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Public Comment of the Institute for Energy Economics and Financial Analysis on the October 6, 2015 Settlement Agreement regarding the Exelon-Pepco merger

Formal Case No. 1119

The Institute for Energy Economics and Financial Analysis (IEEFA), a non-profit organization headquartered in Cleveland, Ohio, conducts research and analyses on financial and economic issues related to energy and the environment. We urge the District of Columbia Public Service Commission to reject the Exelon-Pepco merger as proposed in the October 6, 2015 non-unanimous settlement.

Our public comment addresses several of the Commission's Public Interest Factors: Factor 1 ("the effect of the transaction on ratepayers, shareholders, the financial health of the utilities standing alone and as merged, and the economy of the District"), Factor 4 ("the effects of the transaction on risks associated with all of the Joint Applicants' affiliated non-jurisdictional business operations, including nuclear operations") and Factor 7 ("the effects of the transaction on conservation of natural resources and preservation of environmental quality").

While the settlement has offered new merger commitments to the District of Columbia, we believe that the merger as proposed still is not in the public interest. Our comments specifically address (1) the rate impacts of the proposed transaction; (2) the effectiveness of the ring fencing measures proposed to shield Pepco from a potential Exelon bankruptcy; and (3) the risks to ratepayers stemming from the conflict of interest between Exelon's merchant generation business and Pepco's regulated distribution company.

Rate Impacts of the Transaction

The new merger commitments increase the Customer Investment Fund (CIF) from $33.75 million to $72.8 million and provide that $14 million of this amount is to be used as a residential bill credit (approximately $57 per customer). An additional $25.6 million of the CIF is to be used to offset residential base rate increases through March 31, 2019. The merger commitments provide that if residential base rate increases exceed $25.6 million before March 31, 2019, the excess amount will be credited to a regulatory asset which Exelon will be able to recover, plus a 5% rate of return, after March 31, 2019.

In other words, residential ratepayers will receive a one-time bill credit of approximately $57. They will not experience any residential base rate increase approved by the Commission through March 31, 2019. At that time they will experience the full weight of all base rate increases approved by the Commission in the previous three years. In addition, ratepayers will retroactively pay any amount of rate increase above $25.6 million, plus interest.

In his testimony, DC Government Witness Tommy Wells explains that $25.6 million is Exelon's estimate of expected residential base rate increases that will be approved by the DC Public Service Commission through March 31, 2019 (Testimony of Tommy Wells in Support of Settlement Agreement at page 9, lines 12-18). According to workpapers submitted by AOBA on November 5, 2015, current base rates recover $74.4 million from residential customers, so a $25.6 million residential rate increase would be a 34.4% increase in residential base rates. (The scenario presented by AOBA in its workpapers shows residential base rates increasing 44.9%). Under the terms of the proposed settlement, ratepayers would experience this rate increase all at once instead of spread out over the next three years.

While there is a short-term benefit to what is effectively a three-year moratorium on residential base rate increases, we do not believe that masking the true magnitude of rate increases from residential ratepayers until 2019 is in the public interest.

Furthermore, even if it is likely that the magnitude of residential base rate increases that will be incurred by March 31, 2019 will be approximately $25.6 million, this is not assured. The fact that Pepco will be guaranteed a 5% return on any base rate increase above this amount represents a potential harm to ratepayers.

The proposed merger commitments do partially address some of the concerns outlined by the Commission in its August 27, 2015 rejection of the merger. The Commission argued that, as originally proposed, rates would increase after the merger because the costs to achieve the merger are projected to exceed the synergy savings in the near term. The Commission noted (paragraph 101) that Exelon had not committed to pay the costs to achieve the merger with shareholder funds instead of through rates. The new commitments still do not require Exelon shareholders to pay for the costs to achieve the merger, but they do require that Pepco "not recover CTA in a Pepco rate case in an amount greater than the synergy savings that Pepco demonstrates for the applicable test year." In other words, DC ratepayers will not experience rate increases due to the costs to achieve the merger, though clearly rate increases are anticipated for other reasons.

The $2.5 billion acquisition premium (the amount that Exelon will pay for Pepco above the book value of Pepco's assets) further puts Pepco customers at risk, because Exelon must earn returns high enough to justify the premium. This translates into a significant risk for Pepco's customers of rate increases and service cuts. This concern was expressed by the Commission, which stated (paragraph 134), "the pressure to meet the earnings accretion expectations and the synergies necessary to justify the purchase could lead to pressures for cost cutting and investment curtailments that may be detrimental to customers."

Ring Fencing

As the Commission noted in its August 27th order (paragraph 263), a ring fence can, at best, shield ratepayers from harm. There is no benefit to ratepayers from the proposed ring fence, however, and the risks that the ring fence is designed to protect ratepayers from would not exist in the absence of the merger.

The ring-fence provisions of the Settlement Agreement are designed to maintain and protect the separate financial independence and integrity of Pepco, which will be a subsidiary of Exelon after the merger. Ring-fence provisions in this instance are supposed to protect the interests of the smaller Pepco utility from any potential financial headwinds encountered by the larger Exelon parent company. (see: Settlement Agreement, paragraphs 63 through 105).

The ring-fence provisions cover post-merger debt issuances by Pepco, Pepco's incursion of liabilities, Pepco's revenue distributions to Exelon, Pepco's general business protocols and the maintenance of its books and records. All of these activities are to be carried out independently of Exelon. The Exelon parents' equity interest in Pepco is also separated from the Exelon parent corporate structure. Exelon's equity interest in Pepco will be held and managed by a third-party Special Purpose Entity (SPE) with governance, accounting and financial management strictures that prohibit Exelon from imposing any self-serving financial burdens on Pepco. Most specifically, the creation of the SPE is designed to remove Pepco's equity interest from the estate of Exelon for the purposes of bankruptcy (paragraph 68). Various reporting requirements for both Pepco and Exelon are required in the Settlement Agreement and Exelon is not allowed to take any actions that might impair the ring fence without the consent of the PSC.

Key Questions Regarding the Ring Fence

1. Paragraph 93 requires Exelon to secure an opinion of counsel that "a bankruptcy court would not consolidate the assets and liabilities of the SPE with those of Exelon or EEDC [Exelon Energy Delivery Company], in the event of an Exelon or EEDC bankruptcy, or the assets and liabilities of PHI or its subsidiaries with those of either the SPE, Exelon or EEDC in the event of a bankruptcy of the SPE, Exelon or EEDC."

   This diligence step is useful, but perhaps offers more apparent than real protection. One cannot predict what a future bankruptcy court will decide.

   There are many ways ring fences are dismantled. For example, in the ongoing bankruptcy proceeding of the Energy Future Holdings utility in Texas, a proposal has been made that would, according to Moody's, dismantle the ring fence around its subsidiary utility Oncor. The parent utility, Energy Future Holdings, is supportive of the bankruptcy proposal.[1] The Texas PUC must decide. Nothing in the Exelon-Pepco Settlement Agreement precludes Exelon's support for the dismantling of the ring fence under these circumstances, provided the District of Columbia PSC approved such a dismantling.

   There are a number of questions that might be posed here and the in points below about the ring fence:

   a. Do the ring-fence provisions prevent Exelon from supporting plans or elements of plans in any bankruptcy proceeding that would undermine the ring fence protections?
   b. Does the PSC have to approve any plan emerging from bankruptcy prior to it becoming effective?

2. Paragraph 99 requires Pepco to provide the Commission with an annual certificate from an officer of Exelon attesting to Exelon's general fealty to the ring fence. The certification would be strengthened if it included provisions that: 1) Exelon has not violated the ring-fencing provisions in the last year; 2) it does not plan to violate the provisions in the coming year; 3) it does not plan to petition the PSC to in any way change the terms of the ring-fence provisions in the coming year; 4) all of Exelon's principal creditors have been notified and agree that they have no right of action or claim to any asset of Pepco in the event of any dispute with Exelon; and 5) Exelon's annual certification is based upon both General Counsel opinion and opinion of independent corporate and bankruptcy counsel and is signed by the CEO of Exelon.

   a. Would Exelon accept each of the five strengthening provisions offered above?

[1] See Moody's recent review of company finances for fuller context: http://s3.amazonaws.com/static.texastribune.org/media/documents/EFH_Bankruptcy_Disclosure_Statement_is_Credit_Negative_for_Oncor.pdf and Dan Testa, *Moody's warns EFH's REIT conversion plan for ONCOR a credit negative,* SNL, July 30, 2015

3. Paragraph 84 states that Pepco will not include in any of its debt or credit agreements provisions that link it to Exelon in any cross default provisions or any other trigger provisions related to Exelon. There are no specific reciprocal requirements of Exelon. Exelon should be required to provide in all of its credit agreements provisions that its agreements in no way establish any right of action or claim to the assets of Pepco.
    a. Would Exelon agree to inclusion of language in all of its contracts, debt instruments and other relevant agreements that nothing in the agreements provides any claim or rights against Pepco its assets, revenues or corporate officers?
4. The ring-fence provisions can expire at the end of five years if an application is made to the PSC and then approved by the agency (paragraph 105). Within the first five years the mechanism for review and oversight by the Commission appears to be reserved to the Commission's own initiative. Exelon agrees not to object to the Commission reviewing ring-fence compliance at any time. One of the benefits that accrues to Exelon from the merger is an improvement in the ratio of regulated to unregulated revenues received by Exelon; Exelon will benefit from the more stable revenue stream from Pepco's regulated operations as Exelon's unregulated generation business continues to struggle. One of the risks borne by Pepco is the potential for Exelon's unregulated generation business to pose additional credit problems for the company. Pepco's interests might be better served if Exelon posted a bond for the five-year period that covered ring-fence violations.
    a. Would Exelon agree to post a bond that insures Pepco against any ring fence violations?
5. The ring fence provisions require a separate set of books for Exelon and Pepco and their respective subsidiaries. This separation is designed to protect Pepco, but at least in the short term the new accounting environment needs to be carefully monitored to ensure that Pepco receives its share of the benefits from the merger. The issue of savings from the merger illustrates the point. Operating savings and efficiencies are a critical element of the benefit package that flows from the Exelon-Pepco merger. There are paragraphs in the ring-fence portion of the Settlement Agreement that require Exelon to file an integration plan with the Public Service Commission (paragraph 90). While the contents of the plan are unspecified in the agreement, perhaps this is the venue for a more complete articulation of the savings plan and how the parent and subsidiary will benefit. How baseline expenses are established between the parent and Pepco subsidiary, how the savings are calculated, and how the savings are credited and on what timeline will all flow under the new post-merger ring fence accounting relationship prescribed in the Settlement Agreement. Pepco ratepayers benefit from receiving a fair share of the savings. How these issues are settled is an important early test of the integrity of the ring fence as a tool to protect the financial condition of Pepco. The new accounting environment, while protective of many aspects of Pepco's assets also creates risks that Pepco receives less than its fair share of the savings.
    a. What are the specific savings initiatives that Exelon plans to achieve as part of the merger synergies?
    b. What portion of each savings initiative will be allocated to Exelon and what portion to Pepco?
    c. Assuming a post-merger accounting environment what are the assumptions and rationale used for the allocations?
    d. What are the specific financial means by which the savings are measured and who determines if the savings have been achieved?
    e. What are the specific financial mechanisms to be used to deliver the savings benefits to Pepco? Are cash transfers, accounting treatments or other systems of credits anticipated?

The Commission's August 27 order states (paragraph 266), "Whether additional provisions are necessary for the proposed ring-fencing commitments to provide additional protections to District ratepayers as urged by the Intervenors and some community commenters as additional terms or conditions to the approval of the Proposed Merger is a decision that the Commission will defer until we have examined the remaining Public Interest Factors and made a determination of whether the Proposed Merger, taken as a whole, is in the public interest." Since the Commission ultimately determined that the proposed merger was not in the public interest, it did not need to revisit the potential need for additional ring-fencing commitments. As explained above, we believe that additional provisions would strengthen the ring fence but ultimately cannot eliminate the risk to ratepayers.

Conflict of Interest

Finally, we note that the proposed settlement does not change the risk to ratepayers from the fundamental conflict of interest inherent in the proposed transaction. Exelon has a fiduciary duty to ensure the financial viability of its merchant generation business. While the proposed transaction includes provisions to prevent Exelon from raising rates or passing unrelated costs to its regulated subsidiaries to shore up its struggling merchant generation company, the Commission will have to be continually vigilant to ensure these provisions are followed, given that the financial incentive exists for Exelon to violate them.

Furthermore, Exelon has opposed net metering policies, the federal wind production tax credit and the strengthening of Maryland's renewable portfolio standard, presumably due to its interest in protecting its merchant generation business from further competition from renewables. As the Commission stated in its August 27 order, "While this Commission has the authority to compel performance by utilities in support of District policies, recent experiences with DC PLUG and the Community Renewable Energy Act have demonstrated that a utility that is a partner in the District is vastly preferable to a utility that must be continually compelled to further important District goals" (paragraph 348). Nothing in the new settlement provisions leads us to believe that Exelon has experienced any fundamental change of attitude toward renewable energy. We continue to believe that Exelon would not be a willing partner in achieving the District's goal of 50% renewable energy by 2032.

Thank you for the opportunity to comment.