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December 8, 2014

David J. Collins, Executive Secretary
Maryland Public Service Commission
6 St. Paul Street, 16th Floor
Baltimore, Maryland 21202

Re: Case No. 9361

Dear Mr. Collins:

Enclosed for filing, please find an original and seventeen (17) copies of the Direct Testimony of Scott Hempling and the Public Version of the testimony of J. Randall Woolridge on behalf of the Office of People's Counsel (OPC) in the above referenced case. OPC will file the testimony of its other witnesses later today.

Should you have any questions, please do not hesitate to contact me.

Respectfully submitted,

/electronic signature/
Ronald Herzfeld
Assistant People's Counsel

RH/bl
cc: All Parties of Record

Before the
Maryland Public Service Commission

In the Matter of the Merger	)	
of Exelon Corporation and	)	**Case No. 9361**
Pepco Holdings, Inc.	)	

Direct Testimony and Exhibits of Scott Hempling

On Behalf of the
Maryland Office of People's Counsel

December 8, 2014

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5 **Direct Testimony of Scott Hempling**
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7 **On Behalf of the**
8 **Maryland Office of People's Counsel**
9
10
11 # I. Qualifications and Overview
12
13 ## *A. Qualifications*
14
15 **Q. State your name, position and business address.**
16
17 **A.** My name is Scott Hempling. I am the President of Scott Hempling, Attorney at Law
18 LLC. My business address is 417 St. Lawrence Drive, Silver Spring, Maryland 20901.

19 **Q. Describe your employment background, experience and education.**
20
21 **A.** I began my legal career in 1984 as an associate in a private law firm, where I represented
22 municipal power systems and others on transmission access, holding company structures,
23 nuclear power plant construction prudence and producer-pipeline gas contracts. From
24 1987 to 1990 I was employed by a public interest organization to work on electric utility
25 issues. From 1990 to 2006 I had my own law practice, advising public and private sector
26 clients—primarily state regulatory commissions, and also municipal systems,
27 independent power producers, consumer advocates, public interest organizations and
28 utilities—with an emphasis on electric utility regulation.

29 From October 2006 through August 2011, I was Executive Director of the
30 National Regulatory Research Institute (NRRI). Founded by the National Association of
31 Regulatory Utility Commissioners, NRRI is a Section 501(c)(3) organization, funded

1 primarily by state utility regulatory commissions. During my tenure, NRRI's mission
2 was to provide research that empowered utility regulators to make decisions of the
3 highest possible quality. As Executive Director, I was responsible for working with
4 commissioners and commission staff at all 51 state-level regulatory agencies to develop
5 and carry out research priorities in electricity, gas, telecommunications and water. In
6 addition to overseeing the planning and publication of over 80 research papers by NRRI's
7 staff experts and outside consultants, I published my own research papers, advised
8 contract clients (including state commissions, regional transmission organizations, private
9 industry and international institutions), and wrote monthly essays on effective regulation.
10 In September 2011 I returned to private practice, to focus on writing books and
11 research papers, providing expert testimony and teaching courses and seminars on the
12 law and policy of utility regulation. I am an Adjunct Professor at Georgetown University
13 Law Center in Washington, D.C., where I teach two seminars: "Monopolies,
14 Competition, and the Regulation of Public Utilities"; and "Regulatory Litigation: Roles,
15 Skills and Strategies." Students study the legal fundamentals in class, then apply that
16 learning, under my supervision, in practicums at state and federal regulatory agencies.
17 I have represented and advised clients in diverse state commission cases; and in
18 federal proceedings under the Federal Power Act of 1935 and the Public Utility Holding
19 Company Act of 1935. The latter proceedings took place before the Federal Energy
20 Regulatory Commission (FERC), the Securities and Exchange Commission (SEC), and
21 U.S. Courts of Appeals. As a lawyer, expert witness or Commission advisor, I have

1 participated in 13 merger proceedings.[1] I have testified many times on electric industry
2 matters before Congressional and state legislative committees.

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

[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).

1 My resume is attached to this testimony as Attachment A. More information is at
2 www.scotthemplinglaw.com.

3 **Q. Have you previously submitted expert testimony in other proceedings?**
4
5 **A.** Yes. I have submitted testimony in proceedings before the state utility commissions of
6 California, District of Columbia (in the pending proceeding concerning the instant
7 transaction), Illinois, Indiana, Maryland (on behalf of the State of Maryland in Exelon-
8 Constellation transaction), Minnesota, Mississippi, New Jersey, North Carolina, Texas,
9 Vermont and Wisconsin; before U.S. district courts in Minnesota and Wisconsin; before
10 the Tobacco Arbitration Panel created by the "Master Settlement Agreement" between
11 state attorneys general and major cigarette manufacturers (on behalf of the Maryland
12 Attorney General); before a private arbitration panel in Florida relating to a
13 municipality's proposed acquisition of an investor-owned utility's local electricity
14 business; and before the Superior Court of Justice of Ontario, Canada. In all of these
15 proceedings my testimony or expert report was submitted to the tribunal; in the U.S. court
16 and Ontario matters the witnesses did not appear in person.

17 **Q. For whom do you appear in this proceeding?**
18
19 **A.** I appear on behalf of the Maryland Office of People's Counsel.

20 **Q. Are you attaching any exhibits to your Direct Testimony?**
21
22 **A.** Yes. All my exhibits, other than this Direct Testimony and my resume, are contained in a
23 separate document entitled "Direct Exhibits of Scott Hempling." All those direct exhibits
24 are excerpts from discovery responses and testimony provided by the Applicants in the
25 proceeding on this transaction being held by the Public Service Commission of the
26 District of Columbia. Because those responses and testimony are not jurisdiction-

1 specific, I assume they apply equally to Maryland. Should Applicants notify me of

2 reasons why any of these responses or testimony would be different in Maryland, I will

3 consider the effects of those differences on my testimony.

4 **Q. Explain the relationship between this testimony and the testimony you have**
5 **submitted in the proceeding on this transaction pending before the Public Service**
6 **Commission of the District of Columbia.**

7 **A.** In the D.C. proceeding I submitted Direct Testimony on behalf of the GRID2.0. My

8 Direct Testimony in the instant (Maryland) proceeding does not cover all the issues I

9 covered in D.C. because some were addressed by other witnesses for the Maryland Office

10 of People's Counsel (MD OPC).

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

12 **A.** I reviewed the Application, the testimony and exhibits submitted by Applicants'

13 witnesses, various official financial reports filed by the Applicants (such as 10-K annual

14 reports and PHI's Definitive Proxy Statement associated with this transaction); and

15 discovery from this proceeding, from the related proceeding on this transaction in the

16 District of Columbia and from the Maryland Public Service Commission's 2011-2012

17 proceeding concerning Exelon's acquisition of Constellation.

18 ***B. Overview***
19
20 **Q. What is your conclusion concerning Exelon's proposed acquisition of PHI Holdings?**
21
22 **A.** This acquisition does not satisfy the statutory requirements concerning public interest,

23 benefits and no harm. Here is an overview of my reasons, with cross-references to the

24 relevant parts of my testimony.

25 ***The public interest (Part II):*** The public interest requires a utility that (a)

26 provides obligatory services using the most cost-effective practices; (b) permeates its

1 organization with a full commitment to its jurisdictions' policies; (c) has no motivations,
2 incentives or pressures that are not aligned with its utility service obligations and its
3 jurisdictions' policies; and (d) is fully and willingly accountable to its utility regulatory
4 commissions. A utility cannot satisfy these requirements unless its family's business
5 activities, corporate structure, and financial structure are all consistent with the utility's
6 public service obligations.

7 ***The acquisition fails the "no harm" test (Part III):*** By agreeing to sell PHI to
8 the highest bidder (after structuring a bidding process that pushed the prices up), PHI's
9 Board won for its shareholders an acquisition premium more than 12 times the value of
10 what Exelon is guaranteeing to Pepco's customers. PHI treated its utility franchises like
11 New York City taxi medallions—created by the government as public goods, converted
12 by its owner to private goods and sold to the highest bidder. But a utility franchise is not
13 like a taxi medallion; it is not a private commodity. A utility franchise is an obligation to
14 serve at reasonable cost. Seeking the highest possible purchase price was inconsistent
15 with that obligation. A distinct source of harm is Exelon’s corporate structure, known
16 and unknown. By owning multiple types of businesses throughout the U.S., and by
17 telling its shareholders to expect "growth," Exelon has put itself on a path of acquisitions
18 and risk that is (a) unlimited by geographic or type-of-business considerations, and (b)
19 beyond this Commission's control.

20 Exelon proposes "ring-fencing." But its witness in the District of Columbia case,
21 Ms. Lapson, acknowledges that ring-fencing only reduces—it does not eliminate—risks
22 arising from Exelon's non-Pepco investments. Since each Exelon acquisition adds risk,
23 and since ring-fencing doesn't eliminate those risks, the risks to Pepco are necessarily

1 greater with the acquisition than without. The risks are greater by an increment the
2 Commission cannot calculate, because the source of risk is not only Exelon's existing
3 investments, but also its future acquisitions—acquisitions that are unknown and, due to
4 the 2005 repeal of the Public Utility Holding Company Act of 1935, unlimited by federal
5 utility regulatory law. Not only does "ring-fencing" not promise full protection against
6 the risks it purports to protect against; it does not purport to protect—and does not
7 protect—against any of the following: (1) Exelon-imposed limits on Pepco's access to
8 equity capital, (2) increases in Pepco's cost of capital due to Exelon's other activities, (3)
9 bankruptcy risk if Pepco cannot raise capital, (4) Exelon interference in Pepco's business
10 decisions, and (5) Exelon's abuse of interaffiliate transactions.

11 A distinct source of harm is the loss of "benchmark" competition between Pepco
12 and BGE. Given Exelon's previous acquisition of Constellation, one might view its
13 acquisition of Pepco as a minor, incremental change. But in terms of the Commission's
14 ability to regulate, the change is profound. By eliminating "across-the-fence" rivalry
15 between Pepco and BGE, this transaction removes from the Commission's drawer its
16 sharpest blade: the tool of continuous comparisons between the two companies, each
17 motivated to show up the other.

18 ***The acquisition fails the "benefits" test (Part IV):*** The conflicts and risks
19 introduced by this acquisition are not justified by the asserted benefits. To count toward
20 the public interest, benefits must flow from (*i.e.*, be uniquely attributable to) the
21 transaction; and they must be at a level sufficient to make the acquisition consistent with
22 the public interest. The promised $50 per customer is less than 1/12 the premium over
23 market value that PHI shareholders receive. Customers will forget about that $50 within

1 weeks of receiving it. Exelon's reliability guarantees, addressed in OPC witness
2 Lanzalotta's direct testimony, are illusory, because the Commission can impose them on
3 Pepco as inherent in Pepco's obligation to serve, without Exelon's acquisition.[2] Exelon
4 says it will introduce Pepco to "best practices." But this is a generic category comprising
5 aspirations rather than commitments, and having no features that Pepco could not and
6 should not be employing on its own. And in this context, the term "best practices" is
7 inaccurate. It might have been accurate, had PHI's chief criterion for selecting Exelon
8 been "best performer" rather than "highest bidder."

9

II. The "Public Interest" in Utility Mergers

10
11

A. Maryland's legal standard

12
13 **Q. What legal standard applies to this transaction?**
14
15 **A.** The Commission must find that this transaction "is consistent with the public interest,
16 convenience and necessity, including benefits and no harm to consumers." PUA
17 § 6-105(g)(3). In applying this standard, the Commission must consider 11 "factors,"
18 along with "any other issues the Commission considers relevant to the assessment of the

---

[2] A promise is illusory if one party gives no "consideration,"*i.e.,* nothing of value, to the other party. A party's offer to do something he is obligated to do anyway is not consideration. *See Berger v. Burkoff*, 92 A.2d 376, 379 (Md. 1952) ("The general rule is that a promise to do, or actually doing that which a party to a contract is already under legal obligation to do, is not a valid consideration to support the promise of the other party …").

1 acquisition in relation to the public interest, convenience, and necessity." PUA § 6-
2 105(g)(2).

3 The breadth of this language gives the Commission some flexibility. But that
4 flexibility does not allow the Commission to accommodate conflicts of interest that create
5 a risk of "harm" prohibited by the statute.[3] Utility acquisitions do not occur in a "free
6 market." In such transactions, at least one party, in this case PHI, has (or owns
7 subsidiaries that have) government-granted protections from competition, along with
8 government-imposed obligations to serve. At the same time, at least one party, in this
9 case Exelon, will likely have business aspirations distinct from, and potentially in conflict
10 with, these obligations. The "public interest" standard requires the regulator to eliminate
11 this conflict, because conflict increases the risk of harm. In fact, it is better to prevent the
12 conflict from arising than to hope to dampen it after it arises. A regulator can do so by
13 establishing policies that align the interest of prospective merger partners with the public
14 interest. Such policies then encourage acquisitions that are consistent with the public
15 interest and discourage those that are not, thereby giving guidance to investors,
16 customers, new competitive entrants and others affected by utility acquisitions.

17 In its prior merger decisions, the Commission has focused on the quantity and
18 quality of asserted benefits, and the nature and magnitude of particular risks and costs.
19 But it has not yet articulated a full-fledged definition of the "public interest"—one that

[3] The Commission has found that statutory prohibition against harm includes any increased risk of harm. See Order No. 84698 at text accompanying note 155 ("The statute requires us to ensure that ratepayers are protected against *any* increased risks of harm from this Merger.") (emphasis in original).

1 will produce transactions whose central purpose is to improve performance for
2 Marylanders, as opposed to transactions whose purposes conflict with that goal, which
3 transactions require extensive conditioning in the hopes of avoiding harm. This Part II
4 therefore proposes components for that definition. Part II.B describes the public interest
5 in corporate family characteristics. Part II.C describes the public interest in certainty of
6 outcomes. Part II.D describes the regulatory gap in protection from conflict-inherent
7 corporate structures: a gap caused by Congress's 2005 repeal of the Public Utility
8 Holding Company Act of 1935, and a gap that Section 6-105 requires the Commission to
9 fill.

10 ***B. The public interest in corporate family characteristics***
11
12 **Q. What is the relationship between (a) the public interest in utility acquisitions, and**
13 **(b) the characteristics of utility corporate families?**
14
15 **A.** The public interest requires a utility that (a) provides obligatory services using the most
16 cost-effective practices available; (b) permeates its organization with a commitment to its
17 jurisdictions' policies, so that the motivations and incentives of the investors, executives,
18 workers and the jurisdiction's policymakers are all aligned; and (c) is fully and willingly
19 accountable to the Commission because it does not have, and is not subject to, any
20 business objectives that are in conflict with, or that have the potential to undermine, the
21 jurisdiction's policies. An acquisition will be in the public interest only if the regulator
22 finds that after the acquisition, its utility will satisfy these three criteria.

23 To make the necessary findings, a commission must articulate and carry out
24 policies addressing four key areas: (a) permissible business activities within a utility's
25 corporate family; (b) the types of entities that may own utilities or exercise substantial

1 influence over them; (c) the acceptable corporate structures that connect the corporate
2 family's members, including the acceptable types, terms and conditions of interaffiliate
3 transactions (such as loans, guarantees of indebtedness, and sales and purchases of goods
4 and services); and (d) the market structures that acquisitions can affect. Common to
5 these four areas is the need to avoid conflict between a utility's public service obligation
6 and its owners' business priorities. I will discuss each area in turn.

7 ***1. Business activities***
8

9 **Q. What consideration should a commission give to conflict arising from the post-**
10 **acquisition entity's business activities?**
11

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

Q. How can a commission address these conflicts?

A. A commission can address these conflicts by allowing only those acquisitions 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 underpayment between affiliates. 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-acquisition 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 acquisition, therefore, a commission should

1 ask: Will ultimate control be exercised by individuals whose full focus and professional
2 priority is on service to utility customers? Or will control be exercised by companies and
3 executives whose objectives conflict with the consumer interest?

4 *3. Financial structure*

5

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

8

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

19 *4. Market structure*

20

21 An acquisition changes market structure—the number and types of market
22 participants, the products they sell, their market shares and the assets they control. As
23 Alfred Kahn has written:

24 > The preponderant case for mergers is that they will improve efficiency.
25 > 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.[4]

An acquisition can make a market more competitive or less competitive, resulting in increases or decreases in efficiency, cost, customer service and innovation. A commission's acquisition 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 acquisition assists or impedes progress toward that market structure.

C. The public interest in certainty of outcomes

Q. The statute requires a finding that the transaction "is consistent with the public interest, convenience, and necessity." 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 II.B above), it must find that the transaction "is" consistent with that public interest. The statutory term "is" requires certainty of result. The Commission's policy must make clear that "is" does not mean “might be, under circumstances we cannot guarantee." Certainty requires, from merger applicants, deeds, not words; commitments, not aspirations.[5]

---

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

[5] See Order No. 84698 at text accompanying note 356 (“[P]rojections of benefits through synergies, "shared services" or "best practices" are inherently speculative and, to the extent they materialize, will likely benefit ratepayers only as "forgone requests for

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

10 ***D. The regulatory gap calling for Commission guidance and clarity***
11
12 **Q. Describe the regulatory gap that calls for Commission guidance and clarity in**
13 **merger policy.**
14
15 **A.** The Public Utility Holding Company Act of 1935 (PUHCA) required that each utility
16 holding companies constitute a "single integrated public-utility system." The purpose of
17 this mandate was to align utilities' corporate form with their public service obligations.
18 While the Act had many provisions, the key tools were these:

19 Section 11(b)(1) required the SEC to break up holding company systems that
20 owned scattered utility companies and unrelated businesses, so that after the
21 break-ups, each system would be confined to a single "integrated public-utility
22 system," subject to certain exceptions.
23
24 Section 10(b)(1) required the SEC to disapprove any acquisition by a utility
25 holding company, if the acquisition would "tend towards ... concentration of

---

rate relief," which we have previously held to be too intangible to qualify as a benefit under PUA § 6-105.").

> 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."
>
> 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."

As a result of these provisions, for decades electric and gas utilities “stuck to their knitting,” providing essential utility service to local customers. 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.

Once the SEC, beginning in 1935, achieved 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

1 mergers, for the most part, did not involve the joining of remote electric facilities, or the
2 mixing of utility and non-utility businesses.

3 **Q. How were the Act's restrictions changed in 1992?**
4
5 **A.** The 1992 amendments[6] permitted utility holding companies to acquire, exempt from
6 PUHCA 1935, geographically dispersed generating companies (then known as "exempt
7 wholesale generators"), while still owning traditional state-regulated retail utilities.

8 **Q. What changes did the 2005 repeal bring?**
9
10 **A.** The Energy Policy Act of 2005 removed the remainder of PUHCA 1935's limits and
11 reviews of utility holding company acquisitions. The result was, and is, to allow without
12 limitation holding company arrangements that involve geographically dispersed utilities
13 and mixtures of utility and non-utility businesses. The repeal thus increased the
14 likelihood of structural complexity, because there are no longer any federal statutory
15 limits on geographic remoteness, the mixing of utility and non-utility business,
16 leveraging, private buyouts, or inter-affiliate transactions.[7] Corporate family structures
17 prohibited for 70 years are now possible. Unless states act on their own, acquisitions of
18 dispersed utility companies can occur for reasons other than operational efficiencies. Nor
19 is there any federal legal limit on the mixing of utility and non-utility businesses, the

---

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

[7] There remains some review by the Federal Energy Regulatory Commission under Section 203 of the Federal Power Act, 16 U.S.C. § 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.

number and complexity of corporate layers, or the level of debt-leveraging by the acquirer. In short, no longer does federal law require corporate structure to align with public service obligation. What our grandparents understood as "utilities"—the traditional safe investment—has changed its character.

Q. What about federal antitrust law?

A. Federal antitrust law does not address corporate complication or conflicts of interest between a utility's shareholders and its consumers.

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

A. While PUHCA 1935 was in place, and enforced properly by the SEC, a state commission evaluating a holding company merger could be relatively certain 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 (with certain limited exceptions), the Commission could make a reasonable prediction about the future activities of the family that 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.

That is why the Commission, before addressing this specific transaction, must ask and answer the central question: "What corporate family characteristics will produce the best performance?" Without answering this question first, there is no objective context for judging this transaction, no clear way to align the Applicants' business aspirations with Maryland's priorities. 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 the specific parameters of the public interest in the context of regulated utilities—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 align the motives of acquisition planners with the public interest; and with that alignment, increase the likelihood that the acquisition, once consummated, will be consistent with the public interest.

III. The Acquisition Fails the "No Harm" Test

A. The meaning of "no harm"

Q. The statute requires that there be "no harm to consumers." In applying this test, what factors should the Commission consider?

A. I understand the statutory phrase “no harm” to mean, literally, no harm. That is, the merger must produce benefits, but the benefits are distinct from the requirement of no harm; the benefits are not offsets to harm. There must be a positive result along with the

absence of harm. As the Commission stated in its Exelon-Constellation decision, Order No. 84698 (at text surrounding n.155, emphasis in original, footnote omitted):

> The statute requires us to ensure that ratepayers are protected against *any* increased risks of harm from this Merger; it is our job to eliminate them, either by denying approval outright or through conditions, not to offset them with benefits.

To apply this standard, the Commission first must define "harm." In the public utility context, "harm" means failure to provide quality service cost-effectively. The reason is that 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. Given this requirement, 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. I discuss each type of harm next.

1. Status quo harm

Q. Explain what you mean by status quo harm.

A. An acquisition 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 acquisition 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

1 without fear of losing sales to competitors) or indirect (by discouraging prospective
2 entrants, who will view the jurisdiction as uncommitted to competition on the merits).

3 ***2. Opportunity cost harm***

5 **Q. Explain what you mean by opportunity cost harm.**

7 **A.** As stated in the introduction to this section on harm, in the public utility context "harm"
8 necessarily includes failure to provide quality service cost-effectively. I say "necessarily"
9 because a utility, having received protection from competition, must perform as if subject
10 to competition. It must make all feasible, cost-effective efforts to reduce costs and
11 increase quality. Diverting resources from more productive uses—incurring what
12 economists call "opportunity cost"—fails this test.[8] If a specific merger precludes some
13 other utility action, including some other merger, that would have yielded more customer
14 benefits, that merger causes opportunity costs—harm. In competitive markets,
15 transactions that involve opportunity cost have less success than transactions that do not,
16 all else equal. Disregarding this type of harm in the merger context violates the principle
17 that regulation should produce performance discipline similar to what competition would
18 produce.

19 **Q. How would the opportunity cost concept apply to utility acquisitions?**

21 **A.** A utility acquisition proposal arises, directly or indirectly, explicitly or implicitly, from a
22 competition for control. The target picks the acquirer offering the most to the target's

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[8] "[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).

shareholders. The chosen acquirer is not necessarily the one whose merger with the target would produce the most benefits to consumers. Selecting the 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.

Q. How will you apply these concepts of status quo harm and opportunity cost harm to the instant transaction?

A. As I will describe in Part III.B, PHI did not search for the acquirer that would produce the most customer benefits; it solicited and selected the 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 acquisition.

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. I discuss those harms in Part III.C. 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.

1 *B. The harm from PHI's conflict of interest*
2
3 *1. Factual background: PHI's central goal was highest possible purchase*
4 *price*
5
6 **Q. Describe the gain to PHI's shareholders from Exelon's buyout offer.**
7
8 **A.** The purchase price represents a premium of approximately—

9 "19.6% to the closing price of our common stock on April 29, 2014, the
10 last trading day prior to the public announcement of the proposed
11 Merger."[9]
12
13 "29.5% to our 20-day volume-weighted average share price as of April 25,
14 2014, the third business day prior to the public announcement...."[10]
15
16 58% over the book value of the public utility assets of PHI's three utility
17 subsidiaries.[11]
18
19 **Q. What is your understanding of PHI's goal in this transaction?**
20
21 **A.** PHI's primary goal was to get the greatest gain for its shareholders. The basis for this
22 conclusion is PHI's actions, as PHI has described them:

23 After discussion, the [PHI] Board determined, based on the indications of
24 interest received and the discussions with the counterparties regarding

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[9] 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.

[10] Definitive Proxy Statement at p. 9.

[11] 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-Response to GRID2.0 DR 1-64. PHI's second sentence is irrelevant to calculating the premium based on book value.

> 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.[12]
>
> 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.[13]
>
> 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.[14]
>
> 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 interest and Exelon's comments on the draft merger agreement received on

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

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

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

> 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.[15]

PHI has explained that "[t]he term 'less attractive' [in the preceding quoted paragraph] 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-Response to GRID2.0 DR 1-18(A).[16]

> 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.[17]

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-Response to GRID2.0 DR 1-97 referring to District of Columbia Khouzami Direct Testimony at p. 17 lines 23-25. Even as of October 2014, "Exelon has not yet undertaken an in-depth review of local

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[15] Definitive Proxy Statement at p. 30.

[16] All exhibits cited as "Response" are responses provided by Applicants to data requests in the pending proceeding before the D.C. Public Service Commission.

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

1 priorities in PEPCO's service territory." See Exhibit-Response to DC OPC DR 4-23.

2 PHI claims to have used "due diligence," but it chose a buyer who was willing to pay a

3 multibillion dollar premium over book without "undertak[ing] an in-depth review of local

4 priorities." *Id.*

5 **Q. Is there any evidence that PHI's goal was to obtain from competing bidders the most**
6 **benefit for its utilities' (including Pepco's) customers?**
7
8 **A.** No. At no point was PHI's goal of getting highest price for its shareholders constrained

9 by a goal of finding the merger partner that would produce the most benefit for Pepco's

10 customers. For example, in a section of the Definitive Proxy Statement entitled "Reasons

11 for the Merger" (beginning at p. 32), PHI lists "material factors considered by the Board

12 in determining the desirability of the acquirer." There are 12 positive factors, and nine

13 factors described as "a variety of risks and potentially negative factors." None of 21

14 factors involved ratepayer benefits. The positive considerations all concern benefits to

15 shareholders, most explicitly the one stating that PHI "had conducted a competitive

16 process and that Exelon was the highest bidder in such process." None of the negative

17 considerations include the possible negative effects on utility customers, such as (but not

18 limited to) the possibilities that (a) Exelon's issuance of new debt and equity to finance

19 the purchase will ultimately make it harder for Pepco to borrow money from third parties

20 or access equity from its new parent, (b) Exelon's control of Pepco's spending decisions

21 will prevent Pepco from taking actions necessary to serve its customers cost-effectively;

22 (c) Exelon's interest, as a generation owner, in high generation prices might adversely

23 affect Pepco, which as a non-generation owner has an interest in low generation prices; or

24 (d) Exelon's non-utility businesses, including but not limited to its nuclear activities,

1 could adversely affect Pepco's ability to serve its customers at "lowest feasible cost."
2 Further, the "fairness opinions" commissioned by PHI focus only on whether its
3 shareholders are receiving sufficient value for what they are giving up.

4 **Q. Didn't PHI conduct a "due diligence" investigation of the bidders?**
5
6 **A.** Yes. According to the Definitive Proxy Statement (at p. 31), PHI's senior management
7 performed a "due diligence on Exelon and Bidder D, including with respect to regulatory
8 relationships, reliability, operating track records and employee matters." But a due
9 diligence investigation would focus only on those companies under consideration due to
10 their high price offers. PHI did not search for other prospective acquirers who might
11 perform better. Even among the limited number of companies PHI investigated, there is
12 no sign that PHI compared and ranked them according to their ability to improve Pepco's
13 service. And there is no sign that "due diligence" involved assuring that the chosen
14 bidder would be the best performer.

15 I am not suggesting that PHI ignored its customers; I will assume that PHI did
16 enough "due diligence" to ensure that its chosen acquirer would meet the Commission's
17 minimum standards for performance and might even make some improvements. But
18 price, not performance, was the deciding factor because price, not performance, was the
19 factor PHI used to induce the bidders to compete with each other. PHI could have done
20 the opposite: It could have established a price that was the minimum satisfactory to its
21 shareholders, then required bidders to compete based on how much they could offer the
22 customers. PHI chose the former approach. PHI's approach embodies a decision to have
23 shareholders gain at the expense of consumers.

1 ***2. Regulatory principle: Highest possible purchase price conflicts with***
2 ***service at reasonable cost***
3
4 **Q. Mr. Rigby says there is no conflict between "PHI shareholders wanting the highest**
5 **possible price, and Pepco ratepayers wanting the best possible service." See**
6 **Exhibit-Response to GRID2.0 DR 1-53. What is your response?**
7
8 **A.** His view is illogical. A public utility has an obligation to operate at reasonable cost. Had
9 PHI viewed reasonable cost as its primary obligation, it would have screened prospective
10 acquirers for their ability to meet this standard. But the Board screened acquirers based
11 on their price offers. By not making cost-effectiveness the primary criterion, PHI
12 necessarily failed to consider companies whose price bids would be lower but whose
13 cost-effectiveness would be higher.

14 **Q. What's wrong with a seller of an asset seeking the highest possible price?**
15
16 **A.** Nothing, if all parties affected by the transaction are subject to effective competition.
17 Consider the sale of an apartment building, in a city with plenty of apartment vacancies.
18 The interests of the building seller, building buyer and renters are aligned. The building
19 seller will demand the highest possible price, but the buyer will be willing to pay a price
20 no greater than what he can recover in rentals set by competition in the rental market. So
21 the building buyer will pay a premium no greater than the new economic value he
22 believes he can create as the new owner. That new economic value is a public interest
23 benefit. In a market where there is competition for the ultimate product (in this example,
24 apartment rentals), an acquisition contest run by the acquiree, based on highest possible
25 price, can produce a public interest result.

26 But monopoly utility service is not like apartment rentals. The consumers who
27 depend on Pepco's monopoly distribution service cannot shop elsewhere. That is why the

1 interests of the asset seller, the asset purchaser and the ultimate consumer are not aligned;
2 that is why there is a conflict of interest between the asset seller and the ultimate
3 consumer—between PHI and Pepco's customers. Holding out for the highest price
4 produces an outcome different from holding out for the best performer.

5 **Q. But doesn't regulation replicate the forces of competition?**
6
7 **A.** Possibly, but not necessarily. Regulation, like competition, has imperfections. In the
8 merger context, one imperfection is asymmetry of information.[18] It is unlikely that a
9 regulatory staff could establish for post-merger Pepco, and enforce, the same
10 performance standards that would emerge had PHI selected, competitively, the best
11 performer rather than the highest payor and held it contractually to the promised
12 performance. Utility companies know things regulators don't, like ways to cut costs.
13 With this knowledge advantage, an acquirer of a utility monopoly, unlike the acquirer of
14 an apartment building, can pay a premium and recover it by keeping rates above costs,
15 until the regulator discovers the facts and adjusts the rates.

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[18] *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.").

1 **Q. What was the result of PHI's insisting on the highest possible price?**
2
3 **A.** As calculated by Exelon, PHI's shareholders receive a gain of $1.2 billion premium over
4 market value—12 times the $100 million that the consolidated entity has guaranteed to its
5 customers.[19]

6 ***3. Acquisition premium: Embodiment of the conflict***
7
8 **Q. For regulatory purposes, is the premium over market value the relevant premium?**
9
10 **A.** No. The relevant premium is the much larger premium over book value—58 percent, as
11 noted in Part III.B.1 above. An excess of purchase price over book value is, technically, a
12 windfall, *i.e.*, an amount not within the shareholders' legitimate expectations. The
13 shareholders' legitimate expectation is to receive the net present value of the stream of
14 earnings calculated as a reasonable return on the prudent investment (*i.e.*, book value)
15 made by the utility in assets necessary to serve the public. As Justice Brandeis has stated,
16 in famous language repeated over the decades:

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[19] According to Exelon's response to Exhibit- Response to DC OPC DR 3-7:

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."

1 The thing devoted by the investor to the public use is not specific property,
2 tangible and intangible, but capital embarked in the enterprise. Upon the
3 capital so invested the Federal Constitution guarantees to the utility the
4 opportunity to earn a fair return.[20]
5
6 The gain PHI shareholders will receive bears no relationship to this amount.

7 **Q. You have stated that the premium over book value is technically a windfall because**
8 **it exceeds shareholders' legitimate expectations. Are there other reasons why you**
9 **consider the premium over book value a windfall?**
10
11 **A.** Yes. There is no evidence that Exelon's willingness to pay the premium (and PHI's
12 ability to demand it) is based on Exelon's view that Pepco has demonstrated unique
13 managerial skill, or that PHI's shareholders engaged in unique risk-taking that produced
14 unique business value. In the absence of such evidence, one must infer that Pepco's value
15 to Exelon lies in Pepco's franchise—its longstanding, continuing and exclusive right to
16 provide an essential service in return for monthly customer payments established by
17 government according to statutory and constitutional standards.

18 **Q. Aren't the PHI shareholders entitled to this value because their investment is**
19 **subject to risk, and/or because of Pepco's operational accomplishments?**
20
21 **A.** No. As to shareholder risk, it is necessary to distinguish (a) the utility's investment in
22 public utility assets, from (b) a shareholder's investment in stock purchases. Regulatory
23 law, including the Constitution's Fifth Amendment Takings Clause and the statutory just
24 and reasonable standard, are concerned only with the former: compensating the utility
25 for its investment in public utility assets. The reason is that it is the utility assets that

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

1 constitute the "private property" which the Takings Clause protects. See again the
2 Brandeis quote ("The thing devoted by the investor to the public use is … capital
3 embarked in the enterprise."). Shareholder risk-taking on stock purchases falls outside
4 the constitutional analysis. As for the risk associated with the utility's investment in
5 public utility assets, the rates historically ordered by the Commission have included an
6 authorized return on equity calculated to compensate for that risk. Turning, finally, to
7 Pepco's operational accomplishments: that is what the customers pay for when they pay
8 Commission-mandated rates that reflect the prudent cost of Pepco's operations. There is
9 no logical basis for compensating for performance additionally with an acquisition
10 premium.

11 In short, as I have explained, the premium is a payment exceeding legitimate
12 shareholder expectations, a payment rooted in the value Exelon sees in acquiring a
13 government-granted franchise. Allocating to shareholders a value created by government
14 action rather than competitive success is not consistent with the public interest.

15 **Q. What then should the Commission do about the 58 percent premium?**
16
17 **A.** One might argue that as long as the Commission makes clear that the premium will not
18 be recovered in rates, either directly through rate-basing (which the Applicants have
19 sworn they will not do), or indirectly by delaying a rate case filing so as to withhold
20 merger savings from consumers (which Applicants have not sworn they will not do), then
21 there is no problem. That is, if Exelon wants to overcompensate PHI, that is Exelon's
22 business; the Commission can be indifferent. But viewing the premium with indifference
23 raises at least two problems.

1 First, the fact remains that Exelon must either recover the premium somewhere, or
2 else it has to carry the cost itself, weakening its own fiscal picture and making it harder to
3 raise the capital it will need to inject equity into Pepco. Second, by approving a
4 transaction that pays a premium to people who created no value to justify it (as I
5 explained at the beginning of this subsection), the Commission validates and encourages
6 a market for mergers that operates inconsistently with economic efficiency. It is
7 inconsistent with economic efficiency because there is a mismatch between risk and
8 reward, between performance and compensation. By allowing acquisition decisions to be
9 based on who is willing and able to pay the most for the target company, rather than on
10 who is willing and able to offer the most to customers, the Commission would be
11 rewarding acquirers based on ability to pay rather than on ability to perform. Doing so
12 denies utility customers what they pay for: service at a quality and cost that replicates
13 competitive market outcomes.

14 **Q. What are your concluding thoughts on the acquisition premium?**
15
16 **A.** To allow an acquisition with a premium is to assume that the franchise asset is a private
17 good, a mere commodity, to be sold by its owners to the highest bidder. The utility
18 franchise is not a private commodity; it never loses its public character. Allowing it to be
19 transferred to the highest bidder leads to results like this transaction—PHI shareholders
20 receiving a guarantee worth over 12 times the amount guaranteed to customers.

21 Put another way: The sale of Pepco is a sale of two things: its assets and its
22 franchise. The value of the assets is the net present value of the stream of earnings
23 available from the profitable use of those assets. The only profitable use of the assets is
24 to use them to sell Commission-regulated service at Commission-set rates, *i.e.*, embedded

1 cost rates. Embedded cost rates are based on book value. They are designed to produce
2 revenues that allow recovery of prudent expenses, plus recovery of and return on the
3 book value of assets used and useful in providing obligatory service. The net present
4 value of those assets—the stream of earnings from embedded cost rates—is book value.
5 Whatever the PHI shareholders are receiving above book value, then, must be from the
6 sale of the franchise.

7 But the franchise isn't the shareholders' to sell. The franchise is the government-
8 granted right to be the sole seller of an essential service. The franchise was not created by
9 the shareholders; it was created by government. The market value Exelon sees in the
10 franchise is not value created by shareholders through skill, risk or any other means; it is
11 value created by government action. And that is why the acquisition premium is
12 illogical: It reflects the franchise being auctioned by shareholders to the highest bidder,
13 rather than being awarded by the government to the best performer.

14 For all these reasons, the acquisition premium is a cost to ratepayers, even if it
15 never enters the rates. It is reason enough to reject this transaction.

16 ***4. Avoiding conflict of interest: Commission solutions***
17
18 **Q. In the merger context, can a commission eliminate the conflict between a target**
19 **company's purchase price goals and its service obligations?**
20
21 **A.** Yes. A commission can eliminate the conflict if it requires a target company to prove
22 that it selected the acquirer that can perform most cost effectively for customers. That
23 principle adds nothing to the incumbent's obligation to operate at reasonable cost; it
24 merely applies that obligation to the merger context. Nor does the principle trump the
25 target's fiduciary obligation to its shareholders to get the highest possible price, because

1 that fiduciary obligation is always subject to complying with whatever are the laws in the

2 relevant jurisdiction.

3 ***C. The harm from Pepco's exposure to Exelon's business risks, known and***
4 ***unknown***
5
6 ***1. Exelon's generation faces multiple risks***
7
8 **Q. What types of risks affect Exelon's generation investments?**
9
10 **A.** Exelon has acknowledged risk to its generation business in least four categories:

11 operational risk, climate change risk, risk from low-cost shale, and nuclear-specific risk.

12 ***a. Operational risk***

13 **Q. What has Exelon said about operational risk?**
14
15 **A.** In its 2013 10-K at p. 50, Exelon states:

16 The Registrants' businesses are capital intensive and require significant
17 investments by Generation in energy generation and by ComEd, PECO
18 and BGE in transmission and distribution infrastructure projects. These
19 operational systems and infrastructure have been in service for many
20 years. Older equipment, even if maintained in accordance with good utility
21 practices, is subject to operational failure, including events that are beyond
22 the Registrants' control, and may require significant expenditures to
23 operate efficiently. The Registrants' results of operations, financial
24 condition, or cash flows could be adversely affected if they were unable to
25 effectively manage their capital projects or raise the necessary capital.
26 Furthermore, operational failure could result in potential liability if such
27 failure results in damage to property or injury to individuals....
28
29 ***b. Climate change risk***

30 **Q. What has Exelon said about climate change risk?**
31
32 **A.** As an owner of 12,165 mW of fossil generation plants, Exelon has described a distinct

33 risk (Exelon 2013 10-K at p. 33):

34 Despite its focus on low-carbon generation, Exelon believes its operations
35 could be significantly affected by the possible physical risks of climate
36 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.

c. 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.

d. 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....

1 Constellation Energy Nuclear Group, Inc. Generation [a subsidiary of
2 Exelon] also owns a 50.01% interest in CENG, a joint venture with EDF
3 [Electricite de France]. ... CENG owns and operates a total of five nuclear
4 generating facilities on three sites, Calvert Cliffs, Ginna and Nine Mile
5 Point. CENG's ownership share in the total capacity of these units is
6 3,998 MW. ...
7
8 **Q. What has Exelon said about risks specific to its ownership and operation of nuclear**
9 **plants?**
10
11 **A.** Owning and operating nuclear power plants, which can be subject to rule changes,
12 breakdowns and accidents, is a source of multiple risks. See Exelon's 2013 10-K at p. 14:
13 "Generation is subject to liability, property damage and other risks associated with major
14 incidents at any of its nuclear stations, including the CENG nuclear stations."
15 **Q. Are there other nuclear-related risks?**
16
17 **A.** Yes. In the quote presented immediately above, Exelon lists the risks we know about.
18 There are also risks—unknown risks—concerning nuclear waste. Exelon is legally
19 responsible for the toxic waste caused by its production, but no one has determined what
20 will be the legal means of disposing of that waste permanently. That is Exelon's gamble:
21 that someday, somehow, somewhere, someone will take care of its waste, without
22 unanticipated cost to Exelon:
23 Nuclear Waste Disposal. There are no facilities for the reprocessing or
24 permanent disposal of SNF [spent nuclear fuel] currently in operation in
25 the United States, nor has the NRC licensed any such facilities. Generation
26 currently stores all SNF generated by its nuclear generating facilities in
27 on-site storage pools or in dry cask storage facilities. Since Generation's
28 SNF storage pools generally do not have sufficient storage capacity for the
29 life of the respective plant, Generation has developed dry cask storage
30 facilities to support operations.
31
32 As of December 31, 2013, Generation had approximately 59,900 SNF
33 assemblies (14,400 tons) stored on site in SNF pools or dry cask
34 storage....All currently operating Generation-owned nuclear sites have on-
35 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

1 of new loans to Pepco. In fact, Exelon has acknowledged that "[a]t least one Exelon
2 utility subsidiary witness, prior to electric restructuring, identified 'nuclear risk'
3 associated with utility nuclear operations as one component among the array of business
4 risks, including 'regulatory risk' and other forms of risk, that form the risk profile of a
5 utility company." See Exhibit-Response to GRID2.0 DR 1-42(B).

6 ***2. Exelon can increase its risks, through acquisitions unlimited by***
7 ***geographic or type-of-business boundaries***
8
9 **Q. Beyond the operational, climate change, shale gas and nuclear power risks**
10 **associated with its current generation investments, can Exelon increase its risks?**
11
12 **A.** Yes. As I explained in Part II.D, the 2005 repeal of the Public Utility Holding Company
13 Act of 1935 leaves Exelon free to acquire more companies without geographic or type-
14 of-business limit. Consistent with this open field, "[Exelon] Generation continuously
15 looks to invest in new business initiatives and actively participate in new markets. These
16 include, but are not limited to, unconventional oil and gas exploration and production,
17 residential power and gas sales, solar and wind generation, and managed load response."
18 Exelon 2013 10-K at p. 63.

19 Exelon's acquisition activities will not necessarily be confined to generation. In
20 this Commission's proceeding on Exelon's acquisition of Constellation (Case No. 9271),
21 Exelon opposed my proposed condition (on behalf of the State of Maryland) requiring
22 Commission permission before it made additional acquisitions. Just as Exelon is seeking
23 to buy PHI only two years after buying Constellation and BGE, two years from now
24 Exelon could be buying Southern California Edison, or gold mines, or utilities in
25 Ukraine. Hyperbole, yes; and intentionally so, because it causes the Commission to ask,

1 "Once we approve this transaction, what are the limits on Exelon's activities?" The

2 Commission cannot, consistent with the public interest, be indifferent to the answer.

3 The lack of limits on acquisitions is a public interest concern, because these future

4 acquisitions involve real risk, as Exelon has acknowledged (Exelon 2013 10-K at p. 63):

5 Such initiatives may involve significant risks and uncertainties, including
6 distraction of management from current operations, inadequate return on
7 capital, and unidentified issues not discovered in the diligence performed
8 prior to launching an initiative or entering a market. As these markets
9 mature, there may be new market entrants or expansion by established
10 competitors that increase competition for customers and resources.
11 Additionally, it is possible that FERC, state public utility commissions or
12 others may impose certain other restrictions on such transactions.
13
14 In a discovery response in the D.C. case, Exelon witness Lapson recognized that

15 the level of concern for Pepco's well-being is related to both the size of Exelon's non-

16 regulated activities, and the lending community's perceptions of Exelon's

17 creditworthiness:

18 Two indicators would provide guidance that there is reduced need for
19 strenuous ring fencing provisions that are proposed for the initial period.
20 First, *does the Exelon group still contain a large non-utility merchant*
21 *energy/power generation business*. Companies change their business
22 portfolios over time; for example several years ago, Pepco Holdings Inc.
23 was the parent of a power generation and merchant energy business that is
24 no longer part of the PHI group. A further indicator is *whether the credit*
25 *ratings of Exelon Corp. are equivalent to or higher than the current*
26 *ratings (and not on a negative watch.*
27
28 See Exhibit-Response to AOBA DR 2-10 (emphasis added). Separately, however, she

29 asserts that "D.C. ratepayers do not face any material or quantifiable risk due to the

30 proposed merger, considering the ring-fencing and other measures proposed by the Joint

31 Applicants and the separate corporate structure of Exelon's unregulated businesses." See

Exhibit-Response to DC OPC DR 14-51. I will address the problems with ring-fencing, and Ms. Lapson's views on that subject, next.

3. "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-Response to DC OPC DR 3-2 (emphasis added). See also District of Columbia Khouzami Direct Testimony at pp. 8-13 (discussing ring-fencing).

The question is not what Joint Applicants “believe,” but what the facts show. 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 now, 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 the 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 risk rather than less risk is not consistent with the public interest.

a. 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....

1 **Q. But doesn't ring-fencing protect Pepco from Exelon's "financial stress"?**
2
3 **A.** Not if the result of that financial stress is to leave Pepco with insufficient access to
4 equity. In describing ring-fencing's role, Ms. Lapson states (District of Columbia Supp.
5 Dir. at 10):[21] "[T]he protected company [in this instance, Pepco] should not be exposed
6 to a risk of defaulting on its own obligations or of losing liquidity due to the financial
7 stress or bankruptcy of its parent or affiliates (assuming that the protected company is
8 sound on a stand-alone basis)." Ms. Lapson states also (District of Columbia Supp. Dir. at
9 11) that "the protected subsidiary should maintain independent access to liquidity sources
10 and the ability to fund itself on its own."

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

18 Ms. Lapson states (District of Columbia Supp. Dir. at p. 11) that "there should be
19 controls limiting the ability of the parent or affiliates to draw resources or assets from the

[21] All references to Ms. Lapson, unless otherwise noted, are to her Supplemental Direct Testimony in the D.C. case (filed Sept. 19, 2014). In the interest of a full-throated debate on these points, and on the expectation that Ms. Lapson will be a rebuttal witness in the instant case (or that similar positions will be expressed by some other witness), I have brought forward this material now rather than wait for surrebuttal.

1 protected company, or to transfer liabilities and debt to the protected company." She is
2 correct, and the proposed ring-fencing measures provide that protection. But those
3 measures omit the logical companion: requirements that the parent provide the utility
4 with the equity capital necessary to enable the utility to carry out its legal obligations at
5 the lowest feasible cost to ratepayers.

6 ***b. Increases in Pepco's cost of capital***

7 **Q. Does Exelon acknowledge that its ring-fencing proposal cannot prevent increases in**
8 **Pepco's cost of capital?**
9
10 **A.** Yes. Because securities laws require disclosure of negatives, Exelon has acknowledged
11 that ring-fencing leaves gaps:

12 > These [ring-fencing] measures ... *may help* avoid or limit a downgrade in
13 > the credit ratings of ComEd, PECO and BGE in the event of a reduction in
14 > the credit rating of Exelon. Despite these ringfencing measures, the credit
15 > ratings of ComEd, PECO or BGE could *remain linked*, to some degree, to
16 > the credit ratings of Exelon. Consequently, *a reduction in the credit rating*
17 > *of Exelon could result in a reduction of the credit rating of ComEd, PECO*
18 > *or BGE, or all three*. A reduction in the credit rating of ComEd, PECO or
19 > BGE could have a material adverse effect on ComEd, PECO or BGE,
20 > respectively.
21
22 Exelon 2013 10-K at p. 46 (emphasis added). Exelon has elaborated on this point (see
23 Exhibit-Response to GRID2.0 DR 1-93 (emphasis added):

24 > Exelon is *not saying that there is no possibility* that events elsewhere in
25 > the Exelon corporate family will affect the cost of debt to Pepco.
26
27 > The cost of debt to Pepco is primarily a function of the risk free (US
28 > Treasury) rate plus an issuer-specific credit spread, which is strongly
29 > influenced by ratings given to Pepco's debt by the rating agencies. The
30 > credit ratings of Pepco *may be influenced to some extent by the credit*
31 > *ratings of Exelon Corporation following the proposed merger, despite the*
32 > *ring-fencing and other measures proposed by Exelon*. The proposed ring-
33 > fencing and other measures *may help* avoid or limit a downgrade in the
34 > credit ratings of Pepco in the event of a reduction in the credit rating of
35 > Exelon Corporation, but *those ring-fencing and other measures will not*

1 *completely insulate Pepco from effects of a decline in the credit rating of*
2 *Exelon Corporation.*
3
4 Although the ring-fencing and other measures proposed by Exelon are
5 designed to protect PHI and its subsidiaries from consolidation in a
6 bankruptcy proceeding for Exelon, a bankruptcy of Exelon *could affect* the
7 credit ratings of its subsidiaries. A downgrade in the credit ratings for
8 Pepco could result in an increase in the cost of borrowing for those
9 companies.
10
11 **Q. What do the rating agencies think of ring-fencing?**
12
13 **A.** Exelon has acknowledged that the rating agencies do not view ring-fencing as a
14 guarantee against risk:
15 Standard & Poor's normally assigns a credit rating to a consolidated
16 company using a variety of factors and then assigns credit ratings to the
17 individual members of the consolidated group with reference to the
18 consolidated credit rating. S&P then rates individual debt securities.
19 Normally, the credit ratings assigned by S&P to a holding company's
20 subsidiaries will be aligned with the parent company's consolidated rating
21 from S&P; however, with effective ring fencing measures in place, S&P
22 will allow ratings of subsidiaries to differ by as much as three "notches"
23 on the ratings scale. In contrast, Moody's and Fitch determine the
24 individual ratings of members of the consolidated group, including the
25 holding company, and then *will generally assign a consolidated rating*
26 *based on the aggregate of the subsidiaries*. Moody's and Fitch do not have
27 explicit ring-fencing guidelines in their ratings practices, so the effect of a
28 downgrade for Exelon Corporation on the Moody's and Fitch ratings of
29 ring-fenced subsidiaries is less predictable.
30
31 See Exhibit- Response to GRID2.0 DR 1-93 (emphasis added). So even with ring-
32 fencing, Exelon cannot guarantee protection; Exelon can only "expect" and "believe":
33 Given the current ratings indications from S&P, Moody's, and Fitch on
34 Exelon and PHI and their subsidiaries, Exelon *does not expect* that the
35 merger will result in any change in the ratings of Pepco. With the
36 proposed ring-fencing measures in place following the merger, Exelon
37 *expects* that S&P's current corporate rating for Exelon could decline by
38 one notch without any effect on S&P's current corporate ratings for PHI
39 and its subsidiaries. Exelon Corporation has consistently stated that
40 maintaining its investment grade credit rating is its number one financial
41 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-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 (District of Columbia 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

1 Exelon's corporate family, that lender can insist on the very conditions that Ms. Lapson
2 says "should not [be] include[d]"and neither Pepco nor Ms. Lapson nor Exelon's ring-
3 fencing language can do anything about it.

4 ***c. Bankruptcy risk***

5 **Q. Does Exelon's ring-fencing proposal remove the risk that Exelon's' business failures**
6 **could push Pepco into bankruptcy?**
7
8 **A.** No, it does not remove that risk. The proposal prevents Exelon from using its
9 stockholder control of Pepco to force Pepco into bankruptcy. But the proposal does
10 nothing to prevent Pepco from facing bankruptcy because it suffers a cash or capital
11 shortage due to Exelon's financial stresses—such as where Exelon ability to finance
12 Pepco's equity is constrained due to Exelon's problems (including, should Exelon enter
13 bankruptcy, the bankruptcy court's conditions on Exelon's capital flows).

14 **Q. Does Ms. Lapson assert that due to ring-fencing, Exelon's business failures could**
15 **not cause Pepco to enter bankruptcy?**
16
17 **A.** No. Ms. Lapson recognizes the possibility that a distressed parent might cause a utility
18 subsidiary to need to enter bankruptcy. (District of Columbia Lapson Supp. Dir. at 12-
19 13) She refers to two solutions: "an independent director (or directors) on the Board of
20 Directors [of the protected company] whose affirmative vote is required in order for the
21 protected company to file a voluntary petition of bankruptcy or take certain other
22 bankruptcy-related actions"; and "grant[ing] to a third-party shareholder or another form
23 of independent a 'golden share' with voting rights to cast a deciding vote on decisions
24 regarding filing a petition of bankruptcy or similar actions." In other words, both the
25 independent director and the golden shareholder would have the discretion to vote for, or
26 against, Pepco entering bankruptcy. If Exelon's failures limit cash flow to Pepco, such

1 that Pepco cannot meet its financial obligations, nothing prevents these directors from
2 voting to place Pepco in bankruptcy.
3 Ms. Lapson has stated that the "overall objective [of ring-fencing] is to enable the
4 protected company to sustain its viability and fulfill its business and financial obligations
5 without adverse effects relating to the financial stress of other entities within the related
6 corporate group." District of Columbia Lapson Supp. Dir. at 5. But as I explained above,
7 if Exelon's financial problems render it unable to supply equity to Pepco, or cause rating
8 agencies to downgrade Pepco's debt so as to render Pepco unable to finance its
9 obligations, ring-fencing does not fix this problem. Further, if ring-fencing were truly to
10 achieve the objective of keeping Pepco out of bankruptcy should Exelon fail, the
11 proposed ring-fencing provisions would deny the independent director, and the golden
12 shareholder, the authority to vote for bankruptcy, in situations where the utility has no
13 independent financial reason to take that step. Of course, denial of such authority would
14 not make sense because if Pepco cannot finance its business, whether due to Exelon's
15 failures or other reasons, filing voluntarily for bankruptcy could be Pepco's prudent
16 course. The point is that Exelon's stresses can lead to Pepco stresses, resulting in Pepco's
17 bankruptcy. Ring-fencing does not prevent this result, because it does not alter Pepco's
18 financial dependency on Exelon. It is that dependency on Exelon, as opposed to Pepco's
19 dependency on PHI, that makes this transaction risky for Pepco.
20 Indeed, Ms. Lapson acknowledges, as she must, that these protections could fail
21 in their purpose. She can say only that the special purpose entity (SPE), the presence of
22 its independent director and golden shareholder "will greatly reduce any possibility of a
23 voluntary bankruptcy filing by either the SPE or PHI for any cause other than the

financial distress of PHI or the SPE." District of Columbia 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.

1 *d. Exelon's interference in Pepco's business decisions*

2 **Q. Does ring-fencing prevent Exelon from controlling or otherwise interfering with**
3 **Pepco's activities in carrying out its public service obligations?**
4
5 **A.** No. Ms. Lapson (District of Columbia Supp. Dir. at 10) states that with ring-fencing,
6 "the protected company should have the ability to maintain its own business, resources,
7 and solvency, unaffected by its parent or affiliates." Her term "should" is ambiguous: Is
8 a prediction or a normative statement? What it is not is a guarantee, because the ring-
9 fencing proposals don't achieve this objective. Pepco cannot "maintain its own business
10 [or] resources" if its ultimate parent limits its spending, or causes Pepco to erect entry
11 barriers to new competitors in distributed energy resources. Even if ring-fencing could
12 provide complete protection from financial risk—which it does not, as explained in the
13 preceding subsections—there remains the risk that Exelon's business objectives will
14 interfere with Pepco's public service obligations.

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

1 *e. Interaffiliate transaction abuse*

2 **Q. Does ring-fencing ensure arm's-length relationships between Pepco and Exelon's**
3 **many affiliates?**
4
5 **A.** No. Ms. Lapson states (District of Columbia Supp. Dir. at p. 22) that "PHI will maintain
6 arm's-length relationships with Exelon and its affiliates, including the SPE [special
7 purpose entity] ...." This statement is true only in part. When two companies are in an
8 arm's-length relationship, they behave as if unrelated. That means that each has
9 competitive alternatives to the other, and each is itself subject to effective competition.
10 In the specific context of interaffiliate transactions, I will assume that the Commission's
11 rules will replicate an arm's-length relationship, with interaffiliate pricing rules that
12 replicates what would exist in a competitive market. The problem is that the Exelon-
13 Pepco relationship consists of more than interaffiliate transactions. If Exelon and PHI
14 were in an arm's-length relationship, Exelon could not (a) impose spending limits on PHI
15 and its subsidiaries, (b) determine unilaterally (based on various business objectives
16 conflicting with Pepco's public service obligations) how much equity Exelon should
17 inject into PHI (and from PHI into the utility subsidiaries), (c) dictate who sits on the
18 boards of PHI and its subsidiaries, (d) choose the top utility executives, or (e) establish
19 what positions PHI and its utility subsidiaries should take on regulatory issues (including,
20 for example, the timing of rate cases or PJM's transmission priorities). Exelon and PHI
21 are not in an arm's-length relationship, and nothing about Exelon's ring-fencing changes
22 that fact.

23 The Commission does have interaffiliate transaction rules, but they work only to
24 the extent they are heeded, and only to the extent noncompliance is detected and

1 punished. Exelon's acquisition of PHI multiplies the number and types of interaffiliate
2 transactions involving or affecting Pepco, including transactions where a party has an
3 interest adverse to Pepco and its ratepayers. More transactions mean more opportunity
4 for breaking the rules. When motivation and opportunity combine with low risk of
5 detection, people run red lights, text while driving, and break regulatory rules.[22] Yet
6 Exelon tells us nothing about how it will deal with the risk of rule-breaking—what
7 internal enforcement staff it will use; how that staff will be trained, compensated and
8 promoted; who on the executive team will be held accountable for errors of underlings;
9 and what the consequences will be for violators. Nor has Exelon determined what
10 increase to the Commission's enforcement staff will be necessary to ensure compliance,
11 let alone committed to fund that staff. An acquisition that increases the number and type
12 of possible rule violations, while relying merely on the fact that rules exist, is not a public
13 interest transaction.

[22] 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, 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...."

1 **Q. Isn't the Commission able to disallow from rates Pepco costs associated with**
2 **inappropriate interaffiliate transactions?**
3
4 **A.** Yes, but after-the-fact disallowance does not protect consumers sufficiently when there is
5 no limit on the number and type of possible transactions. Exelon has said that "the PSC
6 retains jurisdiction over incorporation of Pepco costs into customer rates." See Exhibit-
7 Response to GRID2.0 DR 1-9(A) and (C). Exelon also has said that "[t]o the extent
8 service costs are to be borne by utility subsidiaries, the allocations are reviewed in
9 individual rate proceedings." But contradictorily, Exelon opposes a condition, as stated
10 in Exhibit-Response to GRID2.0 DR 1-10 , that "Pepco shall be under no obligation to
11 make any payment for any service under this agreement unless the PSC first has
12 determined that purchasing such service from EBSC [the service company] was
13 consistent with Pepco's obligation to minimize costs for ratepayers."
14 I remind the Commission that these types of costs and cost allocation were
15 formerly subject to review by the SEC under the PUHCA 1935, making it less important
16 that states review them also. With PUHCA 1935 repealed, this Commission will need to
17 be alert to the potential for interaffiliate abuse.
18 ***f. Recommended conditions to address the gaps in ring-fencing***
19 **Q. Does Exelon acknowledge that ring-fencing does not eliminate the risks created by**
20 **this acquisition?**
21
22 **A.** Yes. Exelon has so acknowledged, explicitly or implicitly, in five distinct ways:
23 1. "The SPE structure is intended only to establish "bankruptcy
24 remoteness" for PHI and its utility subsidiaries. Other measures
25 proposed by Exelon will protect the PHI utilities from interaffiliate
26 transaction abuse." See Exhibit-Response to GRID2.0 DR 1-104.
27

1 (But as discussed above, the acquisition allows interaffiliate transactions that are

2 unlimited, while the Commission's knowledge and resources will be limited.)

3 2. "The SPE structure is not intended to "protect a PHI utility from
4 increases in the cost of capital experienced by the holding
5 company....Exelon does not believe its cost of capital or any
6 plausible increase in its cost of capital presents any meaningful risk
7 to the PHI utilities...." *Id.*
8
9 (But the discussion in Part III.C.3 above, referencing statements by Exelon,

10 including references to rating agencies, made clear that cost of capital risk exists.)

11 3. The SPE structure is not intended to "protect a PHI utility from
12 increases in debt cost when lenders worry that insufficient equity
13 will be available to the utility from the holding company because
14 of the holding company's business risks." *Id.*
15
16 (See comment under #2.)
17
18 4. "Lenders to BGE, ComEd and PECO have not expressed concerns
19 to Exelon about the availability of sufficient equity from Exelon.
20 Exelon has proposed measures to insulate PHI and Pepco from
21 risks associated with the business of Exelon. Exelon therefore does
22 not believe that this is a meaningful risk to the PHI utilities." *Id.*
23
24 (See comment under #2. "Belief" is not evidence. Statements by rating agencies

25 that a utility's ratings are affected by a holding company's ratings are.)

26 5. "The SPE structure is not intended to "protect a PHI utility against
27 competition for capital within the holding company
28 family....Exelon has no plans to impose on Pepco limits on
29 spending for utility purposes that differ from those to which Pepco
30 is currently subject." *Id.*
31
32 (Saying one *has* no plans is truthful, but not meaningful. Committing that one *will*

33 *never make plans* is meaningful. Exelon has not made that commitment.)

1 **Q. What if Exelon asserts that eliminating all risk is not practical?**
2
3 **A.** Exelon would be correct. Eliminating all risk is not practical—not where Exelon has
4 chosen to behave in ways that cause risk. And that is the point. To make this debate
5 about the practicality of eliminating all risk implies that Exelon has some right to engage
6 in business activities that create risk. As the prospective acquirer of Pepco, Exelon does
7 not have that right—unless the Commission allows it. Allowing new risk to Pepco,
8 where the source of the risk is not efforts to improve Pepco's service and lower its costs,
9 but Exelon's desire to invest in businesses unrelated to and in conflict with Pepco's
10 obligations, is not consistent with the public interest.

11 **Q. What do you recommend?**
12
13 **A.** The solution to this problem—other than disapproving the acquisition—is a condition
14 requiring Commission permission before Exelon makes any acquisitions of a size or type
15 that the Commission determines could harm Pepco.[23] This is the ring-fence missing from
16 Exelon's "ring-fencing." It is the provision that would actually eliminate risk, or at least
17 subject it to case-by-case limits based on methodical, fact-based assessments—
18 assessments conducted by an unconflicted Commission rather than a conflicted Exelon.
19 But Exelon emphatically opposed such a provision in the Constellation case before the
20 Maryland Commission. Perhaps it will change its position here. Because resisting such a
21 condition means insisting on the right to make unilateral decisions, unchecked by the
22 Commission, on what future risk-adding investments to make—even while

[23] This is in addition to the recommendations of OPC Witness Woolridge relating to ring-fencing.

acknowledging that ring-fencing cannot eliminate the risks arising from these investments. That is not a public interest result.

4. 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 numbers from the respective 2013 10-K reports), 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.

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

14 ***D. The harm from losing benchmark competition between Pepco and BGE***
15
16 **Q. Should the Commission be concerned about the loss of benchmark competition**
17 **between BGE and Pepco?**
18
19 **A.** Yes. Given Exelon's previous acquisition of Constellation, one might view its
20 acquisition of Pepco as a minor, incremental change. But in terms of the Commission's
21 ability to regulate, the change is profound, because the acquisition eliminates benchmark
22 competition between BGE and Pepco.

23 Also known as "across-the-fence rivalry," benchmark competition enables
24 commissions and consumers to compare adjacent companies based on price and quality.
25 With the information and insights thus gathered, we can take action: regulatory action to

1 improve performance or consumer action to change suppliers. When customers observe

2 that nearby utilities differ in prices or performance, they react in at least three ways:

> 3 [1] Existing customers who are facing other pressures to relocate, such as
> 4 plant modernization or expansion, may select a site within the area served
> 5 by the preferred utility. [2] New customers, without an existing location
> 6 in either service area, will make the same election. These will include
> 7 residents who may be accommodated by housing or commercial
> 8 development in areas of the service territory which admit such expansion.
> 9 [3] Finally, existing consumers with neither the opportunity nor means to
> 10 relocate will take their complaints to the management of the utility
> 11 deemed to charge excessive rates or deliver inferior service.[24]
> 12

13 Benchmark competition—the risk of loss from public comparisons—pressures companies

14 to perform.

15 Loss of benchmark competition was among the reasons the California

16 Commission rejected the proposed merger between Southern California Edison and San

17 Diego Gas & Electric. The Commission found that due to those two companies'

18 longstanding rivalry, the public was "advantaged by the presence of proximate

19 comparative data": data that spurred SDG&E to study the reasons for its higher rates.

20 The Commission concluded that "the loss of SDG&E as a regulatory comparison is an

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[24] *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).

1 adverse unmitigable impact of the proposed merger," diminishing the Commission's
2 "ability to regulate the merged utility effectively."[25]

3 With Exelon's acquisition of PHI, BGE and Pepco will no longer be rivals. The
4 Commission, and consumers, will lose a powerful tool to extract cost-effective
5 performance from companies who face no competition for their customers. To extract
6 cost-effective performance, regulators must evaluate performance and assign
7 consequences. They do so when they disallow unreasonable costs from the revenue
8 requirement, and when they impose penalties for poor outage practices. But to evaluate
9 performance effectively, and fairly, regulators must make comparisons, especially
10 comparisons among similarly situated companies, each under continuous pressure to
11 perform better than its neighbor.

12 So when the Commission says to BGE, "Pepco's distribution costs are $X per
13 mile lower than yours—why?", or says to Pepco, "BGE's outages are 20% less frequent
14 and of 30% shorter duration than yours—why?", companies get the message. Continuous
15 comparisons, done carefully, assertively and publicly, with consequences for
16 shortcomings, place neighboring utilities in an arms race toward higher levels of cost-
17 effectiveness. That is what the Commission can do today, because Pepco and BGE are
18 rivals. And that is what is lost, when this acquisition converts Pepco and BGE from
19 rivals to roommates.

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[25] *Southern California Edison, supra.*

Once one understands this negative effect, one attains a different understanding of Exelon's assertions about "best practices." If the Commission's wants Pepco to adopt BGE's best practices, the Commission can bring both companies into a proceeding, require each to describe its practices, then hold Pepco accountable for any failure to adopt the best ones. And vice versa. The separateness of the companies—their rivalry—motivates each to show up the other. But when Exelon talks of "sharing" best practices, it moves in the opposite direction. It replaces uncomfortable comparisons between rivals—administered publicly by an objective regulator with the power to penalize the bottom line—with a comfortable sharing of ideas, administered internally by internal officials whose job it is to increase the bottom line. The key regulatory tool—the pressure of rivalry—will be gone. That is why this transaction is not a minor addition to Exelon's prior acquisition, but a direct hit to one of the Commission's most effective regulatory powers.

IV. The Acquisition Fails the "Benefits" Test

Q. The statute requires that the transaction provide "benefits ... to consumers." What factors should the Commission consider in determining whether a transaction satisfies this standard?

A. To give meaning to the quoted phrase, the benefits must (a) flow from the acquisition transaction and (b) be at a level sufficient to make acquisition consistent with the public interest. I will discuss each criterion in turn.

1 *A. The benefits must flow from the transaction*
2
3 **Q. When determining whether an acquisition's benefits satisfy the statute, which**
4 **benefits should the Commission count?**
5
6 **A.** The Commission should count as benefits only those values that are uniquely attributable
7 to the merger; *i.e.*, improvements caused by the joining of companies previously separate,
8 improvements unattainable without the merger.

9 I based this position, first, on the statutory language. The statute requires the
10 Commission to determine that the "*acquisition* is consistent with the public interest,
11 including benefits ... to consumers...." (emphasis added). What must be consistent with
12 public interest is the "acquisition" itself—the act of legally coupling companies that were
13 previously separate. Further, the phrase "acquisition … including benefits" means that
14 the benefits must be part of the acquisition; they must result from the acquisition.
15 Benefits result from an acquisition only if they are dependent on the acquisition itself;
16 *i.e.*, without the acquisition—the joining of assets under common ownership—they
17 would not have occurred. Finally, since the acquisition is an acquisition of public utility,
18 the benefit must be a benefit to consumers of that utility. The consumers of that utility
19 are consumers of the service provided by that utility; therefore the required benefits must
20 be improvements to, or reductions in the cost of, that service provided by the utility.

21 This understanding of benefit excludes items that are not inherent in the coupling
22 of companies, but instead are only incidental inducements designed to win approval. It
23 is the acquisition, not the strategy accompanying the acquisition, that must produce the
24 statutory benefits.

1 I make this point not only as a matter of statutory interpretation but also as a
2 matter of regulatory policy. When an acquisition is evaluated not for its intrinsic merit
3 but for the inducements offered to make up for its lack of intrinsic merit, we diverge from
4 the purpose of regulation: to induce high-quality utility performance. A student should
5 get an A for excelling at her schoolwork, not for planting flowers in the schoolyard.
6 Counting non-merger inducements also invites discrimination, because the benefits flow
7 only to some customers, usually current ones, while the merger's risks fall on all
8 customers (including future ones).
9 Utilities do not necessarily need an acquisition to improve reliability performance
10 or to introduce "best practices." These types of benefits do not inherently or exclusively
11 grow out of a coupling of companies. Hiring consultants, sharing ideas with peers,
12 attending professional conferences, overseeing contractors, hiring excellent managers and
13 employees, compensating based on operational improvement, all are ways to produce
14 these results. And if Pepco is performing below a professional standard that other
15 utilities are capable of meeting without an acquisition, then PHI, and this Commission,
16 should find out why, rather than viewing the elimination of this suboptimality as a benefit
17 of the merger.
18 A decision to count as benefits things that can occur without a merger therefore
19 conflicts with economic efficiency. Consumers would be incurring merger costs (such as
20 the risks associated with Exelon's non-utility businesses and the risks to distribution
21 resources competition) to receive a benefit they could receive without incurring those
22 costs. Making customers pay extra for something they are already supposed to receive is
23 a form of customer abuse that would not occur in an effectively competitive market.

1 Worse, to count as benefits from a merger benefits that are achievable without a merger is

2 to reward shareholders of low-performing companies with acquisition premiums, because

3 acquirers can demonstrate "benefits" from the merger

4 **Q. Do other jurisdictions reject merger benefits not uniquely attributable to the**
5 **merger?**
6
7 **A.** Yes. Applying the Communications Act of 1934, the Federal Communications

8 Commission has done so repeatedly: "[T]he claimed benefit must be transaction- or

9 merger-specific. This means that the claimed benefit 'must be likely to be accomplished

10 as a result of the merger but unlikely to be realized by other means that entail fewer

11 anticompetitive effects.'"[26] That principle, repeated by the FCC in multiple cases, was

12 applied by the FCC Staff most recently to the proposed merger of AT&T and T-Mobile.

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[26] *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).

1 The Staff rejected benefits that the applicants claimed would result from "the adoption of
2 each company's best business practices, including customer service best practices . . .
3 because the improvement of specific business functions by either AT&T or T-Mobile
4 could be achieved absent the proposed transaction."[27]

5 In applying antitrust law, the Department of Justice and Federal Trade
6 Commission also disregard benefits achievable without a merger. Their *Horizontal*
7 *Merger Guidelines* (2010) states (at Section 10): "The Agencies credit only those
8 efficiencies likely to be accomplished with the proposed merger and unlikely to be
9 accomplished in the absence of either the proposed merger or another means having
10 comparable anticompetitive effects." See also *id.* at n.13: "The Agencies will not deem
11 efficiencies to be merger-specific if they could be attained by practical alternatives that
12 mitigate competitive concerns, such as divestiture or licensing."[28]

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[27] *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 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.

[28] 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. *SCEcorp, Southern California Edison Co. & San Diego Gas & Electric Co.*, Decision No. 91-05-028, 1991 Cal. PUC Lexis 253, at *25. And when a merger applicant offered ratepayers 90 percent of the net proceeds from divesting a fossil fuel plant, the New York

1 ***B. The benefits must be at a level sufficient to make the acquisition consistent with***
2 ***the public interest***
3
4 **Q. How should the Commission ensure that the benefits offered by merger applicants**
5 **are at a level sufficient to make the acquisition consistent with the public interest?**
6
7 **A.** The answer lies in the relationship between regulation and competition. Effective
8 competition serves the public interest because it forces a never-ending search for
9 improvements, from horses to stage coaches to street cars to buses to jet engines; from
10 telegrams to telephones to faxes to cell phones to the internet to the world wide web. The
11 price paid for a computer 20 years ago buys a much better computer today. If we protect
12 a utility from competition, we need regulation to make it perform as if subject to
13 competition. Applying this logic to an acquisition of a utility: The public interest is not
14 satisfied by a mere absence of performance decline; otherwise the public would be worse
15 off under regulation than under competition. And if that statement is true, then the public
16 interest cannot logically be defined as status-quo-plus-some-undefined-benefit, because
17 that standard leaves unstated any way to assess the sufficiency of the benefit.

18 **Q. How would you illustrate this last point?**
19
20 **A.** Suppose the Commission required, as a condition of an electricity merger, that the local
21 utility trim all trees monthly, and that all customer care representatives to be trilingual.

Commission disregarded this "benefit" because the Commission had full authority to determine the proceeds' disposition without any merger. *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 *162-163 (finding the possibility of BGE adopting its post-merger affiliates business practices "too intangible to qualify as a benefit").

1 This "merger benefit" obviously exceeds what the Commission could impose under the
2 public interest standard, because it exceeds what would the company could accomplish if
3 subject to the pressures of effective competition. The public interest standard thus
4 protects the utility from requirements that extract excess benefits, *i.e.*, benefits exceeding
5 what would occur in a competitive market. If the public interest standard protects the
6 utility from extraction of excess benefits (benefits exceeding what would occur in a
7 competitive market), it must conversely protect the consumer from insufficient benefits
8 (benefits below what would occur in a competitive market). But requiring that an
9 acquisition produce only *some benefit* sets no standard; it leaves us unknowing as to
10 whether the benefits were excessive or insufficient. A benefits package guaranteeing a
11 per-customer payment of $50 and a suite of asserted new reliability commitments tells us
12 nothing about how well a utility would perform if pressured by competition, and
13 therefore what it would be obligated to do for its customers without an acquisition.

14 So if the Commission standard is "some benefit is sufficient benefit," the
15 necessary inference is that the commission has one of three policies: (a) any amount of
16 benefit is sufficient, regardless of how small; (b) a benefit is sufficient if the applicant is
17 willing to offer it; or (c) a benefit is sufficient whenever the Commission says it is
18 sufficient. Option (a) is arbitrary, Option (b) substitutes applicant self-interest for the
19 public interest, and Option (c) is circular. All three are wrong.

20 Common to the three wrong answers is this: Each is subjective rather than
21 objective. An objective standard would be the one stated above: It would require that
22 level of benefit that competition would produce; competition, that is, to satisfy the
23 consumer, not competition to buy the company. In that way, the benefit is consistent

with the public interest. 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. That, of course, is not the route this transaction took. On this record, therefore, the Commission has no way to determine whether the benefits offered by the Applicants are sufficient to be "consistent with the public interest."

C. The benefits must bear a proper relationship to cost

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

A. For an acquisition to be consistent with 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? As I have explained, benefits should include only those uniquely attributable to the acquisition (Part IV.A above); while the costs must include, among other things, the risks associated with the mixing of utility and non-utility businesses; the diminution in Pepco's importance relative to its corporate family; and, the distortion in business incentives caused by the acquisition premium (Part III above).

I will turn now to the third question: What is the appropriate relationship of benefits to costs? 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 in buying stock, and the risks they chose to assume, are they getting the highest possible return relative to comparable alternatives?

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 acquisition, 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.

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 a package that involves increased risk (insufficiently mitigated by "ring-fencing," as explained in Part III.C.3), and some benefits that fail the tests I stated in Part IV.A and B). That difference in treatment reflects a transaction that promotes the Applicants' private interests but is not consistent with the public interest. It is a distinct reason why the Commission must disapprove this transaction.

Conclusion

Q. Applying the standards you have described, how does this transaction fare?

A. The Applicants have not met their burden of proving that the acquisition is consistent with the public interest. Each of the conflicts and risks discussed in Part III.B (PHI's conflict of interest) and Part III.C (Pepco's exposure to Exelon's business risks, known and unknown) causes some level of harm. How much harm 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; it treats the harm as "zero." But treating the harm as "zero" does not make the harm "zero." There is, therefore, an absence of proof for the very issue on which the statute requires proof. 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 approval). Those future acquisitions (which as explained in Part III.C.2 have no geographic or type-of-business limit, due to the repeal of PUHCA), carry a positive cost, but we have no way to know what it is, other than that it is not zero.

As for the benefits, other witnesses have explained that they are either minor or achievable without the merger.

Given these facts, here is how things line up:

1. The Applicants have the burden of proving that the acquisition "is" 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. In this context, is a burden of proof more than a description of s legal burden?

A. Yes, it is also a declaration of policy. 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 acquisition "is" in the public interest. That burden reflects a legislative policy: a policy presumption that absent persuasive evidence that an acquisition is in the public interest, the acquisition 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 III.C.3, 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

1 show that benefits bear a proper relationship to the costs—whatever that relationship
2 should be. That is the state of play: Applicants have not shown that the benefits bear a
3 proper relationship to costs.

4 **Q. How can the Commission best signal to the Applicants, and to prospective merger**
5 **applicants, what the public interest in mergers requires?**
6
7 **A.** By applying the requirement of Section 6-105, that an acquisition must be "consistent
8 with the public interest, convenience, and necessity, including benefits and no harm to
9 consumers," to describe the mix of business activities, corporate structure, financial
10 structure and market structure that, when embodied in each utility privileged to serve in
11 Maryland, will most likely ensure reliable, cost-effective service.

12 In its prior merger decisions, the Commission has focused on the proposals in
13 front of them: identifying merger costs, defining the types of benefits that deserve to be
14 counted against those costs, and then comparing the two in an effort to find that the
15 transaction has "benefits and no harm to consumers." The next step—a necessary step—
16 is to define that public interest independently of specific proposals.

17 I can best illustrate my point by reviewing a key passage from the Commission's
18 opinion approving the Exelon-Constellation transaction:

> 19 We cannot deny that this transaction arises in the context of broader trends
> 20 in the national and international electricity markets that give us pause. As
> 21 its Chairman and Chief Executive Officer ("CEO") testified, Constellation
> 22 has sought (since its trading business melted down in 2008) to create a
> 23 vertically integrated company that combines its regulated distribution
> 24 business (BGE) with an unregulated retail supply business (Constellation
> 25 New Energy, Inc.). That, ironically, sounds a lot like the company BGE
> 26 was before deregulation, but with one key difference: the parent gets the
> 27 steady return on its monopoly distribution business and the upside of a
> 28 supply business no longer restrained by the regulatory compact. As a
> 29 result, though, the unregulated returns available to the supply side of the
> 30 business drive the financial community's, and thus the parent company's,

> expectations for the company as a whole. This includes the regulated utilities, which in the Exelon model are expected to contribute a 10 percent return on equity to the parent. In addition, as the companies' executives themselves acknowledged, this business paradigm requires greater and greater scale. Current Exelon CEO John Rowe considers industry consolidation "inevitable," and so it seems, do the rest of the industry and the financial community.
>
> It is not obvious to us that tying our regulated utility companies to this business model will be good in the long run for ratepayers or regulated utilities. Having watched major financial institutions become "too big to fail," we wonder too if further consolidation in the electricity sector could expose BGE to a wider range of unregulated business risks or bury BGE deeper down Exelon's priority list if the company grows still bigger in the future. But these general reservations do not afford us a basis to deny approval to a transaction that otherwise passes muster under sec. 6-105. By repealing the Public Utility Holding Company Act and passing Maryland's electric restructuring laws, the United States Congress and the Maryland General Assembly created the legal and policy backdrop for transactions and companies like these, and it is not our role to thwart or second-guess those judgments here.[29]

Up to the sentence in the second paragraph beginning "But these general reservations...," the Commission recites factual and policy bases for concern about the consolidation trend and its application to Maryland. Up to that point, the passage is consistent with the points I and other witnesses in this case are making in the present case. And in the present case, the Commission's "general reservations" present themselves as problems sufficiently serious to compel a finding of harm that cannot be mitigated. Working with the language in the above-quoted passage, here are five reasons:

[29] Order 84698 (text accompanying notes 6-9 and the following paragraph) (footnotes omitted).

1 *First*, there is nothing to "wonder" about. There is no dispute that Exelon's
2 continued acquisitions outside Maryland (which Exelon will decline to subject to this
3 Commission's oversight, if its rebuttal testimony matches its position in the Constellation
4 case) will "expose BGE [and Pepco] to a wider range of unregulated business risks or
5 bury BGE [and Pepco] deeper down Exelon's priority list if the company grows still
6 bigger in the future." The post-acquisition entity will not be "a lot like the company BGE
7 was before deregulation;" BGE and Pepco will be small parts of a company with multiple
8 conflicts and risks, most of them outside the Commission's jurisdiction to control.
9 *Second*, it is precisely the Commission's "general observations," along with the
10 detailed critique of this transaction that I and others have offered, that "affords ... a basis"
11 for detailed scrutiny, along with an objective application to Exelon and PHI of its
12 statutory burden of proof: the duty to prove consistency with the public interest and "no
13 harm to consumers." What the Commission expresses, in the first one-and-a-half
14 paragraphs, are examples of the very inputs to "harm" that the Applicants must negate to
15 carry their burden. Parts III and IV of my testimony explain how Applicants have failed
16 to do so.
17 *Third*, to say that such a transaction "otherwise passes muster under sec. 6-105"
18 leaves unexpressed what factors are necessary to "pass muster under sec. 6-105." The
19 question under sec. 6-105 is whether such a transaction is consistent with the public
20 interest, produces benefits and causes no harm. The Commission can answer this
21 question only by defining the public interest—the point of my discussion in Part II of this
22 testimony. The "legal and policy backdrop" to which the Commission refers is not
23 defined by the business goals of acquirers like Exelon, just because Congress repealed a

1 statute that previously limited those goals. The "legal and policy backdrop," for
2 Maryland, remains what it has been: the public interest mandate of Section 6-105.
3 *Fourth*, Congress's decision to repeal the Public Utility Holding Company Act
4 was only that: a decision to remove the federal limitation of utility holding companies to
5 a "single integrated public-utility system." The repeal carries no preemptive intent. I
6 participated intensively in the debate over PUHCA repeal, from the late 1980s through
7 2005, testifying before the committees of U.S. Senate six times and committees of the
8 U.S. House of Representatives six times. Throughout the many hearings, meetings, draft
9 bills, committee reports and floor debates, no one—no lobbyist, utility executive, no
10 member of Congress, no FERC representative and no state representative, no one—
11 suggested that PUHCA repeal preempted or otherwise confined state regulation. The
12 effect of PUHCA repeal was to remove federal constraints, but to leave states with their
13 longstanding authority to determine their own visions for holding company structure.[30]

[30] Indeed, during the many discussions and hearings on PUHCA, on any number of occasions I heard advocates for repeal support their position by saying, in some form, "We don't need federal restrictions because state regulation has matured since 1935 and therefore can handle the complexity." *See, e.g.*, the following excerpts from testimony provided to the Senate Energy Committee on Feb. 6, 2002, a hearing at which I also testified: Testimony of Isaac Hunt on behalf of the Securities and Exchange Commission (supporting PUHCA repeal "as long as repeal is accomplished in a way that gives the FERC and state regulators sufficient authority to protect utility consumers"); Testimony of David Sokol on behalf of MidAmerican Energy Holdings Company ("effective state and federal regulation are the true keys to consumer protection, not a [federal] statute that deals primarily with details of corporate structure"); Testimony of Roy Hemmingway, Chairman of the Oregon Public Utilities Commission, on behalf of the National Association of Regulatory Utility Commissioners ("NARUC believes that Congress should reform PUHCA in the manner proposed in S. 1766, but in doing so, should allow the States to protect the public through maintaining effective oversight of holding

1 *Fifth*, there is nothing in Maryland's legislative policies that precludes the
2 Commission from arriving at its own standards for business activities, corporate structure
3 and financial structure, independently of the acquisition strategies made possible by
4 PUHCA repeal and especially in a context where there is not a "free market" to align
5 acquisition decisions with the public interest. On the contrary, the public interest
6 mandates requires such standards. To apply that standard is not to "thwart or second-
7 guess" Congressional judgments (again, there is no sign of a state law "backdrop"
8 supporting such acquisitions), but to carry out the legislative command to ensure
9 consistency with the public interest. I recommend the Commission do so here.

10 **Q. Does this conclude your Direct Testimony?**
11
12 **A.** Yes.

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company practices and expanding State access to holding company books and records, independent of any similar authorities granted to the federal regulatory bodies.").