock for stock in the combined company, becoming owners of a company that performs better than before.

Q. What if, as a result of the Commission requiring that the financial savings go to ratepayers, Exelon withdraws from the transaction?

A. Then the District and its ratepayers will have avoided the conflicts, costs and risks that I describe in Parts II, III, IV and VI—harms arising from a transaction that, as far as I know, no one at the Commission invited, desired or even contemplated. The Commission then can, and should, establish a merger policy that distinguishes transactions motivated by performance from those that are not. With that policy in place, any transactions that emerge will more likely place customers first.

C. Costs: Affiliating lower-risk Pepco with higher-risk Exelon, while paying an acquisition premium 58% above book value, causes costs that outweigh the benefits

1. Affiliating lower-risk Pepco with higher-risk Exelon

Each of the conflicts and risks discussed in Parts III (Exelon's conflicts) and IV (Exelon's business risks) is a distinct cost to ratepayers. The level of these costs is unknowable. One can try to quantify the costs of the risks we know about, by identifying cost-causing scenarios, then estimating the costs of each scenario and the probability of their occurrence. Exelon has made no effort to do so. But treating the cost as "zero" does not make the cost "zero." Even if Exelon had made the effort, and done so properly, that effort would have addressed only the conflicts and risks that are known. We still would be left with the unknowns: all future acquisitions that Exelon will make, without Commission approval (unless the Commission establishes a condition requiring its approval). Those future acquisitions, which as explained in Part IV.B have no geographic or type-of-business limit, carry a positive cost, but we have no way to know what it is, other than that it is not zero.

Given these facts, here is how things line up:

1. The Applicants have the burden of proving that the consolidation "will be" in the public interest. Exelon does not dispute this point.

2. The benefits, whatever they are, must bear some positive relationship to cost. Exelon does not dispute this point.

3. There are risks to Pepco due to conflicts among Exelon's varied business activities. Exelon disputes this point; we will put it aside for purposes of this line of reasoning.

4. There are risks to Pepco due to Exelon's investments in non-utility businesses. Exelon does not dispute this point, except to disagree over the level of risk.

5. There is no legal limit on what future acquisitions Exelon can make. Exelon does not dispute this point.

6. Any one of those future acquisitions can create risks to Pepco. Exelon cannot dispute this point, because it is no different than #4 above.

It necessarily follows that Applicants cannot meet their burden of proof that this transaction causes no harm.

Q. Is your conclusion that Applicants cannot meet their burden of proof a legal statement or a policy statement?

A. It is both. If the Commission is concerned about legal argument in expert testimony, it can ignore the phrase "Applicants cannot carry their burden of proof" and substitute the phrase "The Commission cannot logically find that the consolidation 'will be' in the public interest." But expert testimony about burden of proof should be seen as policy statement because a burden of proof, while taking a legal form, represents a declaration of policy.

Q. Explain why a burden of proof is a declaration of policy.

A. If a party has a burden of proof, it has the risk of non-persuasion; that is, if it fails to persuade, it loses. That is the Applicants' risk. In this proceeding, Applicants have the burden of proving that the consolidation "will be" in the public interest. That burden reflects a legislative policy: a policy presumption that absent persuasive evidence that a consolidation will be in the public interest, the consolidation should not occur. To apply that presumption in this context makes logical sense. When a company (a) seeks to mix relatively high-risk generation businesses with relatively low-risk distribution businesses, (b) refuses to accept any limits on its future acquisitions of any type, and (c) offers as protection the "ring-fences" that have the gaps described in Part IV.C, it is necessary to presume, that customers will incur costs. And if a party cannot quantify the costs (or like the Applicants, makes no effort to do so), that party cannot show that benefits bear a proper relationship to the costs—whatever that relationship should be. That is the state of play before the Commission: Applicants have not shown that the benefits bear a proper relationship to costs.

2. The 58% acquisition premium

Q. Should the Commission have concerns about the acquisition premium?

A. Yes. In terms of regulatory principle, shareholders have no legitimate expectation of receiving an acquisition premium (which I define here as excess of purchase price over the utilities' book value). If Exelon sees value in Pepco that exceeds Pepco's book cost, that value is a result of two things: (a) the expectation that the District government will continue to give Pepco a valuable franchise to provide services subject to Commission regulation; and (b) ratepayers' monthly obligation, honored by them over many years, to pay rates designed by regulators, in evidentiary proceedings that are constrained by statutory and constitutional law, to cover Pepco's costs and provide an opportunity to earn a fair return on investment.

Q. Aren't the PHI shareholders necessarily entitled to this value because their investment is subject to risk, and/or because of Pepco's operational accomplishments?

A. No, because the rates ordered by the Commission included an authorized return on equity calculated to compensate them for risk; and Pepco's operational accomplishments are what the customers pay for when they pay Commission-mandated rates that reflect the prudent cost of operating Pepco.

In terms of regulatory principles, therefore, there is no logic to PHI shareholders receiving a premium. Yet the PHI shareholders obviously feel entitled to receive it, because they own their stock and because that stock has value to prospective acquirers; otherwise Mr. Rigby and the PHI Board would not have created a competition among bidders to get the highest price.

Q. How, then, should the Commission think about the premium?

A. One might argue that as long as the Commission makes clear that the premium will not be recovered in rates, either directly through rate-basing (which the Applicants have sworn they will not do), or indirectly by delaying a rate case filing so as to withhold savings (which, as I explained in Part V.B.3, Applicants have not sworn they will not do), then there is no problem. That is, if Exelon wants to overcompensate PHI, that is Exelon's business; the Commission can be indifferent.

But viewing the premium with indifference raises at least two problems. First, the fact remains that Exelon must either recover the premium somewhere, or absorb it. Recovering the premium means that somewhere, not necessarily in the District, some customers will pay more for an Exelon product than they would otherwise, because this Commission approved a merger with a premium. That is not a public interest result.

That the cost falls on citizens outside the District does not make it irrelevant to the District; the Commission would be contributing to a pattern of regulatory decisionmaking that, if practiced by other jurisdictions, could affect the District. And if Exelon is unable to recover the premium from customers somewhere (remembering that Exelon will be able to recover the premium, at least in part, from Pepco ratepayers if Exelon can avoid having its rates lowered to reflect merger savings), then it has to carry the cost itself, weakening its own fiscal picture and making it harder to raise the capital it will need to inject equity into Pepco.

Second, by approving a transaction that pays a premium to people who created no value to justify it (as I explained at the beginning of this subsection), the Commission validates and encourages a market for mergers that operates inconsistently with economic efficiency. It is inconsistent with economic efficiency because there is a mismatch between risk and reward, between performance and compensation. By allowing acquisition decisions to be based on who is willing and able to pay the most for the target company, rather than on who is willing and able to offer the most to customers, the Commission would be rewarding acquirers based on ability to pay rather than on ability to perform. Doing so denies utility customers what they pay for: service at a quality and cost that replicates competitive market outcomes.

Q. Does the possibility that Pepco's actual return on equity is less than its authorized return on equity justify PHI's shareholders receiving the premium?

A. No. According to Exelon, "Pepco has demonstrated that it is not earning, and has not earned since 2002, its authorized rate of return approved by the Commission. The primary reason is because the Company is not receiving timely recovery of the significant investments it is making in the infrastructure to improve reliability and customer service." See Exhibit GRID2.0 (A)-2 (Response to GRID2.0 DR 1-64). (The question asked, among other things, why PHI believed that its shareholders should receive the premium.) I will assume for purposes of this paragraph that the quoted statement is undisputed. But one thing has nothing to do with the other. The possible reasons why a utility does not earn its authorized return are many, including: sales below forecast, costs above forecast, delinquencies above forecast, utility's failure to seek rate increases timely, regulator's failure to grant rate increases timely, and utility's failure to perform according to expectations underlying the approved revenue requirement. If rates don't reflect costs, the solution is to file a rate case so that rates reflect costs; and to challenge unsatisfactory regulatory decisions in court. These options are fully available to Pepco. A premium 12 times what ratepayers receive is not the solution to insufficient earnings.

Q. What are your concluding thoughts on the acquisition premium?

A. To allow an acquisition with a premium is to assume that the franchise asset is a private good, to be sold by its owners to the highest bidder. That is the model for New York's taxi medallions—awarded initially by the City, then traded in a secondary market—a process that converts a public privilege into a private commodity. But an exclusive franchise to provide life-preserving distribution service is not like a taxi medallion. The utility franchise is not a private commodity; it never loses its public character. Allowing it to be transferred to the highest bidder leads to results like this transaction—PHI shareholders receiving a guarantee worth over 12 times the amount guaranteed to customers.

Put another way: The sale of Pepco is a sale of two things: its assets and its franchise. The value of the assets is the net present value of the stream of earnings available from the profitable use of those assets. The only profitable use of the assets is to use them to sell Commission-regulated service at Commission-set rates, i.e., embedded cost rates. Embedded cost rates are based on book value. They are designed to produce revenues that allow recovery of prudent expenses, plus recovery of and return on the book value of assets used and useful in providing obligatory service. The net present value of those assets—the stream of earnings from embedded cost rates—is book value. Whatever the PHI shareholders are receiving above book value, then, must be from the sale of the franchise.

But the franchise isn't the shareholders' to sell. The franchise is the government-granted right to be the sole seller of an essential service. The franchise was not created by the shareholders; it was created by government. The market value Exelon sees in the franchise is not value created by shareholders through skill, risk or any other means; it is value created by government action. And that is why the acquisition premium is illogical: It reflects the franchise being auctioned by shareholders to the highest bidder, rather than being awarded by the government to the best performer. By rejecting the transaction, or by preventing Exelon from recovering the premium indirectly (which Exelon would do by withholding the financial savings), the Commission ensures that the steward of the franchise is not PHI's departing shareholders, but the District and its citizens.

For all these reasons, the acquisition premium is a cost to ratepayers, even if it never enters the rates. It is reason enough to reject this transaction. The Commission can, however, reject the merger without prejudice, leaving open the possibility that should the Commission ever design a merger competition in which the winner is the one to offer the best service at the best rates, Exelon can reapply.

* * *

Q. Taking into account all you have said on benefits and costs, what do you conclude?

A. All that this transaction promises ratepayers, independent of what they could have without the transaction, is $50 each—an amount most District residents could save (and quickly forget about) by foregoing cable TV for a month. In return, the utility they depend on becomes "**Pepco—An Exelon Company**." In return for that forgettable $50, their utility leaves the control of the non-generation-owning, low-risk-taking PHI, and comes under the control of Exelon, with its nuclear fleet and fossil generation stock, all its unknown future acquisitions and all the associated risks.

VI.
Competition:
Effects of a Horizontal, Vertical and Convergence Merger on Distributed Energy Markets

Q. In terms of effects on competition, how would you characterize this merger?

A. In terms of effects on competition, this acquisition is three transactions in one. It is a horizontal merger, a vertical merger, and a convergence merger. After describing each of these features, I will address their combined effects on competition in the nascent markets for distributed energy resources.

A. Horizontal aspects

Q. Describe this transaction's horizontal aspects.

A horizontal merger combines two companies that sell, or could sell, the same product or service in the same geographic market. Before the merger, the product or service sold, or to be sold, by one company is viewed as a reasonable substitute by customers of the other company. A horizontal merger therefore eliminates competition between companies that are or could be competitors of each other. Pepco and BGE both sell physical distribution service and electric service, to customers in adjacent territories. Each could sell these services in the other's territory. Competition between them could take the form of benchmark competition, franchise competition, or in the case of services other than physical distribution, head-to-head competition.

Q. What do you mean by head-to-head competition?

A. Head-to-head competition means two or more companies competing simultaneously to sell the same products or services to the same set of customers. Because both Maryland and the District authorize retail competition, each company could sell, directly or through an affiliate, competitive retail electric service in competition with the other. Given each company's size, name recognition, experienced employees and knowledge of the region's load patterns and electricity infrastructure, each company would be a formidable competitor of the other.

Q. What do mean by benchmark competition?

A. Benchmark competition—also known as "across-the-fence rivalry"—enables commissions and customers to compare adjacent companies based on price and quality, and then take action: regulatory action to improve performance or consumer action to change suppliers. As the California Public Utilities Commission has explained, when customers observe that nearby utilities differ in prices or performance, they react in at least three ways:

> [1] Existing customers who are facing other pressures to relocate, such as plant modernization or expansion, may select a site within the area served by the preferred utility. [2] New customers, without an existing location in either service area, will make the same election. These will include residents who may be accommodated by housing or commercial development in areas of the service territory which admit such expansion. [3] Finally, existing consumers with neither the opportunity nor means to relocate will take their complaints to the management of the utility deemed to charge excessive rates or deliver inferior service.[51]

Loss of benchmark competition was among the reasons the California Commission rejected the proposed merger between Southern California Edison and San Diego Gas &

[51] *SCEcorp, Southern California Edison Co. & San Diego Gas & Electric Co.*, Decision No. 91-05-028, 1991 Cal. PUC LEXIS 253, at *236-37 & n.68, *238, *262. *See also AT&T, Inc. & BellSouth Corp.*, 22 FCC Rcd 5662, at 5755 para. 188 (expressing concern that mergers reduce benchmarks, especially concerning "introduction of new technologies and services"), *citing GTE Corp. & Bell Atlantic Corp*, 15 FCC Rcd 14,032, 14,101-03 paras. 132-137 (2000), and *SBC Communications Inc. & Ameritech Corp.*, 14 FCC Rcd 14,712, at 14,770-80 paras. 125-143 (1999).

Electric. Addressing those companies' longstanding rivalry, the Commission found that the public was "advantaged by the presence of proximate comparative data"; data that actually spurred SDG&E to study the reasons for its higher rates. The Commission concluded that "the loss of SDG&E as a regulatory comparison is an adverse unmitigable impact of the proposed merger," diminishing the Commission's "ability to regulate the merged utility effectively."[52] Exelon's acquisition of PHI, which necessarily includes a merger of BGE and Pepco, will similarly deprive customers and this Commission of the ability to compare performance and regulate effectively. It will eliminate "across-the-fence rivalry" because Pepco and BGE will no longer be rivals.

Q. What do you mean by franchise competition?

A. "[T]he public has an obvious interest in competition, 'even though that competition be an elimination bout.'"[53] Pepco and BGE both sell physical distribution service on a franchised monopoly basis. They also each have been appointed by their respective jurisdiction to be the exclusive "last resort" provider of electric service to customers in their service territories who do not shop with competitive providers. As with benchmark competition, each company's knowledge of the region and its infrastructure, and experience in providing these services, makes each a potential competitor of the other for the franchise, should either jurisdiction invite franchise competition. If, for example, the Commission became dissatisfied with Pepco's performance, and decided to investigate

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[52] *Southern California Edison, supra.*

[53] *Hecht v. Pro-Football, Inc.*, 570 F.2d 982, 991 (D.C. Cir. 1977) (*quoting Union Leader Corp. v. Newspapers of New England, Inc.*, 284 F.2d 582, 584 n.4 (1st Cir. 1960)).

the feasibility of alternative suppliers, BGE would be a logical candidate.[54] The threat of a BGE takeover of Pepco's service would act as a competitive discipline that spurred Pepco to keep its costs reasonable and its service quality high. Retail franchise competition thus provides consumers "with their most meaningful opportunity to compare alternate price, quality, and service."[55] Merging BGE with Pepco, as this transaction does, eliminates this opportunity.

Q. What about Ms. Solomon's view (Supp. Dir. at 3) that the merger "presents no material horizontal competitive effect for retail customers in the District"?

A. It is not logically possible to view a merger of two adjacent companies as "present[ing] no material horizontal competitive effect...." BGE and PEPCO are each other's most obvious and formidable competitors—or potential competitors—for various retail and distribution services. Were this transaction solely a merger of BGE and Pepco, she could not have ignored the issue. That there are holding companies layered above each of the two utilities does not change the merger's horizontal character.

It is true, as Ms. Solomon says (Supp. Dir. at 6), that "Pepco and its affiliates are not active in competitive retail markets." But it is not true, as she then says (*id*.) that "no actual or potential retail competitors in the District ... will be eliminated as a result of the

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[54] *See, e.g., Borough of Ellwood City v. Pa. Power Co.*, 462 F. Supp. 1343, 1346 (W.D. Pa. 1979) ("If plaintiffs [municipalities] were to become unable to serve their customers profitably, Penn Power [the local investor-owned utility] would logically be in the best position to assume plaintiffs' present service").

[55] *Town of Massena v. Niagara Mohawk Power Corp.*, No. 79-CV-163, 1980 U.S. Dist. LEXIS 9382, at *28 (N.D.N.Y. 1980) (finding that "it is this very potential [for franchise competition] that provides an incentive for [wholesale competitors] to control costs and improve their performance in the areas that they serve").

Merger." That Pepco's retail competitive electricity affiliate chose to exit that market does not change the point. Absent this merger, Pepco could change its mind, form a new affiliate and enter the competitive market. We'll never know, because if Pepco or its affiliate does enter, it will not be in competition with affiliate BGE. Subsidiaries of the same company don't compete with each other. As the Supreme Court has said:

> A parent and its wholly owned subsidiary have a complete unity of interest. Their objectives are common, not disparate; their general corporate actions are guided or determined not by two separate corporate consciousnesses, but one. They are not unlike a multiple team of horses drawing a vehicle under the control of a single driver. With or without a formal "agreement," the subsidiary acts for the benefit of the parent, its sole shareholder.[56]

B. Vertical aspects

Q. Describe this transaction's vertical aspects.

A. A vertical merger involves companies in the same chain of production, where one company makes or sells an input used by the other company. As the acquisition by a competitive generation seller of a monopoly distribution buyer, this vertical transaction creates the potential for favoritism that would discourage competition to provide generation service to the District's consumers.

Ms. Solomon acknowledges that Exelon has an affiliate competing in the District. But she dismisses its presence by saying it is "but one of about 50 approved retail suppliers in the District; and one of 30 that are currently supplying residential and/or commercial customers." Supp. Dir. at 15. She has isolated one data point that, on its

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[56] *Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752, 777 (1984) (holding that "Copperweld and its wholly owned subsidiary Regal are incapable of conspiring with each other for purposes of sec. 1 of the Sherman Act").

own, cannot logically describe any market's competitiveness. Her statement says nothing about market shares, current or future; nothing about entry barriers, current or future; and nothing about the unearned advantages that a combined Exelon and Pepco could bring to the retail competitive process through positive and negative advertising and through name recognition.[57]

Mr. O'Brien (Direct at pp. 17-18) also says there will be no effect on competition. His statement is not grounded in expertise on competition, because he has spent his entire career working for utilities protected from competition. *Id.* at 1-2. He says that Exelon will comply with the Commission's Code of Conduct rules and "will have in place standards and procedures to prevent preferences and the improper flow of information between Pepco and Exelon's subsidiaries." "Standards and procedures" are evidence of anticompetitive risk; they are not reasons to ignore anticompetitive risk. Were rules and procedures all that were necessary, FERC would not have found, after a decade observing transmission owner behavior under a standard 100-page tariff, that the tariffs contained "flaws that undermine realizing its core objective of remedying undue discrimination."[58] Transmission owners were using their discretion, over how to interpret the rules and even whether to obey them, to behave anticompetitively. Were rules and procedures all that

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[57] That Exelon's rebuttal testimony will seek to address these points—thereby offering arguments that belonged in their direct testimony instead of the generalities offered there—is why GRID2.0 asked the Commission to make provision for surrebuttal. If the Applicants value a full-throated debate, we expect they will support our reiterated request for that opportunity.

[58] Order 890, *Preventing Undue Discrimination and Preference in Transmission Service*, F.E.R.C. Stats. & Regs. para. 31,241, 72 Fed. Reg. para. 12,266 at para. 1 (2007).

were necessary, Constellation (now owned by Exelon) would not have "agreed to pay ... a $135 million civil penalty and $110 million in disgorgement," to settle a FERC investigation of "certain of Constellation's power trading activities in and around the ISO-NY from September 2007 through December 2008."[59]

Nor does it work for Ms. Solomon to say (Supp. Dir. at 5-6) that the various utility affiliates and Exelon Generation and Constellation operate as separate entities. The statement is not consistent with case law or with corporate governance reality. Exelon's CEO has the power to order any of Exelon's subsidiaries to behave as he wishes them to behave—as made clear in the above-quoted passage from *Copperweld*.

In fact, Exelon is trying to have it both ways. Mr. O'Brien and others repeat the Exelon mantra that "best practices" will be spread through the companies through cooperation and idea-sharing, and that "integration" will be successful due to an Exelon-wide corporate culture (as in "**BGE—An Exelon Company**"). To make those things happen, Exelon has to influence Pepco's decisions (and control them if influence doesn't work). But then Ms. Solomon says that in competitive contexts, the individual companies will operate as separate entities, treating each other as rivals to obliterate—so all idea-sharing and cooperation bets would be off. This picture does not work. The risk remains high, given human nature and Exelon's ambitions, that the open communication required to share best practices will remain open when the separate entities can benefit competitively by sharing sensitive data. People with motivation and opportunity have a way of getting around rules—especially when the chance of detection is low and the

[59] Exelon 10-K (2013) at p.406.

consequences if caught are small. On this record there is no information about the chance of detection or the extent of the consequences. Saying "there are rules" proves only that "there are rules."

C. Convergence aspects

Q. Describe this transaction's convergence aspects.

A. A convergence merger joins providers whose products or services can be marketed and provided together in some complementary relationship—where the purchase of one product leads to the purchase of the other. An electric utility (Pepco) merging with a gas utility (BGE or Delmarva) could sell a combined "energy product" to homeowners and businesses. A physical distribution company merging with an energy conservation company could sell a "reduce your energy bills" product.

The transaction also is a conglomerate merger, since it joins companies selling products that have no useful relationship to each other, like Exelon's nuclear generation in the Midwest combined with Pepco's distribution service. Its conglomerate characteristic does not necessarily have competitive effects; it does have the effects of risk-mixing discussed in Part IV.

D. Effects on markets for distributed energy resources

Q. What is the potential for competition in the distribution space?

A. After a century of choicelessness, of buying a uniform product from a single supplier, consumers now have a chance to use new distribution technologies to lower their costs, raise their comfort and reduce the environmental effects of their consumption. New companies are offering thermostat controls, time-of-use pricing, and renewable energy packages, among other products. Consumers are self-supplying with solar panels;

neighborhood-level microgrids and customer-shared supply arrangements may also become feasible, physically and economically. Aggregators of demand response are entering retail markets, offering to pay consumers to use less, thereby displacing higher-cost generation. All these possibilities are important to the District.[60]

These forces are stimulating policy debates about market structures affecting distribution services. Prominent examples are Maine, which is exploring whether to appoint a "smart grid coordinator"; and New York, which is examining the possible roles for a "distribution system platform provider."[61] In both jurisdictions, the questions include whether to make this new service provider an entity other than the incumbent utility.

Q. Given this transaction's characteristics—horizontal, vertical and convergence—what actions could Exelon, or an Exelon-controlled Pepco, take to slow or prevent competitive entry into distribution services markets?

A. Whereas Maine and New York are studying ways to create contests for who can best provide various new distribution services, the Applicants are proposing a combination whose horizontal and vertical features would deter such contests. By combining a non-generation distribution company with a generation company having nuclear and fossil

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[60] *See, e.g., Sustainable DC* at pp. 58-63 (discussing goals of improving the efficiency of energy use to reduce overall consumption, reducing fossil fuel dependency, identifying opportunities for neighborhood-scale renewable energy systems, allowing community solar and renewable energy systems, developing wind farm in the region, developing plan for smart meters and smart grid infrastructure).

[61] *See Investigation into Need for Smart Grid Coordinator and Smart Grid Coordinator Standards,* Maine Public Utilities Commission, Docket Number 2010-267; and "Order Instituting Proceeding," *Proceeding on the Motion of the Commission Regarding Reforming the Energy Vision*, Case 14-M-0101 (N.Y. Pub. Serv. Comm. Apr. 24, 2014).

generation interests, this transaction subjects Pepco's distribution monopoly role to control by an actor whose economic interests can motivate it to oppose competition in distributed resources markets, and who is capable of acting on that motivation.[62]

Here is a list of five actions incumbents can take to deter entry by newcomers. Each is within Pepco's ability to implement; with Exelon as its owner, each is within Pepco's motivation to implement.

1. Enter one of the distributed energy businesses, then lower prices to levels that recover variable cost but not fixed cost. This tactic makes it difficult for the less-resourced competitors to survive because if they try to match the incumbent's price they cannot recover their fixed costs. On their departure, the incumbent can raise prices to recover the fixed costs it did not recover in the prior period. This is not predatory pricing prohibited by the antitrust laws, because the price remains above variable cost. (Courts define the appropriate price floor differently, but pricing above some measure of variable cost is sufficient to avoid pricing unlawfully.) A related strategy is to grant certain customers "most favored nation" status, whereby the incumbent promises those customers a refund of any price increment exceeding the price quoted by any new entrant. Exelon would be able to supply the temporary funds that would allow Pepco to charge prices below fixed cost. Also because of Exelon's large size, it could get volume discounts on products or contracted services, discounts that would not be available to

[62] *See, e.g.*, Federal Communications Commission, WT Docket No. 11-65, *Staff Analysis and Findings* on the proposed (later withdrawn) AT&T and T-Mobile merger (2011) (citing T-Mobile's "disruptive" innovations in retail products and pricing as a reason to keep the companies separate).

independent entrants. Exelon may argue that these discounts simply reflect the efficiencies of large size. But those efficiencies are what economists call "static efficiencies"—short run savings based on current infrastructure. If new entrants are discouraged from entering the market, we lose the potential for dynamic efficiencies—long run savings arising from more competition and more innovation.

2. Create surplus capacity in existing obligatory services, in the name of "load growth." This tactic gives the incumbent a "sunk cost advantage." Customers who want to leave the incumbent for a new supplier may have to pay a stranded cost charge, mandated by the regulator, to allow the incumbent to recover its sunk costs. That charge, combined with the price charged by the new entrant, can make the total cost to the customer higher than if he remains a customer of the incumbent.[63]

3. Refuse to deal (non-discriminatorily, or at all) with a prospective supplier of distributed energy services. A refusal to deal can take different forms. It can be a refusal to provide an important input, like timely interconnection, information on interoperability, data on neighborhood-level load and location, or information necessary to determine the potential for independently-provided storage. It can be a refusal to buy a service, such as storage, distributed generation output or special meters, any or all of which could make unnecessary a prospective utility investment like a substation or

[63] *See United States v. Aluminum Co. of Am.*, 148 F.2d 416, 431 (2d Cir. 1945) ("We can think of no more effective exclusion than progressively to embrace each new opportunity as it opened, and to face every newcomer with new capacity already geared into a great organization, having the advantage of experience, trade connections and the elite of personnel."); *United States v. Syufy Enterprises*, 903 F.2d 659, 673 (9th Cir. 1990) ("It is well known that some of the most insuperable barriers in the great race of competition are the result of government regulation.").

distribution feeder. The refusal to deal could also be indirect, such as discouraging existing customers from buying services from or selling service to the prospective entrant. A variant of refusal to deal is exclusive dealing, where a firm offers a lower price to a party in exchange for its refusal to buy from, sell to, or associate with the offeror's rival.

4. Create entry barriers. Entry barriers are "additional long-run costs [to enter a new market] that were not incurred [or already incurred—my addition] by incumbent firms but must be incurred by new entrants," or "factors in the market that deter entry while permitting incumbent firms to earn monopoly returns." [64] Exelon-controlled Pepco could create entry barriers by withholding customer load data or expansion plans (*i.e.*, data and plans Pepco relies on for its own competitive entry), and using proprietary

[64] *Rebel Oil Co., Inc. v. Atl. Richfield Co.*, 51 F.3d 1421, 1439 (9th Cir. 1995). Other examples of entry barrier definitions are:

> "the extent to which, in the long run, established firms can elevate their selling prices above minimal average costs of production and distribution . . . without inducing potential entrants to enter the industry." (Joe Bain)
>
> "a cost of producing (at some or every rate of output) which must be borne by firms which seek to enter an industry but is not borne by firms already in the industry." (George Stigler)
>
> "socially undesirable limitations to entry of resources which are due to protection of resource owners already in the market." (Carl von Weizsacker)

W. Kip Viscusi, Joseph E. Harrington & John M. Vernon, *Economics of Regulation and Antitrust* at p.159 (4th ed. 2005).

protocols for communications between distributed loads and its own distributed generation assets.[65]

5. Bundle products or services for customers while denying the bundling opportunity to competitors. Customers and suppliers of distributed energy resources will need some set of related services, such as physical distribution, billing services, interconnection, storage, and/or supplemental and backup energy. The Commission's telecommunications experts will recall that 47 U.S.C. sec. 251, added to the Communications Act of 1934 by the Telecommunications Act of 1996, required each incumbent local exchange carrier (ILEC) to offer their local phone service competitors—competitive local exchange carriers (CLECs)—a series of "unbundled network elements" and other wholesale options. The purpose was to prevent the ILEC from using its control of those elements and options to gain an unearned competitive advantage. While Pepco presumably provides retail electricity sellers with nondiscriminatory access to Pepco's physical distribution system, we do not know what other elements currently controlled by Pepco will give Pepco a competitive advantage in various distributed energy resources markets. An element need not be a non-duplicable asset to provide a competitive advantage; it can be, as noted in the discussion of entry barriers above, any "factor[] in

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[65] For a detailed study of the entry barriers electric utility incumbents can create in the distribution space, particularly the "smart grid" space, see Johann Kranz and Arnold Picot, *Toward an End-to-End Smart Grid: Overcoming Bottlenecks to Facilitate Competition and Innovation in Smart Grids* (National Regulatory Research Institute 2011), available at http://www.energycollection.us/EnergyRegulators/TowardEndEnd.pdf. The authors identify three incumbent-controlled "bottleneck facilities": the "last mile," meter data, and interoperability protocols.

the market that deter[s] entry while permitting incumbent firms to earn monopoly returns."

These five strategies, and possibly others, will be available to Pepco not because of its inherent comparative ability or even random luck, but because of two factors: its history of regulatory protection from competition; and its affiliation with Exelon, which will have the motivation and ability to finance these strategies—and the corporate governance power to direct them. And none of these strategies necessarily violates antitrust law. An action need not be anticompetitive in an antitrust sense to stall progress toward effective competition—meaning competition on the merits—in distributed energy resources.

Q. What about the transaction's effect on innovation?

A. To answer that question we need to ask more questions—before the transaction is consummated. We should view competition not only as a way to lower prices but also as a way to induce innovation. The Commission cannot know the effect of this consolidation on innovation without asking questions on matters the Applicants have not addressed. A conscientious inquiry into this transaction's effects on innovation would have at least these four steps:

1. Specify the product areas in which innovation is necessary or desirable; including, at a minimum, where market performance is currently suboptimal.

2. Ask what type of actors and actions will produce the innovations that improve performance in the areas deemed necessary or desirable.

3. Ask what type of market structure will attract the necessary actors, and induce them to take the necessary actions.

4. Determine whether this merger, some other merger, or no merger, affects the market structure in the desired direction, taking into account the range of

> regulatory techniques available to the Commission to induce the necessary actions.

Q. Is it premature to consider these competitive concerns in this proceeding?

A. No. For distributed energy resources to be cost-effective, they must be subjected to distribution-level competition. But distribution-level competition is unlikely to be welcomed by companies that historically have been protected from competition, especially when controlled by companies whose generation assets lose value when distribution customers can choose non-generation alternatives. That is why we need to ask more questions.

The Applicants might argue that these competitive concerns are premature because the District has not yet opted to follow the leads of Maine or New York, that is, investigating market structure options for distributed energy resources. The concern is not premature because the merger will itself change the competitive picture, by creating the motivations and opportunities discussed above. The potential for Exelon and Pepco to adopt the strategies I described, coupled with a Commission decision to approve the transaction without considering these concerns, will reduce the optimism that prospective new entrants might otherwise have about the market for distributed energy resources in the District.

In theory, the Commission could approve the merger without a finding on competition, and then observe its effects. If the effect is negative, the Commission could require Exelon to divest Pepco (which is one reason I recommended the spin-off condition in Part IV.C.6 above); or, start proceedings to replace Pepco as the District's franchisee. But that after-the-fact approach, dramatic as it is, would not correct the error, in the instant proceeding, of failing to examine effects on competition. And as a practical matter, either approach will be complicated and time-consuming. The more practical approach—the approach that creates the necessary insights at the time when we need them—is to have the inquiry about competition now. There is no necessary reason to rush this merger through without essential information.

E. Presumptions and burdens relating to competition

Q. What are your comments on presumptions and burdens, as they apply to the acquisition's effects on competition in the distributed resources markets?

A. As with the benefit-cost relationship (see Part V.C.1 above), it is helpful to consider the policy consequences of the burden of proof and burden of production in the competition context. I have explained that this merger has horizontal, vertical and convergence features, each with consequences for competition. The transaction creates a company serving the distribution space whose economic interests are in keeping generation prices high, in keeping customers dependent on generation, and in keeping customers dependent on the Exelon system. It creates a company that will have available to it the five strategies I discussed above, along with the motivation to carry out those strategies and the financial wherewithal to sustain them until they succeed, or to cover the losses if they fail. Under these circumstances, to presume no adverse effects on competition, thus placing the burden of proving anti-competitive effects on intervenors, is to ignore the obvious: The post-acquisition Exelon, if rational, will seek to maintain and extend control of the distribution space, not cede its growth potential to self-supplying customers and customer-empowering suppliers. The policy presumption must be that the transaction will deter and discourage competition unless shown otherwise, not the other way around.

In considering whether the Applicants have rebutted this policy presumption, the Commission should consider these facts: The competition witnesses offer generalities without analysis (with the exception of Ms. Solomon's discussion of wholesale generation competition, which I do not address). They identify no relevant product market, and no relevant geographic market (same comment). They do not discuss Applicants' current and future plans in those markets, the unearned advantages they will have, or the entry barriers that exist (or that Exelon and Pepco could create). Under these circumstances, I see no path by which the Commission can view Applicants' presentation as sufficient to show that the transaction will not affect distribution services competition adversely.

F. Recommended condition

Q. What is your main recommendation concerning how the Commission should address the merger's effects on competition in distributed energy resources?

A. This merger's structural features create tension with the goal of enhancing competition in the markets for distributed energy resources. There being no need for this merger (prior to its announcement, there was no effort by the Commission to invite this or any other acquisition), the Commission should reject it. If, however, the Commission finds that benefits bear an appropriate relationship to cost, it must preserve its ability to structure future distribution services markets to create the most benefits for District residents, consistent with cost-effectiveness. It can preserve that ability by making clear that its approval does not grant the post-merger entity any right (a) to continue owning and controlling the poles-and-wires business, (b) to become the provider of any new monopoly platform services, or (c) to compete in any of the new distributed services markets; and that whether any of these three activities will be available to Pepco will depend on further investigation and decision.

This three-part condition does no more than preserve the Commission's existing powers. But by stating the condition explicitly, the Commission alerts all affected parties that merger approval means only merger approval. A merger is a purchase of control—in this case, not only of Pepco's assets but its franchise privilege to use those assets to provide exclusive distribution service to District residents. If that future control is uncertain, the value of this transaction to Exelon declines. While that value decline is not the Commission's concern (because the Commission has no duty to protect Exelon's shareholders from their bets), pre-merger clarity helps everyone: Exelon's shareholders, whose company is paying a premium based on its expectation that it will still control the District's franchise; the prospective entrants into the distributed energy markets, who may be investing in products and services designed to reduce Exelon's control; and retail consumers, who want to know what services they will be able to buy, and from whom.

With respect to the foregoing three-part condition, the Commission has three main options.

1. The Commission adopts the recommended condition. If the commission adopts the condition—making clear that the incumbent has no permanent lock on the future distribution roles—one of two things will occur: (a) The companies will merge (perhaps after renegotiating the price) knowing their risks because the Commission has been forthright; or (b) Exelon will withdraw from the transaction, thereby revealing that one reason why it paid a premium was to control the District's service territory. The Commission can then proceed, like Maine and New York—without the distraction of overseeing a multibillion dollar integration process while worrying about Exelon's next acquisition—to assess alternative market structures for distributed energy resources.

2. The Commission explicitly rejects the recommended condition. The logical inference from this action would be that the merged entity will continue to control poles and wires, provide platform services, and be allowed to compete (perhaps through an affiliate) in the markets whose essential infrastructure the utility controls. The Commission could change its mind someday. But having rejected the condition, thus favoring Exelon's control of the service territory, such change-of-mind would be unlikely. The message to prospective entrants would be discouraging.

3. The Commission decides not to decide. A "no-decision," especially silence creates three problems. First, it could be viewed by the Applicants as continuing Pepco's control, indefinitely. Thus comfortable with the transaction price, the parties would consummate their merger. Legally speaking, commission silence signals non-commitment. But the practicalities argue otherwise. If the Commission then were to announce a competition for one or more distribution roles, the merged company's stock value would drop. As explained above, that value loss is not the Commission's legal concern, because shareholders made their bets voluntarily (and it is not necessarily a societal loss, because the value of prospective competitors could rise). But Exelon and Pepco could seek to make Exelon's stock value loss a regulatory concern, by arguing that it raises their cost of capital. Second, consumers won't know which new services will be available, from whom or when. Third, prospective new entrants will hesitate to enter the market, because unlike Pepco, they have no certainty of serving customers while waiting for clarity.

Given these three options and their effects, I recommend the first option: If the Commission does approve this merger, it should make clear that its approval does not grant the post-merger entity any right (a) to continue owning and controlling the poles-and-wires business, (b) to become the provider of any new monopoly platform services, or (c) to compete in any of the new distributed services markets. This option sends the clearest signal possible.

VII.
Possible Conditions:
Insufficient to Correct the Transaction's Imbalances

A. The cost-benefit imbalance

Q. What is your ultimate recommendation to the Commission?

A. I recommend that the Commission reject Exelon's proposed acquisition of PHI because the benefits do not justify the costs.

The proposed $50 per customer benefit is finite in date and amount. Exelon claims the $50 will produce job gains, but there must be easier ways to free up those $50 than completely changing the character of the company that controls Pepco. Exelon's reliability guarantees are illusory, in a literal sense, because the Commission can impose them on Pepco without Exelon's acquisition. The charitable contributions are no more than what Pepco does today. The "best practices" are aspirations rather than commitments, and there is no showing of uniqueness that makes them unavailable to Pepco without this transaction.

While this transaction's "benefits," such as they are, are finite, illusory or noncommittal, the risks and associated costs are real, with no known ceiling or time limit. They will grow as Exelon acquires more companies. That leaves the Commission with the inter-family conflicts, inter-family business risks, the costly acquisition premium and the adverse effects on competition I discussed in Parts III, IV, V and VI.

Notwithstanding my recommendation to reject this transaction, I believe an expert witness should, where possible, contribute value toward options that diverge from his recommendation. This Part VII therefore presents conditions that might reduce the risk of harm. But even if these conditions are practical and enforceable (and I raise questions about their practicality and enforceability), and even if the Commission has the resources to enforce them, they are insufficient to correct the transaction's imbalance between private and public interests.

B. Conditions: Options and objections

Q. Provide proposed language for these conditions.

A. I provide here seven sets of conditions, along with a reference to the sections of my testimony that support them.

1. Future acquisitions

Subject to some minimum level established by the Commission—such level designed ensure no harm to Pepco—no member of the Exelon corporate family shall acquire any interest in any business, unless the Commission finds that such acquisition will improve Pepco's operations or lower Pepco's costs. [See Part IV.B.]

2. Interaffiliate transactions

a. Prior to consummation of the merger, the Commission shall issue a final rule defining the categories of interaffiliate transactions that, if engaged in by any Exelon affiliate, would create a risk of harm to Pepco. Such categories shall include, but not be limited to, financial support provided to non-utility businesses, transactions whose terms vary from arm's-length transactions, and transactions that give any Exelon affiliate any unearned advantage in any market affecting any service subject to the Commission's jurisdiction. This condition does not preclude the Commission from revising the rule from time to time as necessary. Exelon shall (i) agree that all affiliates, existing or future, shall comply with this rule; and (ii) provide to the Commission, for review and approval before any interaffiliate transaction occurs, Exelon's internal rules for compliance, accountability and consequences for violation. [See Part IV.C.5.]

b. Pepco shall not join the General Services Agreement (GSA) until the Commission has found that the GSA, as amended to the extent required by the Commission, will cause no harm to Pepco, including but not limited to opportunity cost harm. In any rate proceeding before the Commission, Pepco shall have the burden of proof (and the burden of producing evidence supporting such proof), that any payment made or received under any interaffiliate agreement was reasonable. [See Part IV.C.5]

3. Budgeting

Exelon shall guarantee that Pepco management will create its own budgets, free of any constraints imposed by Exelon, and that such budgets will be approved by Exelon as submitted by Pepco to Exelon. The Commission will not approve or disapprove Pepco's budgets directly; but Pepco must submit them to the Commission at the time it submits them to Exelon. Exelon shall ensure that whatever funding is necessary to carry out each Pepco budget is made available to Pepco. Executives of both Pepco and Exelon shall certify, according to a form and schedule established by the Commission, that Exelon took no action to constrain Pepco's budget or to constrain Pepco from raising the funds necessary to carry out that budget. [See Part III.D.2.]

4. Spending

Exelon shall guarantee that if the Commission orders Pepco to make any expenditure requiring spending exceeding any Exelon-set budget cap, no Exelon entity or official will prevent Pepco from carrying out such order. This condition does not preclude Pepco from acting on its own to contest any Commission order. [See Part III.D.3.]

5. Competition

a. No later than 1 year following consummation of the merger, the Commission will design and hold a competition to determine what entity can best provide retail SOS service at the lowest feasible cost. Pepco shall provide all data required by the Commission as it designs and holds the competition. [See Part III.B.3.e.]

b. Neither Pepco nor any Exelon affiliate shall deny to any provider of distributed energy services any service, or access to any facility, if the Commission determines that such service or access is necessary for such provider to compete effectively. The Commission shall ensure reasonable compensation to Exelon or its affiliate for any such service or access. [See Part VI.D.]

c. Commission approval of this transaction does not grant the post-merger entity any right (a) to continue owning and controlling the poles-and-wires business, (b) to become the provider of any new monopoly platform services, or (c) to compete in any of the new distributed services markets. [See Part VI.F.]

6. Preservation of benefits for ratepayers

a. As of the date of merger consummation, Pepco's rates shall be "interim subject to refund."

b. Pepco shall flow through to its ratepayers their full pro rata share of the financial savings, relative to finance cost assumptions underlying Pepco's current rates, resulting from Exelon's use of debt to buy PHI's equity.

7. Compliance

a. Prior to consummation of the merger, Exelon shall demonstrate to the Commission's satisfaction that (a) Exelon has instituted internal procedures, with consequences for violations, sufficient to prevent or detect all violations of these conditions; and (b) Exelon employees face no incentives to violate these conditions. [See Part III.C.2.]

b. In addition to any power the Commission has under current law, the Commission has the power, as a result of this condition to which Exelon agrees, to require Exelon to spin-off Pepco to its shareholders, or to require Pepco to disaffiliate from Exelon, if the Commission finds that (i) Exelon's ring-fencing protections prove insufficient to protect Pepco and its ratepayers from any harm, or (ii) the affiliation is harmful to ratepayers for any other reason. [See Part IV.C.6.]

Q. How would you respond to possible objections to these conditions?

A. In the Maryland Commission proceeding addressing its acquisition of Constellation, Exelon opposed any condition that limits the amounts and types of acquisitions Exelon can make, including any requirement that the regulator first determine that a proposed acquisition poses no risk of harm to the local utility. As Mr. Crane stated in his rebuttal testimony in Maryland (at pp.21-23), Exelon does not want to limit its future growth; doing so would "cripple its ability to adapt to a continually changing marketplace and to make decisions that are in the best interests of all of Exelon's stakeholders, including Maryland-based Constellation NewEnergy and BGE." I will restate here what I said then in the surrebuttal allowed by the Maryland Commission:

> I disagree with Mr. Crane's statement of priorities. Exelon's first obligation is to honor the Commission's expectations for [Pepco's] public service performance. To suggest that Exelon cannot honor that obligation without abdicating its other responsibilities is to reverse the priorities. My disagreement with Mr. Crane distills to a simple question: In determining whether an Exelon business opportunity is good or bad for [Pepco], who is the better arbiter—Mr. Crane or the Commission? Rather than allow Exelon to take any risk, regardless of size or wisdom, hoping that the proposed ring-fencing will prevent all harm, the Commission should assess these risks first—just as Exelon will for its investors.

To insist that the holding company should be able to make future acquisitions without limit and without any advance regulatory review is to assume either that (a) a company with multiple conflicts of interests can never make an acquisition harmful to Pepco; or (b) in the event of a conflict, the holding company will always place the public interest first. Neither assumption is supported by logic or common sense.

I have recommended that the Commission reject this transaction because the benefits are too small relative to the costs and risks. If these conditions appear to involve intensive regulatory involvement, I agree; it is because of the intensity of the risks involved in the District becoming dependent on a utility controlled by a holding company with so many activities, conflicts and risks.

Q. Wouldn't financial penalties be more acceptable to Exelon?

A. The question is not what is acceptable to Exelon; the question is what will work. Financial penalties come in two forms. Rate disallowances exclude from the utility's revenue requirement costs not properly attributable to utility service. Fines disgorge the wrongdoer's ill-gotten gains, with some multiplier to make risk-takers calculate conservatively before acting improperly. Both financial penalties share a weakness: The larger the utility error, the weaker the post-penalty company; and so the greater the regulatory hesitance, because unless there is some alternative company ready, willing and able to replace the incumbent, the public interest in a viable supplier competes with the public interest in assigning financial consequences for misbehavior. This moral dilemma inheres in every too-big-to-fail setting. Relying on financial penalties for structural abuse, therefore, is less effective than preventing structures that invite abuse to begin with.

C. Enforceability: Authority and feasibility

Q. Do you have concerns about the enforceability of your conditions?

A. Yes. Most of these conditions apply not to Pepco, but to Exelon and its other affiliates. Exelon might contest these conditions has outside the Commission's current legal powers. Nor is it clear that Exelon, by accepting these conditions, can create in the Commission jurisdiction it does not have by statute. The Commission would have to assure itself of these conditions' enforceability before relying on them. If the Commission finds enforceability is not free from doubt, but that a condition is necessary to ensure that the transaction "will be" in the public interest, it must reject the transaction, or condition its approval on the City Council amending the statute to create the necessary jurisdiction.

Q. Is there a way for the Commission to protect against the possibility of non-enforceability?

A. Yes. If the Commission believes there is doubt about its authority to enforce the conditions against Exelon and its non-Pepco affiliates, it can make clear that its response to an Exelon violation will be to require that Pepco, to retain its franchise to serve in the District, will have to dis-affiliate itself from Exelon. I will refer to this condition as the "spin-off" condition because to satisfy it, Exelon would need to transfer ownership of

Pepco to Exelon's ultimate shareholders, or to some other company approved by the Commission to be Pepco's new owner.

Here is the general principle: The Commission will need to consider this disaffiliation/ spin-off option whenever it determines that Pepco's affiliation with Exelon has become, or is likely to become, detrimental to Pepco's ability to carry out its public service obligations at cost and quality levels that meet the Commission's standards. Examples of such situations include the following:

a. Exelon has blocked Pepco initiatives that the Commission deems necessary.

b. Exelon has declined to raise capital for Pepco in amounts the Commission deems necessary.

c. The Commission finds that the cost to Pepco of equity or debt is higher than it would have been absent its affiliation with Exelon.

d. The magnitude or nature of the business activities in which Exelon or its affiliates are engaged has exceeded some level determined by the Commission to cause a risk of harm to Pepco.

e. A rating agency has downgraded, or has indicated the possibility of downgrading, Pepco's debt due to its affiliation with Exelon.

f. The Commission discovers an interaffiliate transaction that violates appropriate interaffiliate transaction standards to the possible detriment of Pepco.

g. An Exelon affiliate resists Commission requests for information about business activities that could affect Pepco's well-being.

h. The Commission obtains information that Exelon has intervened in Pepco decision-making in a manner potentially detrimental to Pepco.

i. An event external to Exelon, but related to Exelon's business activities, changes the risk portfolio of Exelon's business activities negatively, so as to affect Pepco detrimentally.

Upon a Commission finding of one or more of these events, the Commission would initiate a proceeding to determine whether spin-off or franchise revocation is necessary to ensure that Pepco can serve its customers consistent with the Commission's standards. In that proceeding, the Commission would of course take into account any possible advantages accruing to Pepco from the affiliation that would be lost with a dis-affiliation.

Q. Are there concerns about the feasibility of the spin-off or revocation option?

A. Yes. Exelon (or some interested party, like a shareholder or bondholder or contract partner) could challenge the Commission's authority to order Exelon to spin off Pepco, even if Exelon agrees to such a condition on the merger approval. (That possibility should give the Commission pause, since the public interest does require an exit ramp should circumstances justify separating Pepco from Exelon). I assume, however, that the Commission has the authority to revoke Pepco's franchise to serve the District's customers, for reasons that include any violation by Exelon or an affiliate of these conditions. (And if that authority is unclear, again the Commission should pause, because imposing conditions that are necessary to protect the public interest, without having the ability to enforce those conditions, is not in the public interest.). The Commission therefore should make clear that any approval of this consolidation does not cede whatever authority it now has to revoke Pepco's franchise to serve unless Pepco becomes unaffiliated with Exelon. It then would become Exelon's voluntary decision whether to spin off Pepco or continue to own a Pepco that lost its franchise.

Another concern is practical: There is no way to know now whether there will be an alternative provider willing to take over a utility placed at risk due to Exelon's behavior. Bottom line: If the Commission does not have the ability—legal and practical—to undo corporate affiliations that disserve the public interest, then it must avoid those affiliations to begin with, just as a pilot who does not know how to land a plane should not leave the runway.

Q. What would Applicants' objection to these options say about their priorities?

A. In his Maryland rebuttal (at p.22), Mr. Crane described the spin-off or revocation condition as "draconian." His use of dramatic language exposed his misplaced priorities. A spin-off or franchise revocation might be "draconian" from the holding company's perspective, but not from Pepco's. Post-spin-off, Pepco would be where it is today, with the same standalone status it had, and that hundreds of other utilities once had, and that some utilities still have, with no necessary disadvantage to their customers. To return a utility to simpler times, to its prior low-risk, public interest-dedicated context, is not draconian—from the perspective of the utility's customers.

D. Procedural approach

Q. Do you have a procedural suggestion concerning your conditions?

A. Yes. If the Commission chooses to approve this merger but recognizes the need for conditions, it will need to create, prior to consummation, a second phase to this proceeding to explore and design these conditions. I say this because the present record is insufficient to adopt them in detailed form. The Commission cannot approve the merger first, then design the conditions later, because should it find the necessary conditions impractical or unenforceable, it will be difficult to unwind the merger—and many employees will have wasted their time trying to make the integration work. Should the Applicants object that their merger agreement will fail if the approval does not come sooner, the Commission loses nothing that it could not achieve without the merger (other than the $50 per customer).

Conclusion

Q. **Does this conclude your Direct Testimony?**

A. Yes.

Scott Hempling, Attorney at Law

Scott Hempling is an attorney, expert witness and teacher. As an attorney, he has assisted clients from all industry sectors—regulators, utilities, consumer organizations, independent competitors and environmental organizations. As an expert witness, he has testified numerous times before state commissions and before committees of the United States Congress and the legislatures of Arkansas, California, Maryland, Minnesota, Nevada, North Carolina, South Carolina, Vermont, and Virginia. As a teacher and seminar presenter, he has taught public utility law and policy to a generation of regulators and practitioners, appearing throughout the United States and in Canada, Central America, Germany, India, Italy, Jamaica, Mexico, New Zealand and Nigeria.

The first volume of his legal treatise, *Regulating Public Utility Performance: The Law of Market Structure, Pricing and Jurisdiction*, was published by the American Bar Association in 2013. It has been described as a "comprehensive regulatory treatise [that] warrants comparison with Kahn and Phillips." The second volume will address the law of corporate structure, mergers and acquisitions. His book of essays, *Preside or Lead? The Attributes and Actions of Effective Regulators*, has been described as "matchless" and "timeless"; a Spanish translation will be widely circulated throughout Latin America, through the auspices of the Asociación Iberoamericana de Entidades Reguladoras de la Energía and REGULATEL (an association of telecommunications regulators from Europe and Latin America). The essays continue monthly at www.scotthemplinglaw.com.

His articles have appeared in *The Electricity Journal*, *Public Utilities Fortnightly*, *ElectricityPolicy.com*, publications of the American Bar Association, and other professional publications, covering such topics as mergers and acquisitions, the introduction of competition into formerly monopolistic markets, corporate restructuring, ratemaking, utility investments in nonutility businesses, transmission planning, renewable energy and state–federal jurisdictional issues. From 2006 to 2011, he was the Executive Director of the National Regulatory Research Institute.

Hempling is an adjunct professor at the Georgetown University Law Center, where he teaches courses on public utility law and regulatory litigation. He received a B.A. *cum laude* in (1) Economics and Political Science and (2) Music from Yale University, where he was awarded a Continental Grain Fellowship and a Patterson research grant. He received a J.D. *magna cum laude* from Georgetown University Law Center, where he was the recipient of an *American Jurisprudence* award for Constitutional Law. Hempling is a member of the U.S. Department of Energy's Future Electric Utility Regulation Advisory Group. More detail is available at www.scotthemplinglaw.com.

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Professional Experience

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Adjunct Professor, Georgetown University Law Center (2011–present)

Executive Director, National Regulatory Research Institute (2006–2011)

Founder and President, Law Offices of Scott Hempling, P.C. (1990–2006)

Attorney, Environmental Action Foundation (1987–1990)

Attorney, Spiegel and McDiarmid (1984–1987)

Past Clients

Independent Power Producers and Marketers

California Wind Energy Association, Cannon Power Company, Electric Power Supply Association, EnerTran Technology Company, National Independent Power Producers, SmartEnergy.com, U.S. Wind Force.

Investor-Owned Utilities

Madison Gas & Electric, Oklahoma Gas & Electric.

Legislative Bodies

Vermont Legislature, South Carolina Senate.

Municipalities and Counties

Connecticut Municipal Electric Energy Cooperative; Iowa Association of Municipal Utilities; City of Winter Park, Florida; Montgomery County, Maryland; American Public Power Association.

Public Interest Organizations

American Association of Retired Persons, Consumer Federation of America, Energy Foundation, Environmental Action Foundation, GRID2.0 (Washington, D.C.), Illinois Citizens Utility Board, Union of Concerned Scientists.

State Commissions and Consumer Agencies

Arkansas Public Service Commission, Arizona Corporation Commission, Connecticut Department of Public Utility Control, Connecticut Office of Consumer Counsel, Delaware Public Service Commission, Hawaii Public Utilities Commission, Indiana Utility Regulatory Commission, Kansas Corporation Commission, Maryland Energy Administration, Maryland Attorney General, Massachusetts Attorney General, Massachusetts Department of Public Utilities, Minnesota Public Utilities Commission, Mississippi Public Service Commission, Mississippi Public Utilities Staff, Missouri Public Service Commission, Montana Public Service Commission, National Association of Regulatory Utility Commissioners, Nevada Consumer Advocate, Nevada Public Service Commission, New Hampshire Public Utilities Commission, New Jersey Division of Ratepayer Advocate, North Carolina Utilities Commission, Ohio Public Utilities Commission, Oklahoma Corporation Commission, Pennsylvania Office of Consumer Advocate, South Carolina Public Service Commission, Texas Office of Public Utility Counsel, Vermont Department of Public Service, Virginia State Corporation Commission, Wisconsin Attorney General.

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"Preserving Fair Competition: The Case for the Public Utility Holding Company Act," *The Electricity Journal* (Jan./Feb. 1990).

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"The Legal Standard of 'Prudent Utility Practices' in the Context of Joint Construction Projects," *NRECA/APPA Newsletter Legal Reporting Service* (Dec. 1984/Jan. 1985) (co-author).

Speaker and Lecturer

United States: American Antitrust Institute; American Association of Retired Persons; American Bar Association; American Power Conference; American Public Power Association; American Wind Energy Association; Chicago Bar Association (Energy Section); Columbia University Institute for Tele-Information; Columbia University Institute for Tele-Information; Electric Cooperatives of South Carolina; Electric Power Research Institute; *Electric Utility Week;* Electricity Consumers Resource Council; *Energy Daily;* Executive Enterprises; Exnet; Federal Energy Bar Association; Federal Energy Bar Association; Harvard Electricity Policy Group; Independent Power Producers Association of India; India Institute of Technology-Kanpur; Infocast; Louisiana Energy Bar; Management Development Institute at Gurgaon, India; Management Exchange; Maryland Resiliency Through MicrogridsTask Force; Mid-America Association of Regulatory Commissioners; MidAtlantic Demand Resources Initiative; Mid-Atlantic Conference of Regulatory Utility Commissioners; National Association of Regulatory Utility Commissioners; National Association of State Utility Consumer Advocates; National Conference of Regulatory Attorneys; National Governors Association; National Independent Energy Producers; New England Conference of Public Utility Commissioners; New England Public Power Association; New York Bar Association (Energy Section); North Carolina Electric Membership Corporation; Pennsylvania Bar Institute; Regulatory Studies programs at Michigan State University, New Mexico State University and University of Idaho; Society of American Military Engineers; Southeastern Association of Regulatory Utility Commissioners; U.S. Department of Energy Forum on Electricity Issues; World Regulatory Forum; Yale Alumni in Energy.

International: Canadian Association of Members of Utility Tribunals; Canadian Energy Law Forum; Central Electric Regulatory Commission (India); Comisión Reguladora de Energía (Mexico); Independent Power Producers Association of India; Ludwig-Maximilians-Universitat (Munich, Germany); National Association of Water Utility Regulators (Italy); New Zealand Electricity Authority; New Zealand Commerce Commission; Nigeria Electric Regulatory Commission; Office of Utility Regulation of Jamaica; Regulatel (an international forum of telecommunications regulators); Regulatory Policy Institute (Cambridge, England); The Energy and Resources Institute (India).

Community Activities

Member, PEPCO Work Group, appointed by County Executive of Montgomery County, Maryland (2010–2011).

Sunday School Teacher, Temple Emanuel, Kensington, Maryland (2002–2006, 2008).

Board of Trustees, Temple Emanuel (2005–2006).

Musical performer (cello), Riderwood Village Retirement Community (2003–present).