Exelon's Proposed Acquisition of Pepco:

Corporate Strategy at Ratepayer Expense

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Executive Summary

In a move aimed at shoring up its faltering business model, Chicago-based Exelon Corp. in April 2014 proposed acquiring Pepco Holdings Inc., the utility holding company that provides electricity to Washington, D.C. and parts of Maryland, Delaware, and New Jersey.

Exelon, the largest owner of nuclear power plants in the United States and one of the largest electric utilities in the country, has been challenged in recent years by low wholesale power prices driven by cheap natural gas, reduced demand for power, and the growth of renewable energy and energy efficiency. The company's stock price has dropped, its dividend has been reduced, its credit ratings are stagnant, and it faces a worrisome outlook based on rising nuclear power costs from aging plants.

By contrast, Pepco's regulated distribution companies earn steady revenues through the rates charged to electricity customers for the delivery of electricity to homes and businesses. These rates are guaranteed by public service commissions with jurisdiction over wherever Pepco does business.

Exelon has proposed paying $6.4 billion—a price that includes an acquisition premium of $2.5 billion over and above the value of Pepco's assets—to acquire Pepco. If the deal goes through, Exelon would acquire a stable earnings stream from Pepco's regulated utilities that would help Exelon balance out the volatility of its merchant electricity generation business, which has proven susceptible to weakness in the competitive energy markets.

Pepco's customers, on the other hand, will face the risk that Exelon will seek rate increases to boost its regulated earnings. The high price to be paid for Pepco also increases the risk of rate increases, as there will be pressure on Exelon to extract as much value as possible from the acquisition to justify the premium. A merger with Exelon would also subject ratepayers to risks associated with Exelon's aging nuclear fleet. Residents and businesses may be asked to accept rate increases and policy accommodations to assist Exelon with the management of aging nuclear plants.

Washington, D.C. has developed renewable energy and sustainability goals. The District needs a utility that is a partner in this undertaking. Exelon's heavy reliance on nuclear power in the mid-Atlantic region means the company would probably oppose public policies that run counter to the interests of maintaining the profitability of those plants. Moreover, Exelon has historically opposed policies to support the development of renewable energy. As a result, the proposed acquisition of Pepco will likely make it more difficult for the District to reach its renewable energy and sustainability goals.

Although Exelon has promised public benefits from the merger—including establishment of a $14 million Customer Investment Fund for Washington, D.C. —its promises do not mitigate the long-term risk to Pepco customers.

The proposed Exelon-Pepco merger would:

- Expose residents and businesses to rate increases aimed at supporting Exelon's struggling business model
- Undermine the District of Columbia's renewable-energy initiatives
- Expose Pepco customers to long-term risks significantly larger than the short-term protections and public benefits claimed by Exelon

The merger should be rejected.

Merger Proposal Background and Detail

In April 2014, Exelon Corp. announced plans to acquire Pepco Holdings Inc. for $6.8 billion.

Chicago-based Exelon is one of the largest utility holding companies in the United States. Its subsidiaries include Exelon Generation, a merchant generation company that owns power plants that compete in deregulated electricity markets; and three electricity distribution utilities—Commonwealth Edison, PECO Energy, and Baltimore Gas & Electric—all of which purchase electricity and/or natural gas from the wholesale market and distribute it to customers. These three distribution companies have approximately 6.6 million electric customers in Illinois, Pennsylvania, and Maryland.[1]

Much of Exelon's business takes place within the footprint of PJM Interconnection, LLC. PJM is a company that is regulated by the Federal Energy Regulatory Commission. It is tasked with managing a regional electric transmission grid and with operating the wholesale electricity markets for an area that includes Pennsylvania, New Jersey, Maryland, the District of Columbia, West Virginia, Ohio, Virginia, Delaware and parts of six other states. PJM includes approximately 167,000 megawatts (MW) of capacity. Exelon's three distribution companies operate exclusively within PJM. Of Exelon Generation's 35,000 MW of power plant capacity, more than 23,000 MW is in PJM, making Exelon one of the largest merchant generators in PJM. Exelon Generation also owns more nuclear plants than any other utility in the country (with a capacity of more than 19,000 MW), with almost 90 percent of that capacity concentrated within PJM (Table 1).[2] In 2013, nuclear plants accounted for 81 percent of Exelon's electricity generation.[3]

Table 1. Exelon's nuclear power plants

Nuclear Plant	Location	Exelon's ownership stake	Capacity owned by Exelon (MW)	In PJM?
Braidwood	IL	100.00%	2,384	Yes
Byron	IL	100.00%	2,384	Yes
Calvert Cliffs	MD	50.01%	867	Yes
Clinton	IL	100.00%	1,078	No
Dresden	IL	100.00%	1,750	Yes
LaSalle County	IL	100.00%	2,313	Yes
Limerick	PA	100.00%	2,386	Yes
Nine Mile Point	NY	44.19%	789	No
Oyster Creek	NJ	100.00%	637	Yes
Peach Bottom	PA	50.00%	1,163	Yes
Quad Cities	IL	75.00%	1,364	Yes
R.E. Ginna	NY	50.01%	291	No
Salem	NJ	42.59%	1,017	Yes
Three Mile Island	PA	100.00%	829	Yes

Exelon was formed in 2000 through the merger of Unicom (the owner of Commonwealth Edison) and PECO Energy (formerly Philadelphia Electric

[1] Exelon 2013 Summary Annual Report, p. 9.
[2] Source: SNL Financial.
[3] Exelon Corporation, http://www.exeloncorp.com/energy/generation/generation.aspx

Company). Exelon in 2004 attempted to expand through a merger with New Jersey-based Public Service Enterprise Group, but that merger was abandoned due to opposition from the New Jersey Board of Public Utilities.[4] Exelon acquired Constellation Energy Group (the parent company of Baltimore Gas & Electric) in 2012.

Pepco Holdings is a utility holding company in the mid-Atlantic region that owns three distribution utilities—Potomac Electric Power Company (Pepco), Delmarva Power & Light Company, and Atlantic City Electric Company—all of which purchase electricity and/or natural gas for distribution to their customers. These three companies operate exclusively within PJM. Pepco Holdings also owns a high-voltage transmission system within PJM.

Each regulatory commission is charged with ensuring that any proposed merger in its jurisdiction is in the interest of utility customers.

The acquisition of Pepco Holdings by Exelon is subject to the regulatory approval of all of the public service commissions in the states in which Pepco Holdings does business (New Jersey, Delaware, Maryland, and Virginia) and in the District of Columbia and by the Federal Energy Regulatory Commission (FERC). Each state regulatory commission is charged with ensuring that any proposed merger is in the interest of utility customers in that state (the District of Columbia commission carries a similar responsibility); FERC is charged with evaluating mergers based on effects on competition, wholesale transmission rates, and on regulation. So far, FERC and the Virginia State Corporation Commission (which has no distribution customers impacted by the merger) have approved the Exelon proposal. Exelon has stated that it hopes to close the acquisition in the second or third quarter of 2015.[5]

Why Exelon Wants to Acquire Pepco

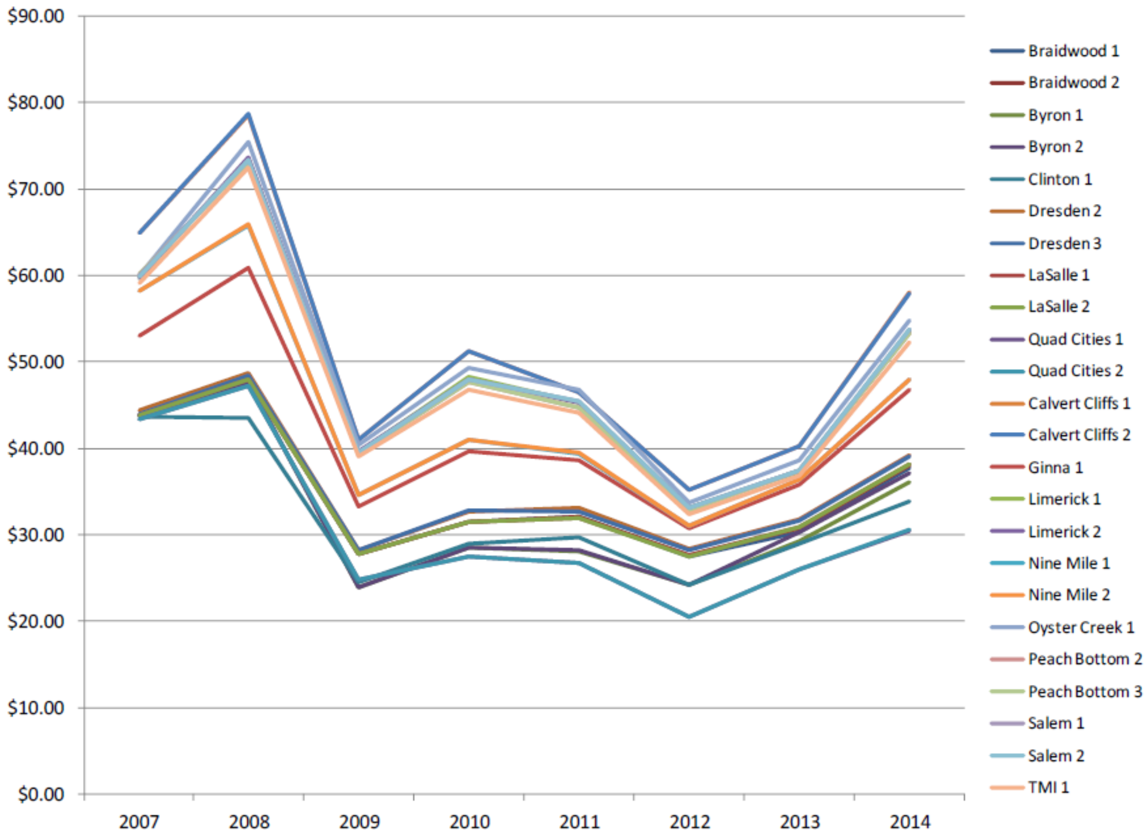
Pepco shareholders stand to gain significantly from the acquisition by Exelon. The proposed acquisition price of $6.8 billion represents a 20 percent mark-up over Pepco's actual stock value just before the merger was announced, or a $1.1 billion windfall for the stockholders of Pepco.[6] Pepco's stock price was already inflated relative to the net book value of the assets of Pepco; Pepco's assets are valued at only $4.3 billion.[7]

[4] Foster Electric Staff, "Unable to reach deal with New Jersey regulators, PSEG and Exelon call off proposed merger," SNL Financial, September 20, 2006.
[5] Exelon 3rd Quarter 2014 earnings call, October 30, 2014.
[6] Pepco's stock closed at $22.79 on April 29, 2014. Exelon agreed to pay $27.25 per share. Pepco had 251,025,051 shares of common stock outstanding. (Pepco Q1 2014 10Q May 7, 2014).
[7] "Net book value" refers to the value of a company's assets. A stock price higher than net book value reflects investor confidence in the future growth of the company. The net book value of Pepco was $17.23 per share at the end of 2013(Pepco 2013 10K February 28, 2014 p. 44).

Why is Exelon interested in buying Pepco for such a high price? Exelon's operations have been challenged in recent years by low wholesale electricity prices, which have depressed earnings from Exelon's nuclear plants. Exelon's power plants are merchant plants, meaning that they must compete with other power plants to sell power on the wholesale market. Exelon's plants make a profit when their cost of providing power is lower than the market clearing price.

Recent low wholesale power prices have been driven by low natural gas prices, flat demand for electricity, and the increasing penetration of renewable sources of electricity.[8] A recent report by Illinois public agencies found that the average price received by Exelon's nuclear plants has declined by nearly 40 percent from pre-recession levels (see Figure 1).[9]

Figure 1. Annual energy prices received by Exelon's nuclear plants have declined significantly since the recession



Source: Illinois Commerce Commission, Illinois Power Agency, Illinois Environmental Protection Agency, and Illinois Department of Commerce and Economic Opportunity, *Potential Nuclear Power Plant Closings in Illinois, Report to the Illinois Legislature*, January 5, 2015.

[8] Exelon 2013 10K (February 2, 2014) p. 85-86.

[9] Illinois Commerce Commission, Illinois Power Agency, Illinois Environmental Protection Agency and Illinois Department of Commerce and Economic Opportunity, *Potential Nuclear Power Plant Closings in Illinois, Report to the Illinois Legislature*, January 5, 2015.

Exelon has identified several of its nuclear plants at risk of early retirement, including Byron, Clinton, Quad Cities, Oyster Creek, Ginna, and Nine Mile Point Unit 1.[10]

Exelon Generation Company has provided approximately 60 percent of Exelon's total operating revenues for the past three years.[11] Acquiring Pepco would help diversify Exelon's holdings by providing the company with a stable revenue stream from Pepco's regulated utilities. These regulated utilities have steadier incomes than merchant generation utilities because their rates are set by the public service commissions of the states where they operate and by the D.C. Public Service Commission. Figure 2 shows how Exelon's overall operating income has fluctuated with the income of its merchant generation company (Exelon Generation), in contrast to Pepco Holdings' more stable income stream.

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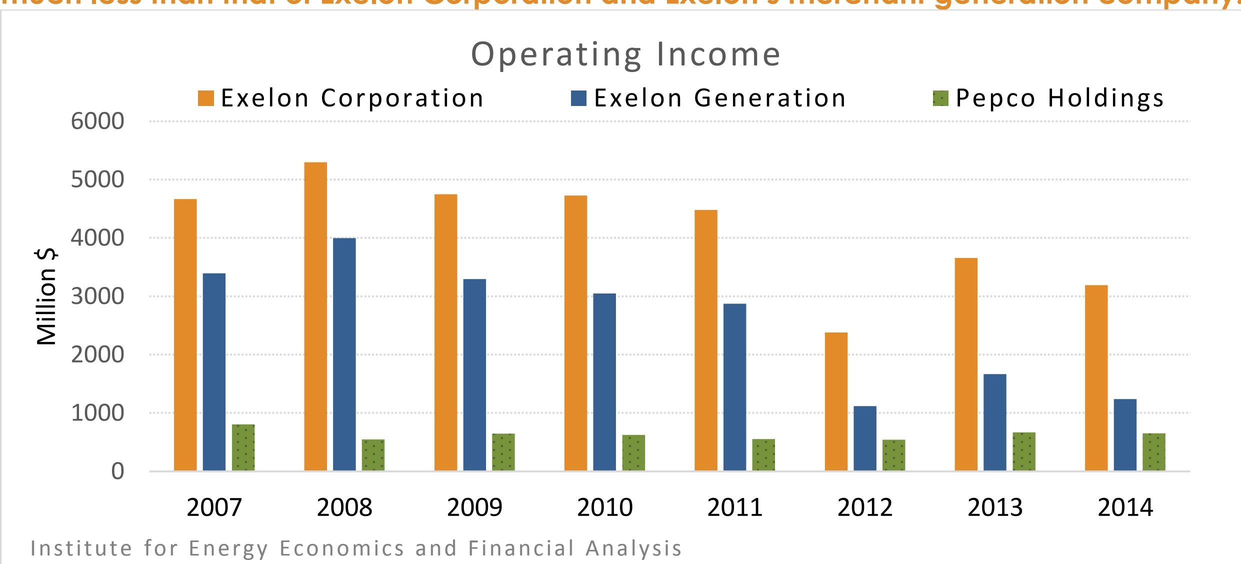
Figure 2. The operating income (revenue less expenses) of Pepco Holdings has fluctuated much less than that of Exelon Corporation and Exelon's merchant generation company.[12]



Exelon's bid to acquire Pepco is part of a larger trend among utilities focusing more and more on moving into regulated operations as a strategy aimed at mitigating low wholesale power prices.[13]

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[10] Joint Applicants response to DC Government Data Request No. 7 (Question 19), DC Public Service Commission Case No. 1119, October 10, 2014.

[11] Exelon 2013 10K (February 2, 2014) p. 74-5 and Exelon 2014 3Q 10-Q (October 29, 2014) p. 9-14.

[12] 2014 figures were annualized from data for the first 9 months of 2014. Source: SNL Financial.

[13] Exelon joins FirstEnergy, American Electric Power, PPL, Duke and others in this shift to acquire additional regulated operations and/or divest merchant power plants.

Commenting on the proposed acquisition of Pepco, Moody's Investors Service noted that the transaction "fundamentally shifts Exelon's business mix towards lower risk regulated transmission and distribution utilities."[14]

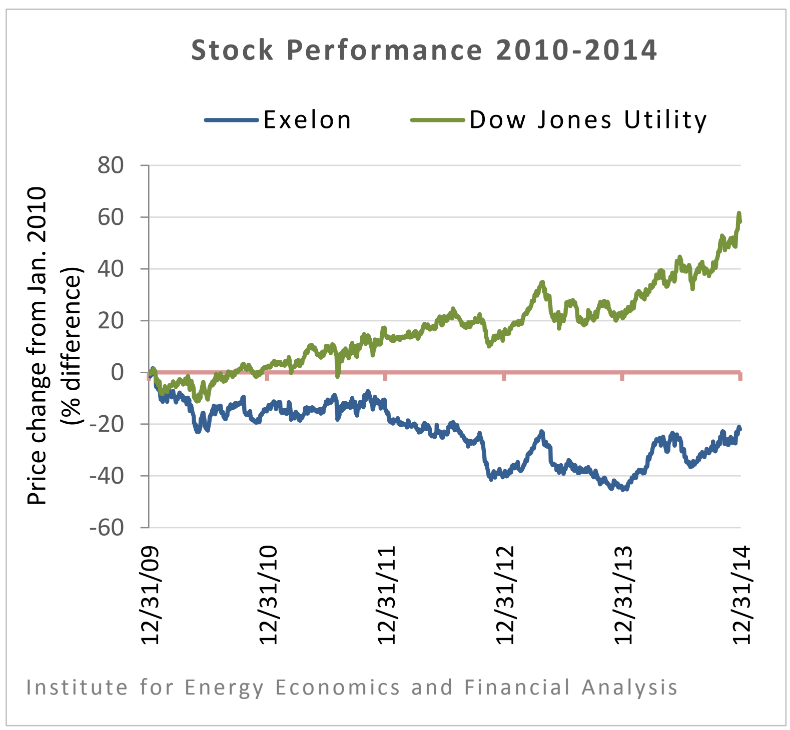
Pitting Investors Against Ratepayers

Exelon's ownership of merchant generation represents a business model that is fundamentally different from Pepco Holdings'. Exelon's fiduciary responsibility to increase revenues from its nuclear generation will create new pressures on Pepco that do not currently exist.

Exelon's merchant generation segment has weakened the financial performance of Exelon as a whole in recent years. This means that there will be pressure from investors on Exelon to extract as much value as possible from the acquisition of Pepco. Symptoms of Exelon's struggling financial performance include:

- *Stock Price*. Exelon's stock value has declined since 2009 (Figure 3), and the stock has performed significantly worse than the utility industry average.[15]
- *Reduced dividend*. Exelon cut its dividend by 41 percent in 2013, citing low wholesale power prices that had hurt the company's earnings and the uncertain timing of a recovery.[16] A dividend cut is a relatively rare event in the electric utility industry; from 2010 through 2013, Exelon was the only electric utility to reduce its dividend.[17]
- *Credit ratings*. Exelon credit ratings have stagnated: In 2014, Standard & Poor's upgraded a number of electric utility companies, raising the industry

Figure 3. Exelon's stock has performed worse than the Dow Jones Utility index.



[14] N. Qureshi, *Fitch, Moody's, S&P weigh in on Exelon-Pepco deal*, SNL Financial, May 1, 2014.

[15] Source: SNL Financial, retrieved 12/31/14.

[16] D. Testa, UPDATE: Exelon execs outline methodical, painstaking decision to slash dividend, SNL Financial, February 2, 2014.

[17] Edison Electric Institute, Dividends: Q4 2013 Financial Update http://www.eei.org/resourcesandmedia/industrydataanalysis/industryfinancialanalysis/QtrlyFinancialUpdates/Documents/QFU_Dividends/2013_Q4_Dividends.pdf, p. 2

average from BBB to BBB+.[18] Exelon's credit rating was not upgraded.[19] Meanwhile, Moody's upgraded the credit ratings of Exelon's three regulated subsidiaries, downgraded Exelon Generation's credit rating, and left the overall parent company's rating unchanged.[20,21]

- *Operating income*. Exelon's operating income has declined since 2011 (Figure 2). This decline has been driven by a drop in operating income from its merchant generation segment. Exelon has seen a greater decline in operating income than the electric utility industry as a whole.[22]

Exelon's financial risks will likely increase even further in coming years due to a poor outlook and significant uncertainty for its nuclear plants. In 2014, Moody's noted that Exelon's sizeable nuclear fleet will suffer from increasing costs as it ages and characterized those plants as the company's "Achilles heel." Moody's stated, "Today's concentration in nuclear will become a major challenge over the next decade as reactor operating licenses expire, and early retirements will add increased scrutiny on decommissioning liabilities."[23]

Exelon's weak financial position has also prompted financial analysts to raise concerns about the high price the company would be paying to acquire Pepco. According to Fitch Ratings, the acquisition would not "meaningfully lessen" Exelon's business risk.[24] "We do not hear cheering from existing [stock] holders about the deal," analysts at Credit Suisse said.[25]

And Jeffries cited concerns that the debt Exelon would need to take on to finance the deal would put further downward pressure on the company's credit ratings ("The additional leverage contemplated in the merger will weaken credit metrics and may put pressure on the company's bond and commercial paper ratings, "Jefferies analysts wrote.)[26]

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[18] In rebuttal testimony on behalf of Exelon Corporation Ellen Lapson states that Exelon's BBB rating provided by Standard & Poor's is not an indication of any existing credit concerns. Exelon's BBB rating has been consistent over the last several years. What Ms. Lapson ignores is the fact that in the last two years the three credit agencies have initiated industry wide credit upgrades for the utilities. The utility industry collectively has not seen this level of upgrades from the credit agencies in over a decade. (See: Rebuttal Testimony of Ellen Lapson on behalf of Exelon Corporation, Maryland Public Service Commission Case No. 9361, January 7, 2015 at p. 6, lines 4-6 and Edison Electric Institute, *Credit Ratings: Q2 2014 Financial Update – Backup Data,* http://www.eei.org/resourcesandmedia/industrydataanalysis/industryfinancialanalysis/QtrlyFinancialUpdates/Pages/default.aspx.).

[19] Edison Electric Institute, *Credit Ratings: Q2 2014 Financial Update – Backup Data,* http://www.eei.org/resourcesandmedia/industrydataanalysis/industryfinancialanalysis/QtrlyFinancialUpdates/Pages/default.aspx

[20] W. Azeem, *Moody's issues upgrades across electric utility sector on improved view of regulatory framework*, SNL Financial, February 4, 2014.

[21] D. McKenzie and N. Powell, *6 utility holding companies, 23 subsidiaries at risk of credit downgrade*, SNL Financial, February 14, 2013.

[22] From 2010 to 2013, operating income for all utilities ranged from $64.5 billion to $68.6 billion (See: Edison Electric Institute, *2013 Financial Review: Annual Report of the U.S. Investor-Owned Electric Utility Industry*, 2014.) Exelon's operating income ranged from $2.4 billion to $4.7 billion over the same period.

[23] Moody's specifically raises the concern that if any of Exelon's struggling nuclear plants are forced into early retirement, they may not have accumulated sufficient funds for decommissioning. (Moody's Investors Service, "Exelon Generation Company: Well capitalized to manage challenging market conditions facing the nuclear fleet," September 11, 2014).

[24] N. Qureshi, *Fitch, Moody's, S&P weigh in on Exelon-Pepco deal*, SNL Financial, May 1, 2014.

[25] Quoted in the Direct Testimony of J. Randall Wooldridge on behalf of the Maryland Office of People's Counsel, Maryland Public Service Commission Case No. 9361, December 8, 2014, p. 7 lines 14-17.

[26] Quoted in the Direct Testimony of J. Randall Woolridge on behalf of the Maryland Office of People's Counsel, Maryland Public Service Commission Case No. 9361, December 8, 2014, p. 10 lines 7-9.

The $2.5 billion acquisition premium further puts Pepco customers at risk, because Exelon must earn returns high enough to justify the premium.[27] This translates into a significant risk for Pepco's customers of rate increases and service cuts.

The $2.5 billion acquisition premium puts Pepco customers at risk because Exelon must earn returns high enough to justify the premium.

The 2011 merger of FirstEnergy with Allegheny Energy provides an example of how this type of financial pressure on a utility can harm ratepayers. FirstEnergy paid a premium to acquire Allegheny, but the merged company's financial performance was hindered by low wholesale power prices that reduced the profitability of its coal-fired power plants. In 2013, FirstEnergy received approval from the West Virginia Public Service Commission to sell one of its newly acquired merchant power plants from its deregulated generation subsidiary to Monongahela Power, its regulated utility subsidiary in West Virginia. The price that Monongahela Power paid for the plant included a $257 million mark-up that had been part of the acquisition premium from the merger; this cost will be paid by Monongahela Power's customers over the remaining life of this coal plant. In the end, West Virginia ratepayers will pay a portion of the acquisition premium from the merger, even though the utility had previously committed not to push this cost onto customers.[28, 29]

Finally, as part of its strategy of moving toward acquiring more low-risk, regulated utility operations, Exelon has announced that its capital expenditure plan over the next several years will involve significant investment in its regulated operations – which will lead to increased rates to recover the costs of and earn profits on these investments. In September 2013, Exelon's Senior Executive Vice President and Chief Strategy Officer stated, "[W]e are shifting our internal investment focus to the regulated businesses, in the course of our planning period which is approximately five years."[30] More recently, on its 2014 first quarter earnings call, Exelon's Chief Financial Officer stated, "Exelon has committed $15 billion in capital to ComEd, PECO, and BGE to grow their rate bases over the next five years. The

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[27] The $2.5 billion acquisition premium represents the difference between the $6.8 billion acquisition price and the $4.3 billion book value of the assets (i.e., Pepco Holdings) being acquired.

[28] Dissenting Opinion of Commissioner Palmer, Public Service Commission of West Virginia Case No. 12-1571-E-PC, October 7, 2013, p. 2-5. The nature of these transactions is addressed by IEEFA in two recent studies: D. Schlissel and C. Kunkel, *Mountain State Maneuver: AEP and FirstEnergy try to stick ratepayers with risky coal plants*, Institute for Energy Economics and Financial Analysis, July 30, 2013; and T. Sanzillo and C. Kunkel, *FirstEnergy: A major utility seeks a subsidized turnaround,* Institute for Energy Economics and Financial Analysis, October 2014.

[29] This example provides an interesting contrast to the testimony of Exelon witness Susan Tierney, who cites FirstEnergy as an example of a holding company that owns both regulated distribution utilities and generation to support her arguments in favor of the merger. (Rebuttal testimony of Susan Tierney on behalf of Exelon Corporation, DC Public Service Commission Case No. 1119, December 17, 2014, p. 28-29 and Exhibit (3G)-10.)

[30] Exelon's Management Presents at Barclay's 2013 CEO Energy-Power Conference (Transcript), September 11, 2013, http://seekingalpha.com/article/1688392-exelons-management-presents-at-barclays-2013-ceo-energy-power-conference-transcript?all=true&find=EXC

addition of the Pepco utilities to the Exelon family will add an incremental $8.3 million in regulated rate base."[31] ("Growing the rate base" translates directly into raising electric rates).

In the proposed acquisition of Pepco, Exelon has made no promises regarding rates. Exelon has rejected a request from the District of Columbia Office of the People's Counsel to avoid seeking a rate increase for five years after the acquisition.[32]

Baltimore Gas & Electric customers have already seen four proposed rate increases just since 2012, when BG&E's parent company was taken over by Exelon (Table 2).[33] Despite the fact that one of the conditions imposed by the Maryland Public Service Commission on the takeover was that merger savings be passed through to BG&E customers in the next rate case, those savings did not avert significant rate increases.[34, 35]

Table 2. BG&E has requested four rate increases since its acquisition by Exelon in 2012

PSC Case No.	Date filed	Requested electric rate increase ($M)	Requested gas rate increase ($M)	Approved electric rate increase ($M)	Approved gas rate increase ($M)
9299	7/27/12	$150	$53	$80	$32
9326	5/17/13	$101	$30	$34	$12
9331	8/2/13	0	$400 over 5 years	$0	$400 over 5 years
9355	7/2/14	$118	$68	$22	$38

Undermining D.C.'s Energy and Sustainability Objectives

Washington, D.C. has established a 20-year sustainability plan that calls for D.C. to become the most sustainable city in the country by 2032. The plan specifically calls for increasing renewable energy use to 50 percent of the District's energy supply, increasing green jobs in the city by a factor of five, and cutting city-wide energy use by 50 percent. The District's

[31] Exelon Q1 2014 earnings call, April 30, 2014.

[32] Rebuttal Testimony of Ellen Lapson on behalf of Exelon Corporation, DC Public Service Commission Case No. 1119, December 17, 2014, p. 23-25.

[33] Direct Testimony of Michael Arndt on behalf of the Maryland Office of People's Counsel, Maryland Public Service Commission Case No. 9361, December 8, 2014, p. 56 lines 1-22.

[34] Maryland Public Service Commission Order in Case No. 9271, February 17, 2014.

[35] Exelon's witness Ellen Lapson points to the fact that Exelon's takeover of BG&E led to improved credit ratings in order to support her argument that the proposed acquisition is not risky. However, BG&E's credit rating improvement occurred as four rate increases were passed onto consumers and businesses in Baltimore. As Ms. Lapson correctly states, credit ratings are done for bondholders. (See: Rebuttal Testimony of Ellen Lapson on behalf of Exelon Corporation, Maryland Public Service Commission Case No. 9361, January 7, 2015 at p. 11, lines 7-12 and p. 16, lines 19-21). The PSC proceeding is designed to address issues of the public interest including rate payers and the Washington D.C. community. The deteriorating financial metrics of Exelon should be of concern to the City of Washington and its residents. They, not the bondholders, will be asked for the rate increases.

Renewable Portfolio Standard calls for 20 percent renewable energy by 2020 and 2.4 percent solar by 2023.[36]

These existing policies and objectives are in direct contradiction to the stated policies and objectives of Exelon Corporation.

Exelon's policy positions include:

- *Opposition to distributed solar.* Exelon officials have expressed opposition to net metering, a policy by which utility customers who install solar panels are compensated for the electricity they produce at the going retail rate (approximately 13 cents/kWh in Washington, D.C.). In a recent speech, Exelon's CEO Christopher Crane stated, "the consumer should be compensated at the wholesale price of energy," which is less than half of the retail rate.[37] Rolling back net metering as advocated by Mr. Crane in this speech would impede the District's ability to meet its solar goals.

- *Opposition to the federal wind production tax credit.* Exelon opposes the wind production tax credit, a policy that is widely credited with spurring the growth of the U.S. wind industry.[38] Exelon CEO Christopher Crane asserted in a deposition that the wind production tax credit had led to "unintended consequence," such as "an overdevelopment of wind around multiple nuclear plants that is causing pricing suppression."[39] Although Exelon owns some wind generation (1,300 MW), this amount is very small compared to its ownership of nuclear (17,000 MW). Moreover, more than 90 percent of Exelon's wind resources are located outside of PJM and hence are not in direct competition with the nuclear fleet.[40]

- *Opposition to renewable energy development in Maryland.* After its takeover of Constellation (the parent company of Baltimore Gas & Electric) in 2012, Exelon lobbied against several bills in the Maryland Legislature that would have expanded renewable energy development in the state. One bill would have incentivized energy generation using poultry litter as feedstock. Exelon and its subsidiary BG&E opposed the bill, which would have introduced a competitor to their own generation. Pepco, which owns no generation of its own, did not comment on the bill.[41] Another bill opposed by Exelon would have strengthened Maryland's renewable portfolio standard by increasing the amount of renewable energy (including solar) that Maryland utilities have to procure. Exelon's fact sheet opposing the bill referenced its concern that nuclear power (Exelon's Calvert Cliffs nuclear plant in Maryland) was not able to take advantage of the revenue stream that the renewable portfolio standard provides to renewable resources. And a third bill opposed by Exelon would have established a pilot program for community

[36] DC Office of the Mayor, Sustainability DC, http://sustainable.dc.gov/finalplan

[37] Christopher Crane, "Energy Revolution: Utilities Confront the Shifting Energy Landscape," Resources for the Future Policy Leadership Forum, May 13, 2014, available at http://www.rff.org/Events/Pages/Energy-Revolution-Utilities-Confront-the-Shifting-Energy-Landscape.aspx (at 57:20).

[38] Exelon Corporation, *Exelon's Public Policy Positions*, available online at: http://www.exeloncorp.com/performance/policypositions/overview.aspx#section_2

[39] Quoted in the Direct Testimony of Paul Chernick on behalf of the Sierra Club and the Chesapeake Climate Action Network, Maryland Public Service Commission Case No. 9361, December 8, 2014, p. 30 lines 20-27.

[40] Exelon Corporation, *Exelon Wind*, available online at: http://www.exeloncorp.com/assets/newsroom/downloads/docs/CompanyFactSheets/fact_excwind.pdf

[41] Direct Testimony of Richard D. Tabors on behalf of the Maryland Energy Administration, Maryland Public Service Commission Case No. 9361, December 8, 2014, p. 14 lines 4-19.

renewable energy generation – a step towards the policy support for community renewable energy that D.C. already has in place, with Pepco's support.[42]

- *Support for policies to subsidize its nuclear fleet.* While seeking to defeat the development of a broader, more diverse electrical grid that includes state-sponsored activities to promote wind and solar, in Illinois (where several of its struggling nuclear plants are located) Exelon is pushing for a protected status for its nuclear plants. Exelon has been advocating for a "clean energy standard" that would expand Illinois' current renewable portfolio standard (which requires the utilities to purchase a certain amount of their electricity from renewable energy) to include nuclear. This would provide an additional revenue stream for Exelon's nuclear generation. Exelon also lobbied for the passage of a state legislative resolution urging federal and state agencies and regional transmission organizations to take actions to ensure the continued operation of nuclear plants in Illinois, all of which are owned by Exelon.[43]

The proposed acquisition would put Pepco ratepayers at risk of having to subsidize the continued operation of Exelon's aging nuclear fleet.

Nowhere in its testimony provided to the District of Columbia Public Service Commission in support of the acquisition does Exelon state any approval of or make any promise to support the District's renewable energy and sustainability goals. Instead, Exelon's policies and positions clearly show that the utility's dominant policy objective is to keep its nuclear plants profitable by finding ways to directly support those plants and to reduce policy support for competing sources of generation.

Exelon's behavior is consistent with that of other utilities that own struggling merchant generation. In Ohio, for example, Duke, American Electric Power, and FirstEnergy all own merchant coal-fired power plants that have become less profitable in recent years due to low wholesale market prices. The utilities have responded by seeking to establish long-term power purchase agreements that would require their distribution subsidiaries to pay above-market prices for the power from these plants so that the plants continue to remain profitable. The Public Utilities Commission of Ohio, which regulates the distribution utilities, has not yet ruled on whether it will allow them to enter into such contracts. This example shows how these utilities are attempting to use their regulated distribution operations to provide a guaranteed, above-market price for the output of their uneconomic power plants.[44] The acquisition of Pepco by Exelon puts Pepco's ratepayers at risk of being subject to similar efforts that would ultimately have ratepayers subsidize the continued operation of Exelon's nuclear fleet.

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[42] Direct Testimony of Anya Schoolman on behalf of DC Solar United Neighborhoods, DC Public Service Commission Case No. 1119, November 3, 2014, p. 45-47 and Attachment B of the testimony.

[43] Illinois 98th General Assembly, H.R. 1146, adopted May 29, 2014.

[44] D. Sweeney, *AEP Ohio's proposed coal PPA plan draws familiar criticism*, SNL Financial, October 7, 2014. See also T. Sanzillo and C. Kunkel, *FirstEnergy: A major utility seeks a subsidized turnaround*, Institute for Energy Economics and Financial Analysis, October 2014.

A New Challenge for Regulators

The proposed acquisition would make it more challenging for the District of Columbia Public Service Commission to regulate Pepco.

Pepco currently accounts for 43 percent of the revenues of Pepco Holdings, but it would only account for about 7 percent of the revenues of Exelon.[45] Any penalties that the District of Columbia Public Service Commission might impose to try to improve Pepco's performance would have less of a financial impact on Exelon than they would have had on Pepco Holdings. If Exelon continues to expand, its financial incentive to please regulators in Washington, D.C. will decline further.[46]

If the acquisition is approved, Pepco will be subsumed into Exelon's larger and more complicated holding company structure. Although Exelon has promised that Pepco will maintain an "arms-length" relationship with all of its affiliates,[47] the financial pressures on Exelon will create an incentive to try to enhance its financial condition through more risky affiliate transactions. The District of Columbia Public Service Commission will have to exert more effort to regulate these affiliate transactions.

Furthermore, the District of Columbia Office of the People's Counsel noted in its comments to the Federal Energy Regulatory Commission that it is difficult to figure out where, in a large holding company structure, crucial decisions regarding operation and maintenance and expenditures for reliability are being made. They conclude that the acquisition will "diminish the ability of the D.C. PSC to ascertain and verify the workings of the Exelon corporate structure and craft orders and regulations that send the appropriate and effective regulatory signals."[48]

The testimony of former New Hampshire Public Service Commissioner Nancy Brockway before the Maryland Public Service Commission in the Exelon/Pepco merger case describes several examples of utility mergers in which a local distribution company was subsumed into a larger utility holding company. These examples show that these mergers can and do result in more contested cases and more difficulties in enforcing commission policies when the new corporate parent is less willing to follow commission precedent and more resistant to taking direction from state commissions. Ms. Brockway provides the examples of the acquisition of Bay State Gas Company by NiSource, the acquisition of Allegheny Energy by FirstEnergy, and

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[45] Based on 2014 revenues reported in Pepco Holding's 3rd quarter 2014 10-Q (October 31, 2014) and Exelon's 3rd quarter 2014 10-Q (October 29, 2014).

[46] Direct Testimony of Scott Hempling on behalf of Grid 2.0, DC Public Service Commission Case No. 1119, November 3, 2014, p. 69 lines 3-11.

[47] "The Joint Petitioners' District of Columbia Merger Commitments," DC Public Service Commission Case No. 1119, December 17, 2014.

[48] Comments of the Office of the People's Counsel for the District of Columbia, Federal Energy Regulatory Commission Case No. EC14-96, July 21, 2014, p. 4.

the acquisition of New England Electric System by National Grid to show how quality of service can suffer as a result of a merger, despite initial promises to the contrary.[49]

If the transaction is approved, it would present a contentious quagmire of rate and regulatory issues for the public service commissions involved. To our knowledge, no state commission has ever split up a utility holding company. As stated by utility law expert Scott Hempling in testimony to the District of Columbia Public Service Commission, approval of the acquisition "would subject Pepco's customers to a conflict of interest lasting as long as Exelon lasts."[50]

Short-Term Benefits Versus Long-Term Risks

In its proposed acquisition of Pepco, Exelon has made some short-term commitments – including a two-year commitment not to reduce employment, a commitment to improved reliability with financial penalties if targets are not met, a $100 million "customer investment fund" for the states impacted by the merger ($14 million for the District of Columbia), and a "ring-fencing" commitment. These commitments will be discussed in turn.

- *Jobs.* Exelon has promised to "make a good faith effort to hire within two years of the Merger closing date at least 102 union workers in the District of Columbia," to transfer an additional 50 employees from Virginia to Washington, D.C., and to "ensure no net reduction in the employment levels at Pepco" in the two years following the merger.[51] Exelon believes that the additional jobs will more than offset job losses associated with the merger, although it has also stated, "It is too early in the integration process to estimate the reduction in employment in Pepco's D.C. operations and the associated savings subsequent to the two-year moratorium."[52]
- *Reliability.* One of Exelon's proposed reliability commitments is actually less strict than already required by District of Columbia law.[53] According to testimony provided on behalf of the district government, use of this less strict standard would actually result in negative economic impact to the District.[54]
- *The "Customer Investment Fund."* Exelon's proposal here would represent a very small economic investment, when compared to the windfall $1.1 billion profit Pepco's shareholders would reap as a result of the merger. If distributed as a one-time credit on

[49] Specific examples include: acquisition of Energy North Natural Gas by KeySpan in 2000; acquisition of Bay State Gas Company by NiSource in 1999; and acquisition of KeySpan and other utilities by National Grid (Direct Testimony of Nancy Brockway on behalf of the Maryland Office of People's Counsel, Maryland Public Service Commission Case No. 9361, December 8, 2014, pp. 9-19).
[50] Direct Testimony of Scott Hempling on behalf of Grid 2.0, DC Public Service Commission Case No. 1119, November 3, 2014, p. 6, lines 13-14.
[51] "The Joint Petitioners' District of Columbia Merger Commitments," DC Public Service Commission Case No. 1119, December 17, 2014.
[52] Joint Applicants response to Office of the People's Counsel Data Request No. 6 (Question 6).
[53] "[I]f the Joint Applicants were to meet their own proposed metrics they would produce less frequent interruptions, but the interruptions would be longer than required compared to the current EQSS [Electricity Quality of Service Standard] requirements" (Direct testimony of Maximilian Chang on behalf of the District of Columbia Government, DC Public Service Commission Case No. 1119, November 3, 2014, p. 12 lines 15-17).
[54] Direct Testimony of Maximilian Chang on behalf of the District of Columbia Government, DC Public Service Commission Case No. 1119, November 3, 2014, page 13, lines 1-4.

customers' bills, the "Customer Investment Fund" benefit would work out to about $53 per customer.

- "*Ring-fencing.*" This is a way to structure a parent/subsidiary relationship so that the subsidiary company's assets are protected. Pepco's revenues would be protected from any raids by the parent company, debt transactions and other liabilities would not be commingled, assets would be kept separate, and in the event of an Exelon bankruptcy Pepco's assets and ratepayers would be protected. While this commitment would shield Pepco's ratepayers to some degree, it cannot completely isolate Pepco from the new risks that it would be exposed to through acquisition by a larger holding company. For example, ring-fencing would do nothing to prevent the cost of equity provided by Exelon to Pepco from increasing, nor would it prevent Pepco from entering into inappropriate affiliate transactions (i.e. for being charged too much in contracts with other Exelon companies).[55] If Exelon were to go bankrupt, it is likely that Pepco would change hands, a transaction that would pose its own set of risks for residents and businesses in the service area.[56] From our review of the documents in this matter, no independent assessment of the ring fencing provisions has been made and no opinion by an independent party offered as to their integrity and ability to handle a hostile attack.

The duration of Exelon's proposed ring-fencing commitment is unclear. Exelon's application initially promised a five-year commitment (i.e. that Exelon would "implement robust ring-fencing measures for at least five years following completion of the Merger"[57]), but the company subsequently stated that it would keep its ring-fencing in place in perpetuity unless state regulatory agencies give it approval to do otherwise.[58]

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[55] Direct Testimony of Scott Hempling on behalf of Grid 2.0, DC Public Service Commission Case No. 1119, November 3, 2014, p. 90-98.

[56] For example, Oncor Electric Delivery Co. is currently poised to change hands as a result of the bankruptcy of its parent company, Energy Futures Holdings. See *Uncertainty over Oncor's future ownership constrains additional upgrades*, Electric Light & Power, August 13, 2014.

[57] Joint Application of Exelon Corporation, Pepco Holdings, Inc., Potomac Electric Power Company, Exelon Energy Delivery Company, LLC and New Special Purpose Entity, LLC, DC Public Service Commission Case No. 1119, June 18, 2014.

[58] Rebuttal Testimony of Christopher M. Crane on behalf of Exelon Corporation, DC Public Service Commission Case No. 1119, June 18, 2014, p. 12, lines 17-22.

Conclusion

The proposed acquisition by Exelon is not in the interest of Pepco's electricity customers. The benefits to D.C. electricity customers would be short-term and transitory, but the risks are permanent.

These risks include:

- The risk that the job commitments made by Exelon will go unaudited and that jobs for unemployed D.C. residents will not materialize
- The risk that Exelon's financial objective to support its nuclear plants will drive corporate policies that are not in the interest of D.C. ratepayers, including:
    - The risk that Exelon will pursue policies that seek to undermine the District's renewable energy strategy
    - The risk that Exelon will seek to raise Pepco's rates to increase regulated earnings and counterbalance financial pressures at its nuclear power business
- The risk that the District of Columbia Public Service Commission will have a harder time effectively regulating Pepco
- The risk that Pepco will experience higher costs as a result of inappropriate transactions between Pepco and its affiliates
- The risk that Exelon will seek to remove the ring-fencing of Pepco after five years

None of the risks presented by this proposed acquisition are hypothetical. The proposal comes at a time when utilities across the country are pursuing new strategies to put ratepayers on the hook to pay for uncompetitive power plants.

None of the risks presented by this proposed acquisition are hypothetical.

The proposed acquisition would weaken the District's regulatory control over the electric utility serving D.C., while at the same time subjecting ratepayers to Exelon's financial need to maintain the profitability of its nuclear generation. The acquisition will make it challenging, if not impossible, for the District to chart its own future toward renewable energy and sustainable economic development.

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