STATE OF NEW JERSEY
BOARD OF PUBLIC UTILITIES
OFFICE OF ADMINISTRATIVE LAW

I/M/O THE PETITION OF ATLANTIC CITY ELECTRIC COMPANY, AND CONECTIV COMMUNICATIONS, INC. AND NEW RC, INC. FOR APPROVAL UNDER N.J.S.A. 48:2-51.1 AND N.J.S.A. 48:3-10 OF A CHANGE IN OWNERSHIP AND CONTROL	)	**OAL Docket No:** PUC-04036-01 **BPU Docket No:** EM01050308

INITIAL BRIEF OF THE DIVISION OF THE RATEPAYER ADVOCATE

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REDACTED VERSION

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STATEMENT OF THE CASE

On February 9, 2002, Conectiv Communications, Inc. ("CCI"or "Conectiv"), Potomac Electric Power Company ("Pepco") and New RC,Inc. ("New RC") executed an "Agreement and Plan of Merger"("Merger Agreement"). On May 11, 2001, Atlantic City Electric Company ("ACE" or "Atlantic"), Conectiv and New RC, Inc. collectively referred to as Joint Petitioners ("Joint Petitioners") filed a petition with the New Jersey Board of Public Utilities ("Board") seeking approval of the Merger under N.J.S.A. 48:2-51.1 and N.J.S.A. 48:3-10. ACE, a public utility of the State of New Jersey subject to the jurisdiction of the Board, is a wholly-owned subsidiary of Conectiv, a Delaware corporation and a public utility holding company under the federal Public Utility Holding Company Act ("PUHCA") of 1935. New RC, Inc. is newly formed Delaware corporation currently held as subsidiary of Pepco. If all the necessary regulatory approvals are granted and the merger closes, the merger will result in New RC becoming a registered public utility holding company under PUHCA and the owner of Conectiv and Pepco. New RC will be headquartered in the District of Columbia.

PROCEDURAL HISTORY

On May 11, 2001, the Joint Petitioners filed a petition with the Board seeking approval of the Merger under N.J.S.A. 48:2-51.1 and N.J.S.A. 48:3-10. Simultaneously with the filing, the Joint Petitioners submitted to the Board the pre-filed joint testimonies of Messrs. Derrick and Shaw, Mr. Pace and Mr. Hasbrouck in support of their request for approval of the proposed merger.

The matter was originally transmitted to Office of Administrative Law ("OAL") on June 1, 2001 as a contested case requesting interim rate relief. By letter dated June 5, 2001, the Board refiled the transmittal sheet noting that the earlier transmittal had an error in the special features section contending that the petition sought a "request for interim rate relief." In its transmittal cover letter, the Board explained that the filing is a request for the approval of a proposed change in ownership and control and is not a rate proceeding.

On July 23, 2001, the Honorable Louis McAfoos, ALJ t/a, presided over a pre-hearing conference. The dates for the completion of discovery, and the filing of written direct, rebuttal and surrebuttal testimony were established. Plenary hearings were scheduled for consecutive days from November 13 through November 16, 2001 and November 19 through November 20, 2001, if needed. By letter dated July 24, 2001, Joint Petitioners' attorney confirmed the schedule ordered by the ALJ at the pre-hearing conference.

On August 9, 2001, ALJ McAfoos issued an order granting motions for intervention to PSEG Power, Enron, Shell Energy Services ("Shell"), Independent Energy Producers of New Jersey ("IEPNJ"), Community Energy ("Community") and City of Vineland ("Vineland"). On August 20, 2001, Cogentrix Energy, Inc. ("Cogentrix") was also granted intervention in the proceeding.

On August 21, 2001, the Ratepayer Advocate enumerated the issues concerning incomplete and/or unresponsive discovery responses in a letter to the Company. Pursuant to ALJ McAfoos' instructions at the pre-hearing conference, a subsequent letter was sent to Joint Petitioners' counsel on August 24, 2001 listing specific information requested from the Petitioners regarding discovery responses from other jurisdictions. By letter dated September 10, 2001, the Ratepayer Advocate notified ALJ McAfoos of the recent correspondence between the parties and the current discovery response status. On September 11, 2001, ALJ McAfoos held a conference with the parties at the OAL in Trenton to discuss Vineland's motion to compel.

On September 21, 2001, the Ratepayer Advocate and other intervenors filed their direct testimony. Ms. Barbara Alexander, Messrs. Bruce Biewald/David Schlissel, David Peterson and James Rothschild submitted testimony on behalf of the Ratepayer Advocate.

By letter dated September 21, 2001, the Ratepayer Advocate apprised ALJ McAfoos of the continuing problems with discovery responses and on September 25, 2001 a telephone conference was held with ALJ McAfoos, the counsel for Joint Petitioners, the Ratepayer Advocate, and the Deputy Attorney General representing Board Staff to discuss the Ratepayer Advocate's concerns. ALJ McAfoos held that certain parts of the discovery responses in question should be provided to the Ratepayer Advocate and Board Staff. Joint Petitioners' attorney filed a letter requesting reconsideration of the ALJ's oral ruling concerning discovery on October 10, 2001. The Ratepayer Advocate and the Board responded to the letter on October 19, 2001 and October 22, 2001, respectively.

Rebuttal testimony was filed on behalf of the Company on October 9, 2001. The Ratepayer Advocate filed surrebuttal testimony on November 5, 2001.

By letter dated October 18, 2001, ALJ Masin, Acting Director of the OAL, informed the parties that ALJ McAfoos resigned and ALJ Sukovich was reassigned to the matter.

An in-person conference was scheduled before ALJ Sukovich on November 7, 2001. On November 9, 2001, ALJ Sukovich filed a letter confirming the parameters and rulings from the November 7, 2001 conference.

Hearings were held on November 13 through November 16, 2001. During an in-person conference held on November 19, 2001, the parties established the briefing schedule that was confirmed by ALJ Sukovich's letter dated November 20, 2001. A public hearing was held on November 28, 2001 in Mays Landing, New Jersey. Initial briefs are scheduled to be filed December 19, 2001 and reply briefs are due January 14, 2002.

FINDINGS OF FACT AND CONCLUSIONS OF LAW

A. IMPACT ON RATES

The Joint Petitioners claim that this merger is not driven by synergies and immediate rate reduction is not one of the benefits of this merger. *P-2*, p. 11. Moreover, Joint Petitioners stated that there was nothing to prevent them from producing a synergy study in this proceeding but they did not see a need for one in this case. T76:L1-12. Therefore, costs to achieve the merger and the savings the merger may produce was not quantified for the Board's review. *P-1*, p. 7 (paragraph 17). "The costs to achieve the Merger have not been quantified at this time;" Petition p. 15 (paragraph 34), "the total amount of fees and expenses to be incurred in connection with the Merger are not quantifiable at the present time;" and *P-2* p. 11. (Derrick/Shaw testimony), "there are not substantial, immediate rate reduction opportunities."

In spite of the lack of a synergy study, some general information about the merger costs and savings were available through documents provided in discovery. Merger costs are defined as transaction costs (i.e., costs expended to close the merger transaction such as legal and consultant's fees) and transition costs (i.e., costs to integrate the two merging companies such as dollars spent on new computer system that integrate the companies together). With respect to merger transaction costs, the Joint Petitioners provided an estimate of approximately $45.8 million in its filing with the SEC. *RP-2,* p. 22. The breakdown of the costs as set forth in the Joint Petitioners' SEC Form U-1 is as follows:

Fees, Commissions and Expenses

Commission registration fees	$	959,650
Financial advisors' fees (New RC)	$	9,100,000
Financial advisor's fees (Conectiv)	$	19,800,000
Accountant fees	$	600,000
Legal fees	$	7,000,000
Stockholder communication and proxy solicitation expenses	$	4,336,919
Miscellaneous	$	4,000,000
Total	$	45,796,569
		========

Id.

Details of these transaction costs and the supporting documentation were not provided to the Board or the parties to this proceeding. *RP-6*, p. 23. Merger transition costs were not quantified by the Joint Petitioners in this proceeding. *Id.,* p. 24. Moreover, as stated earlier, a comprehensive merger savings study was not performed by the Joint Petitioners. *Id*. p. 31. An incomplete estimate of some of the possible merger savings was provided through discovery but the Joint Petitioners' maintained that very little, if any, merger savings will be produced by the merger in the short term. *P-2*, pp. 11-12.

Atlantic's rates are currently subject to a cap (not frozen), lasting through July 31, 2003 under the Board's restructuring order. *I/M/O Atlantic City Electric Company -- Rate Unbundling, Stranded Costs and Restructuring Filings*, BPU Docket Nos. EO97070455, EO07070456 and EO97070457, Order dated March 30, 2001. Petitioners have not proposed any performance-based rate plan, or other merger savings tracking mechanism that would ensure that customers receive the benefit of merger-related cost reductions. The Joint Petitioners do, however, request that Atlantic be

permitted to track merger costs to achieve and the ability to defer the decision regarding proper ratemaking treatment of such costs. *P-1,* p. 17.

The Ratepayer Advocate objects to the Joint Petitioners' failure to provide supporting evidence in this case. Atlantic and Pepco have been involved in merger proceedings within the last few years. Both Atlantic in its filing to merge with Conectiv and Pepco in its filing to merger with BGE, included a comprehensive synergy study by Thomas J. Flaherty, Partner of Deloitte and Touche. T63:L20-T64:L2. Moreover, the Joint Petitioners top executives, Mr. Derrick and Shaw stated that their Board of Directors require cost/benefit analysis before undertaking substantial projects. T57:L10-25.

I FIND that the Joint Petitioners have not carried their burden of proof and have presented no evidence that the proposed merger is a positive benefit to the public interest or that the merger will not harm the ratepayers of New Jersey with respect to rates. The Joint Petitioners failure to undertake and file a synergy study unnecessarily limited the Board's ability to review the merits of this case. I FIND that the Joint Petitioner's argument that the merger will not produce merger savings in the immediate future is unconvincing without the synergy study. Given these circumstances, I RECOMMEND that the Joint Petitioners immediately undertake, as a condition of Board approval of the merger, a comprehensive ten year synergy study which includes: 1) a comprehensive estimates of transaction and transition costs, including supporting documentation; and 2) prepare comprehensive estimates of merger savings, including supporting documentation. The Board should direct the Joint Petitioners to file the synergy study and allow the parties to review and to respond to the new evidence through a discovery and evidentiary hearing process. I FURTHER RECOMMEND that if, after careful review of the synergy study, it is determined that there is a net

positive benefit from the merger, the Joint Petitioners be ordered to reduce its deferred balance by 100% of the allocable share of the annualized savings net of reasonable and prudent transition costs. Transaction costs should not be recovered by the Joint Petitioners in this or any future proceedings before the Board. I RECOMMEND that the Joint Petitioners' request to track merger related costs be denied.

B. SERVICE COMPANY

Conectiv's subsidiary Conectiv Resource Partners ("CRP"), is currently the utility's service company pursuant to a service agreement filed with the Board. As the part of the merger, the Joint Petitioners have indicated that they plan to form a new Pepco service company temporarily designated as "New Service Company." The Joint Petitioners are considering transferring CRP's service functions to New RC but no details have been given to date. *RP -6* (Peterson Testimony), p. 39. Details such as where New Service Company will be located, the cost allocation or what functions it will provide to Atlantic have not be disclosed by the Joint Petitioners. Petition page 5.

I FIND the Joint Petitioners' consistent failure to provide substantive information for the Board to review this merger petition troubling. The Joint Petitioners revealed their plans to create "New Service Company" but provides no evidence on either the structure of the service company, what functions the Service Company will perform, or what cost allocation formulas Pepco might propose. The Joint Petitioners attempt to provide limited amount of details to the Board to circumvent its statutory mandate to regulate utilities and utility mergers must be rejected. In the absence of any detailed information, the Board cannot assess whether the proposed merger would affect the ability of the merged company to provide service at "just and reasonable" rates.

I FIND that in order for the Board to determine the impact the New Service Company will have on rates for customers in its New Jersey service territory, the New Service Company costs allocated to Pepco's New Jersey operations is needed. In merger cases, there is an eminent danger of cross subsidization between in-state utilities and out-of-state subsidiaries as well as regulated and unregulated companies may exist and the Board recognizes the need to protect the New Jersey ratepayers. Consistent with the Board's decisions in the previous Conectiv merger with Atlantic and the Rockland merger cases, I RECOMMEND that the Board condition any merger approval upon the requirement that Joint Petitioners: 1) file for Board approval the transfer of service company functions from CRP to the new, post-merger service company; and 2) subject themselves to Board jurisdiction for filing, review, and approval of any service company agreement and cost allocation manual or formulas that the new service company will use, in addition to any other regulatory approvals that may be required.

C. IMPACT ON EMPLOYEES

Joint Petitioners have testified that the Atlantic will have substantially the same number of employees as they have today and the merger will have few if any involuntary terminations and any decrease in employees would likely be addressed largely through attrition (*RP-6*, NJRAR-R, 1-40, 1-42, 1-43, 2-68 attachments) and all collective bargaining and other employment agreements will be honored. *RP-6*, p. 36. However, witnesses for Joint Petitioners have testified that no company can predict how its operations will be structured in the future. *P-3*, p.4.

The Agreement of Merger calls for Conectiv to nominate at least two of the twelve members of the newly-constituted Pepco Board of Directors. *P-6*, p. 7. After negotiations, the Joint Petitioners

agreed that Conectiv will be allowed to nominate a minority of two members subject to Pepco's approval while Pepco retained control of ten board member seats. *RP-6*, p. 37 Mr. Cyrus Holley, one of Conectiv's present board member, voted against the merger because of Conectiv's disproportionate representation on the New RC's Board. *Id.*

The following is a chart that shows the difference in size of Atlantic, Delmarva and Pepco with respect to customers, revenues, assets and long term debts:

($Millions)

	Conectiv		
	ACE	Delmarva	Pepco
Customers	497,000	471,000	711,000
Revenue	$ 956	$ 1,560	$ 2,201
Assets	$ 2,573	$ 2,428	$ 6,585
Long-term debt	$ 1,075	$ 1,092	$ 2,103

As the chart shows, Conectiv shareholders bring approximately 33% of the combined companies' assets but will be given only 16.6% of the representation of the Board of Directors.

At the time of the evidentiary hearings, the only top executives to have been offered a position were Mrrs. Shaw and Derrick. No other executives have been offered a permanent position with the merger company. T79:L10-23. Joint Petitioners have not identified which of Conectiv's and Pepco's officers and managers with executive separation packages will leave after the merger except for Mr. Howard Cosgrove, Chairman and Chief Executive Officers of Conectiv. *P-1*, at 5.

The Joint Petitioners have testified that Atlantic will have substantially the same corporate structure as it does today, however, the New RC's corporate headquarters will be located in Washington, DC. *P-1*, page 4. However, witnesses for the Joint Petitioners have provided testimony that states that no company can predict how its operations will be structured in the future. *P-3*, p.4.

Based on the Joint Petitioners' testimonies, it is unclear how long Pepco will maintain its commitment of a corporate presence in New Jersey post merger.

In order to insure that the Joint Petitioners maintain the current level of employees in New Jersey post-merger as witnesses for the Joint Petitioners have repeatedly assured the Board, I RECOMMEND that the Board condition the merger on no significant changes in employees or employment in New Jersey for a minimum of five years.

Furthermore, I FIND that Conectiv's allocation of only two Board members is unreasonable when considering the assets that Conectiv brings to this deal. The disproportionate representation of Conectiv on New RC's Board may very well be a detriment to New Jersey's interests, as well as the interests of Conectiv throughout its service territory.

In sum, the proposed composition of the Board of Directors, along with the lack of information as to the management structure may unreasonably limit Atlantic's (and Conectiv's) voice in the management and operations of the combined company. Therefore, I RECOMMEND that the Board adopt the Ratepayer Advocate's recommendation that Conectiv be permitted to appoint four members to the New RC Board of Directors.

In order to ensure that decision-makers with knowledge of local issues and New Jersey regulatory policy are available in New Jersey after the merger closes, I RECOMMEND that the Board condition any merger approval on Pepco's commitment to maintain Atlantic's corporate headquarters in New Jersey, staffed with an adequate number of senior-level executives knowledgeable in New Jersey issues and regulatory policy.

D. SERVICE QUALITY STANDARDS

The Joint Petitioners have claimed as a merger benefit an improvement or enhancement in system reliability and customer service. *P*-11, p. 6. To deliver on this benefit, they have offered to implement what they call a "service quality guarantee." *P*-11, p. 7. The service quality guarantee will have two components: 1) customer service guarantees; and 2) reliability guarantees. *Id*. at 11.

Regarding system reliability, Messrs. Derrick and Shaw promise that, "The merger should enhance the reliability of the electric transmission and distribution systems of the operating companies." *P*-2, p. 6, l. 16-18. The two system-wide reliability indices are the Customer Average Interruption Duration Index ("CAIDI"), which measures the duration of customer interruptions and the System Average Interruption Frequency Index ("SAIFI"), which measures the frequency of interruptions experienced by customers. With respect to CAIDI and SAIFI, the Joint Petitioners recommend that in the event either index has resulted in greater than two (2) standard deviations from the historical mean, per the Board interim regulations, a requirement to file plans and their respective deadlines with the Board in order to correct the problem is triggered. *P*-2, pp. 14-15. However, no penalty or rebate is associated with this deterioration in service that has affected all ratepayers.

Also, the Companies will rank all circuits according to SAIFI results, and Joint Petitioners assert that no circuit will be ranked in the bottom 2% of the list for more than two years in a row. Again, there are no penalties or rebates associated with this poor service; rather, corrective plans of action will be filed and progress on the action will be addressed in the annual report that is submitted to the appropriate regulatory agency. *RP*-9, p. 15. The only reliability guarantee that will result in any sort of customer restitution is that if a metered customer loses electric service, that service will

be restored no more than 24 hours after service was lost. If service restoration takes longer than 24 hours, the individual affected customer's account will be credited $50. *P*-11, p. 14.

ACE currently gathers and reports CAIDI and SAIFI data for its entire New Jersey service territory as well as by sub-region within New Jersey. The 1990-2000 data indicates that ACE's CAIDI performance averaged 85.22 minutes, with a high of 137 minutes in 1996 and a low of 60.66 minutes in 1990. *RP*-9, p. 14, l. 19-21. In the last three years, the CAIDI has averaged about 91 minutes. *RP*-9, p. 15, l. 1. The interim CAIDI standard set by the Board is 131 minutes. This standard would represent a 45% deterioration in service compared to how Company has performed in the last three years.

ACE's SAIFI performance has averaged .77 interruptions per customer per year, with a high of 1.03 and a low of .56. Only in 1994 did its SAIFI rise over one (1) interruption per year. *RP*-9, p. 15; *see Exhibit C*. The SAIFI interim standard set by the Board of 1.13 has not been reached in the past ten years by the Company, and if this were the standard to which the Company is held, it could result in New Jersey customers experiencing double the number of reached in the past ten years by the Company. *Id*.

Another reliability index is MAIFI, the Momentary Average Interruption Frequency Index. This index measures interruptions that are shorter than five (5) minutes in length. ACE currently does not have the capability of providing meaningful MAIFI numbers. *P*-12, p. 15, l. 15-16. However, this type of data becomes much more important as all industries, technological and otherwise, increasingly rely upon sensitive high-tech equipment. *RP*-9, p. 15.

CAIDI and SAIFI are the only customer service metrics for which the Board has established standards, interim or otherwise. Both the Joint Petitioners' service guarantee program and the

Ratepayer Advocate's SQI program contain customer service guarantees in addition to the reliability standards addressed by the Board. The Joint Petitioners' service guarantee program contains five customer service standards to enhance customer service, to be implemented 90 days after the merger closing. *P*-11, p. 13. These are:

Performance Area	**Performance Standard**
Appointments	Scheduled in 4-hour window. $25 credit if Company fails to honor.
New connections	Energize residential service within 10 days of the request. $100 credit if Company fails to honor.
Residential billing accuracy, regulated portion of bill	If not corrected prior to customer inquiry, $5 credit over and above adjusted amount.
Call center	70% answered within 30 seconds, using combined statistics of Companies. Corrective action plan if Company fails to meet the standard.
Call abandonment	Less than 10% abandonment, using combined statistics of Companies. Corrective action plan if Company fails to meet the standard.

P-11, p. 12-13.

Ms. Alexander's customer service recommendations are as follows:

Performance area	**Proposed Annual Baseline Performance Standard**
Call center	80% answered within 30 seconds.
Call center busy rate	<3%
Disconnection Ratio (per 1000 customers)	To be established.
Installation of Service	95% within 10 days.
BPU Complaint Rate (per 1000 customers)	2.0

RP-9, p. 23.

In order to achieve Company accountability, the Ratepayer Advocate proposes a customer restitution methodology that assigns points to each reliability performance area and assigns restitution amounts to each area based on whether the Company has achieved the necessary points for that area and, therefore, maintained or enhanced its service performance. *RP*-9, p. 30-32.

I FIND that reliability and customer service issues are not only relevant to this merger proceeding, but must be addressed in a manner specific to this merger situation. I FIND that the merger, as proposed (*i.e.*, without any enforceable service quality or reliability standards), does not meet the lower "no adverse impact"standard of review applied to service factors set out in *N.J.S.A.* 48:2-51.1. I FIND that the Ratepayer Advocate's recommendations are appropriate supplements to the Board's Interim Reliability Standards in response to the Joint Petitioners' specific promises of improved reliability to New Jersey ratepayers. Therefore, I RECOMMEND that additional safeguards be implemented by establishing a measurable and enforceable SQI as a condition of any merger approval.

I FIND that New Jersey customers could experience almost a 50% decrease in service reliability with no Company accountability, even though customers were unequivocally promised that post-merger service would be better than ever. I FIND that by adding the recommendations of Ms. Alexander to their service quality guarantee, the Joint Petitioners would commit to fulfill the promises they have made regarding the provision of safe and adequate service to New Jersey ratepayers. Therefore, I RECOMMEND implementation of the Customer Service Quality and Reliability Index ("SQI") recommended by the Ratepayer Advocate in tandem with the Joint Petitioners' service quality guarantee plan.

Specifically, I RECOMMEND that the Joint Petitioners be held to a CAIDI standard of 100 minutes per customer and a SAIFI standard of 1.0 interruptions per customer, and that 5% of Joint Petitioners Operations & Maintenance expenditures be set aside for the year 2000 for customer restitution in the event that these standards are not met. I RECOMMEND that a disconnection ratio be included as a service quality performance area due to the possibility that ACE may engage in an extremely high rate of disconnections in order to improve its uncollectible expense situation. I FURTHER RECOMMEND inclusion of a performance standard of a maximum call center busy rate of 3% in order to ensure that ACE does not seek to improve call performance by increasing the number of calls that encounter a busy signal at the customer call center. Finally, I RECOMMEND that MAIFI data be collected by the Joint Petitioners.

In order to bring the promised service quality and reliability benefits to New Jersey ratepayers and to prevent any deterioration of services, I FIND that the approval of this merger is contingent upon the implementation of the SQI including a system-wide customer restitution plan for system-wide service deterioration below the Ratepayer Advocate's recommended CAIDI and SAIFI performance standards.

E. UNIVERSAL SERVICE FUND PROGRAM

Low-income customers often are subject to more frequent power outages and degraded service because of the lack of investment in distribution facilities in lower-income areas. *RP*-9, p. 34, l. 3-5. Therefore, these customers are more likely to need assistance from customer service centers to report power failures, to arrange bill payment plans or to inquire about State and Federal financial assistance programs for which they may be qualified. *RP*-9, p. 5, l. 16-19. The types of changes

common to mergers that could negatively impact service for low-income customers include: (1) the use of lower-paid and less experienced customer service personnel in order to save staffing costs; (2) the transfer of corporate offices, resulting in fewer local decision-makers and employees; (3) coordinating procedures and processes from the merged companies, causing temporary (yet confusing) errors in computerized billing and accounting systems; (4) generalized reduction in programs (such as service training programs) as a cost-saving measure; and (5) closure of satellite customer service centers that add to the inconvenience or inability of customers to rectify their service problems. *RP*-11 p. 4, l. 12-15, p. 5, l. 1-9.

Joint Petitioners assert that it is "inappropriate" to include the issue of a USF program in a merger proceeding (*P*-4, p. 11, l. 10), but the importance of this issue is evident in the press release statement made by Board President Connie O. Hughes after the Board voted for an Interim USF proposal for this year, to be implemented during the winter of 2002. In the press release, President Hughes states that, "While we are working to establish a long-term Universal Service Fund, there is a *critical* need for *immediate* assistance." (emphasis added) (BPU press release #24-01, dated October 25, 2001).

ACE does participate in some low-income financial programs (LIHEAP, NJSHARES and Lifeline), but does not sponsor any bill payment assistance plan that provides ongoing regular financial help to its low-income customers. *RP*-9 p. 36, l. 9-11. The program that the Ratepayer Advocate recommends the Joint Petitioners implement is an ongoing 'percentage of income' ("PIP") plan, which is not tied to any conditions (such as weatherization) and not just a one-time subsidy.

A PIP plan is one in which the amount of the bill payment assistance provided to a low-income customer is based on the annual household electric consumption in monetary terms as a

percentage of the annual household income. The plan consists of two components: 1) a percentage of income-based monthly subsidy component; and 2) a debt forgiveness component. *RP*-9, p. 38, l. 17-18. Financially troubled customers with a gross household income at or below 150% of federal poverty guidelines receive both a monthly subsidy and debt forgiveness for pre-program arrears. Those with a gross household income between 151% and 200% of federal poverty guidelines will not be eligible for the monthly subsidy, but will receive debt forgiveness on a one-time basis. In either case, it must also be established that the customer is "payment troubled," meaning that there is less than $100 in disposable household income after expenses. *RP*-9 p. 39, l. 8-17. The balance left after the percentage payment is the amount of the subsidy. This benefit is portable, for the monthly subsidy benefit is allocated first to the transmission and distribution portion of the bill, followed by the generation part of the bill. *RP*-9, p. 39, l. 1-24.

Regarding the debt forgiveness part of the plan, a payment made prior to its due date results in an automatic monthly forgiveness equal to 1/24 of the total amount of arrearage at the time of the customer's initial enrollment in this program. *RP*-9, p. 40, l. 3-5. Customer enrollment in this plan would be coordinated by local community organizations that are already involved in LIHEAP and other financial assistance programs. *RP*-9, p. 39. L. 1-3.

Another low-income assistance program is the hot weather moratorium, the analog to the cold weather moratorium already widely in place. A hot weather moratorium suspends disconnection of service during periods of extreme high temperature. The Conectiv hot weather policy is to suspend disconnections of residential service for non-payment when the forecast calls for three (3) consecutive days when "the daily high temperature and average percent humidity readings combine[d are] greater

than or equal to 180." Termination is suspended for the first day of the 3-day period, and may be extended based on the long-range forecast. *RP*-9 p. 41, *NJRAR-SQ* 3-44.

I FIND that as a matter of public policy, the Board must also determine whether a merger is contrary to the public interest. *See In re E'Town Corp*., 2000 WL 1736898 (N.J.B.P.U., Oct. 10, 2000)(NO. WM99120923); *In re Lyonnaise American Holding, Inc*., 2000 WL 1289328 (N.J.B.P.U., Jul. 20, 2000); *In re QWest Communications Corp*., 2000 WL 1055418 (N.J.B.P.U., Jun. 28, 2000). I FURTHER FIND that section 2(a)(4) of EDECA states that one of the purposes of the Act is to "...[e]nsure universal access to affordable and reliable electric power and natural gas services." N.J.S.A. 48:3-50(a)(4). Therefore, I RECOMMEND that, in order to prevent the merger from being contrary to the public interest, as a condition of merger, a Universal Service Fund in the form of the recommended PIP program must be implemented.

Additionally, I FIND that ACE should create and manage PIP plan enrollment procedures to target its low-income customers, using information already gathered from the agencies that administer LIHEAP and Lifeline, and information gathered during ACE's education and community outreach efforts. Finally, I RECOMMEND that as part of the USF program, a hot weather moratorium and a low-income aggregation plan be formal conditions of merger.

F. CAPITAL STRUCTURE

If the merger is consummated as proposed, then Pepco and Conectiv will become first tier subsidiaries of the holding company, New RC. ACE and Delmarva will remain subsidiaries of Conectiv. New RC has applied with the SEC to register as a holding company under the Public Utility Holding Company Act of 1935. *P-1*, Exh. B; *RP-5*, pp. 5-6. The Petitioners allege that in this

case they are not asking for any change in the rates of the New Jersey utility, ACE. *P-1*, p. 9, ¶23B. However, as found by the Ratepayer Advocate's witness, James A. Rothschild, holding company structures can increase the complexity of determining the proper capital structure for future ratemaking purposes. As a company's structure becomes increasingly more complex, the greater the chance that the capital structure of a regulated subsidiary might not reflect the true capital structure that is or should be financing the regulated operations of the company. *RP-8*, p. 4. In this case, the structure of the post-merger New RC can complicate ratemaking for ACE, the New Jersey regulated utility.

The merged company's complexity can make it more difficult for the Board to discover ACE's true earnings in a base rate case if the capital structure proposed by the utility in a rate case does not reflect any cost savings from the holding company's consolidated capital structure. These cost savings could come from a lower percentage of equity in the actual consolidated capital structure than the percentage of equity in the utility's proposed capital structure for ratemaking. The cost of equity is usually higher than the cost of debt. T457:L19-23. If the lower cost of capital from the consolidated capital structure is not passed through to regulated utility customers so that they share in the benefits coming from the merger, then those utility customers could effectively subsidize the operations of other affiliated companies under the holding company structure. The Ratepayer Advocate proposes several conditions that should be made mandatory before the Board should decide to approve the merger. These procedures as outlined below will minimize the chance that the company can use capital structure to (1) mask the true level of earnings being achieved by its regulated New Jersey operations and (2) force New Jersey ratepayers to subsidize any of the numerous other companies in the New RC combined operations. *RP-8*, p. 5.

I FIND that the Board should reject this proposed merger unless the Petitioners can prove that the merger will provide positive benefits to New Jersey ratepayers. The Petitioners have made a filing with the U.S. Securities and Exchange Commission ("SEC") showing a capital structure for New RC with 31% common equity which is much less than the 36.7% common equity reported by ACE in its 10Q report to the SEC. *RP-8*, pp. 4-5. If it holds true that New RC will have less equity in its capital structure than ACE post-merger, then using the consolidated capital structure in ACE's base rate cases will save the ratepayers money. However, as pointed out by Mr. Rothschild, it is possible that the reduction in common equity levels could be done in a way that will not be visible to the Board because the cost savings benefits of the lower common equity ratios appear at the parent level, not at the regulated subsidiary level. *RP-8*, p. 5. If the merger is completed, the increased complexity of the combined companies could obfuscate the impact of future changes to the consolidated capital structure. For ratepayers to benefit from this revised, more cost competitive capital structure, I FIND that this new reality of how the merged entity is being financed has to be factored into the regulatory process. Accordingly, I find that the Board should not approve the merger unless New RC is required to implement certain safeguards concurrent with completing the merger. *Id.*

I FIND that the Board should not approve this merger unless it determines that, in future rate proceedings, it will set the overall cost of capital for ACE based upon either the capital structure of the consolidated company or the regulated subsidiary, using whichever has the lower percentage of common equity. In that way, New Jersey customers will share in the positive benefits that may come from the proposed merger.

This should be done unless the Board sees convincing proof in future rate proceedings that a different method will provide the greatest benefits to New Jersey customers. The Ratepayer

Advocate recommended that ACE (and any other party) be allowed to propose whatever capital structure it believes to be appropriate, including the reported "actual" capital structure of the regulated subsidiary. However, it also recommended the company should be required to demonstrate that the capital structure it proposes is the most beneficial to New Jersey ratepayers. *RP-8*, p. 6 and T421:L20-25. If ACE does not propose to use the consolidated actual capital structure as the basis for the overall cost of capital computation, then the justification for any other capital structure should include an analysis of why it is better for New Jersey ratepayers than if the consolidated capital structure were used. As stated by the Ratepayer Advocate witness, Mr. Rothschild:

> A primary goal of the capital structure selection should be the use of a capital structure that will minimize the overall cost of capital IN THE LONG-RUN.

Id.

While the Petitioners have referred to a recent case wherein the Board adopted the capital structure of the regulated subsidiary for ratemaking,[1] the Board has even more recently adopted Mr. Rothschild's recommended use of the consolidated capital structure in the case, *I/M/O the Board's Review of Unbundled Network Elements Rates, Terms and Conditions of Bell Atlantic-New Jersey, Inc.*, BPU Docket No. TO00060356. The order in this telephone matter has not yet been issued, but at its November 20, 2001 public agenda meeting, the Board orally adopted Staff's recommendation to use Mr. Rothschild's weighted cost of capital that used the consolidated capital structure.

<u>I FURTHER FIND</u> that the Board should adopt the Ratepayer Advocate's recommendation that another mandatory condition for merger approval should be requiring ACE to file annual reports

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[1] *I/M/O Middlesex Water Company*, BPU Docket No. WR00060362, Order dated June 6, 2001, pp. 34-35.

showing the returns on equity or returns on rate base calculated in two different ways. *R.-8*, p. 6. One way should be based on the capital structure of the regulated utility and the other way should be based on the capital structure of the post-merger New RC. These reports should be sent to the Ratepayer Advocate at the same time they are sent to the Board.

The purpose behind these reports would be twofold. One purpose would be to identify the positive benefits that could be attributed to the merger in an improved capital structure. The reports would provide a mechanism for the timely review of the impact of actual capital structure changes implemented by the New RC. *R.-8*, p. 5. Another purpose would be for the Board to have this information readily available to best evaluate the actual earnings rate and to give the Board guidance as to what capital structure it finds to be most beneficial to New Jersey customers in future rate proceedings. Failing to pass this benefit of the lower overall cost of capital on to ratepayers could result in the regulated subsidiary subsidizing New RC's unregulated subsidiaries. The more subsidiaries a company has, the more careful the Board should be to protect ratepayers from potential capital structure abuse. *Id.*

The abuse of capital structure can be visited on utility ratepayers when the utility files its post-merger base rate cases. As stated by Mr. Rothschild, "There is a very strong tendency for utility companies to be able to justify a higher revenue requirement as its percentage of common equity in the capital structure increases." *RP-8*, p. 10, l. 17-19. The utility's management may want to keep costs down, but at the same time may want to use a base rate case to increase revenues more than is likely to be allowed by a utility commission. This creates a conflict of interest for the utility management, *i.e.,* wanting to use less equity to contain excess costs (and increase net utility income

between rate cases), but proposing a capital structure in a rate case that uses more equity to maximize revenue requirements. *RP-8*, p. 10, l. 19-23.

In contrast, the consolidated capital structure of the holding company is not generally subject to a conflict of interest because the consolidated capital structure is an actual capital structure that reflects full arms-length transactions between the public debt and equity investors. *RP-8*, pp. 10-11. Because regulated utility services are among the least risky businesses, it is likely that the operations of other subsidiaries, both regulated and unregulated, that will be owned by the New RC will be equally or more risky than the utility operations in New Jersey. *Id.*, p. 11, 3-6. As noted by Mr. Rothschild, using the consolidated capital structure as an estimate of the actual capital structure of the regulated New Jersey operations produces a conservatively high estimate of the percentage of common equity financing New Jersey regulated electric operations because the consolidated capital structure has to finance the entire company's business risk, not just the business risk of the regulated utility company. For these reasons, I FIND that New RC's consolidated capital structure should be a factor in the Board's review of ACE's capital structure. *Id.,* p. 11, l. 6-13.

Moreover, the Petitioner's witness, J. Mack Wathen, testified that if New RC's capital structure presented additional risk for ACE's customers, "when it comes to ratemaking, the Board of Public Utilities ultimately controls and can manage that risk that becomes apparent to customers of Atlantic Electric" (T254:L3-7) and that if "they [the Board] feel that for whatever reason the capital structure is out of kilter from what they believe to be reasonable, they can make adjustments." T256:L17-20. In his prefiled rebuttal testimony, Mr. Wathen said:

> Importantly, however, for ratemaking purposes, the Board will retain full authority to determine the appropriate capital structure for ratesetting regarding ACE's utility operations.

P-4, p. 9, l. 12-16. However, Mr. Wathen said that he believed the issue need not be dealt with in this case. T265:L8-17 and T267:L9 to T268:L10.

Rather than relying solely on the Board's broad authority to set appropriate rates at some point in the future after the merger is completed, as Mr. Wathen suggests, I FIND that the Board should adopt the Ratepayer Advocate's recommendations that the Board in this proceeding make an explicit condition of merger approval its statement that it will affirmatively examine using the consolidated capital structure in future rate proceedings if that structure should be the one most beneficial to New Jersey customers and that it will require ACE to report annually its return on equity or return on rate base using both capital structures so that the utility's true earnings level is apparent between rate cases as well. Since the Petitioners seek to make the structure of the company much more complicated through this merger, I FIND that it is important to recognize the merger's effect on ACE on an ongoing basis, rather than having to be determined only in discovery well after a rate case is underway. In this manner, the Board and ratepayers can identify some of the benefits that may arise due to the merger and also avoid discovering some of the merger's complications only after the fact in a subsequent rate case.

Likewise, as pointed out by Mr. Rothschild, the firm that audits the financial statements of both Conectiv and Pepco, PricewaterhouseCoopers, LLP, recognized the importance of this issue. Prior to the merger that formed PricewaterhouseCoopers, LLP, a partner of the accounting firm Price Waterhouse in June 1997 advised one of the firm's other clients (the Long Island Power Authority) that:

> … whenever you have a situation where you have a holding company, it is important to have provision for hypothetical cap structure **because a holding company can capitalize its operating**

> **companies any way it wants**, a hundred percent equity or anything else in between, a hundred percent debt or anything else in between.

(Emphasis added) (Footnote omitted). *RP-8*, p. 12. The flexibility open to the holding company makes it incumbent on the Board to have the ability to use a hypothetical capital structure for the regulated utility to protect its captive customers. As affirmed by Mr. Rothschild at the November 14 evidentiary hearing:

> My concern is that what can happen, not necessarily will happen, but can happen, if the board [sic] doesn't look to that consolidated capital structure, the new perhaps more efficient lower equity capital structure might not work it's [sic] way into the benefit of ratepayers.

T429:L18-23.

If approved and completed, I FIND that the proposed merger will make the new company more complex and more impacted by unregulated operations. Therefore, the Board needs to be all the more careful about how it uses computations based on the reported capital structure of the regulated New Jersey operations. Old procedures that used to provide some presumption that the capital structure of the regulated entity was chosen by management to be reasonable lose their meaning in the new, complex combination of Pepco and Conectiv because there is increased likelihood that the capital structure of a regulated subsidiary might be allocated, for book purposes, more than its appropriate share of the equity needed by the entire consolidated entity. *RP-8*, pp. 12-13.

As testified by Mr. Rothschild, the New RC holding company has substantial incentive to reduce the cost of capital on a consolidated basis, but it does not have the same incentive to reduce the overall cost of capital for ACE for ratemaking. *RP-8*, pp. 13-14. As long as New RC believes its subsidiary capital structure might be used for ratemaking, the holding company has an incentive

to keep ACE's common equity ratio relatively high. This would tend to increase the revenue requirements found in a base rate case. This is especially true because the New RC holding company structure gives the holding company substantial ability to borrow funds to repurchase common stock and thereby lower the overall cost of capital. Since a regulated subsidiary such as ACE can and does provide cash flow to service more debt than it currently has outstanding, that cash flow could be used either to increase borrowing at the New Jersey subsidiary level or at the consolidated level. The important difference, however, is that unless regulatory procedures are implemented to protect against this, if ACE's extra cash flow is used to finance a higher proportion of debt at the parent level rather than at the ACE level, the percentage of equity in ACE's capital structure remains high and increases the revenue requirements in a base rate case, even though the overall debt/equity ratio of the consolidated company is brought to more cost effective levels. *R.-8*, p. 1. The unfairness of that kind of action by New RC is readily apparent. Therefore, I FIND that the Board should condition any merger approval on implementing the recommendations of the Ratepayer Advocate as to capital structure used in rate proceedings and the above mentioned reporting requirements.

G. IMPACT ON COMPETITION

The Petitioners allege the proposed merger will not detrimentally affect competition since the combined companies "would not have any market power that could be used to adversely affect competition." *P-1*, p. 9, ¶23A. However, I FIND the standard of review for the merger is that the Petitioners must prove the merger would provide positive benefits for competition in the New Jersey electric market. The Petitioners have not even alleged that they meet that standard. I FIND that the merger as proposed should be rejected since the Petitioners have not carried the burden of proving that the merger would provide positive benefits for competition in the New Jersey electric market as required. Furthermore, as outlined below, I FURTHER FIND that the Petitioners have not met the burden of proving that the merger will not harm competition.

The entirety of the evidence presented by the Petitioners in their original prefiled testimony on competition and market power was the conclusions of their witness, Joe D. Pace, that the combined companies would not own enough generation plants to exercise market power in the wholesale electric markets and that in the retail markets there are other competitors who could serve that market. *P-32*, p. 26, l. 19 to p. 27, l. 4. Dr. Pace later supplemented his original conclusions with his prefiled rebuttal testimony. *P-33*. However, the rebuttal testimony offered mainly more conclusory statements without sufficient credible factual evidence to support them. The bulk of the support for his conclusions was apparently contained in his testimony and attachments filed at the Federal Energy Regulatory Commission ("FERC") which the Petitioners did not move to include in the record of this proceeding. *Id.*, pp. 2-4. Since this alleged evidence does not exist for the purposes of the record before me, I will disregard the alleged conclusions based on those documents as being wholly unsupported by facts in this record. However, even if the Petitioners had presented

those documents from the FERC case for my review, the Petitioners' reliance on them is misplaced. The Petitioners' case at the FERC is not dispositive of the issues before me, *i.e.*, it does not prove that the proposed merger will either provide positive benefits for competition in the New Jersey electric market or even that the merger will not harm competition.

The Petitioners rely heavily on the fact that other regulatory agencies, *i.e.*, the FERC and the U.S. Department of Justice ("DOJ") have cleared the merger. *P-33*, p. 3, l. 7 to p. 4, l. 3. In this part of Dr. Pace's rebuttal testimony, he also cites for support that the Ratepayer Advocate did not intervene at the FERC. This fact is irrelevant to the case before me and I do not consider it as supportive of the merger approval. The decisions by the FERC and DOJ do not relieve the Board of the obligation to make its own independent decision on whether the proposed merger will provide positive benefits for competition in New Jersey. *See, N.J.S.A. 48:2-51.1.*

The Petitioners' reliance on the FERC decision approving the merger does not support the approval of this merger. The FERC's opinion on wholesale market power does not prevent the Board from reviewing the issues as they relate to this merger. In fact, the FERC specifically noted that no state public utility commission had requested that the FERC review the proposed merger's impact on retail rates in their jurisdictions. *Section III.B.4 of the FERC Order, 96 FERC ¶ 61,323, Docket No. EC01-101-000, dated September 26, 2001, p. 13* ("*FERC Order*"). Therefore, the FERC ruling cannot prevent the Board from reviewing these issues despite the Petitioners' intimation that the ruling should somehow replace the review of the competition issue here. Indeed, the FERC specifically found that the proposed merger does not adversely affect the state commissions' regulation over the Petitioners. *Id.*

By citing to the FERC decision, the Petitioners' witness, Dr. Pace, seems to suggest that the FERC's ruling on wholesale market power somehow should preempt the Board from examining the issue as it relates to retail competition and retail rates. *P-33*, pp. 3-4. Contrary to this suggestion, the division between federal and state jurisdiction is hardly as clear as the Petitioners have suggested. In fact, the grey area between federal and state jurisdiction is further clouded by an appeal to the Supreme Court of the United States concerning the FERC's Order 888 on open transmission access which questions the federal preemption issue. *New York v. FERC, No.00-568 (U.S., argued October 3, 2001).* That case involves the conflict over the FERC's claimed jurisdiction over unbundled transmission of electricity for retail sales, utility retail stranded costs due to competition and the use of local distribution facilities for wholesale electricity sales. The Petitioners in that proceeding argue that the FERC overstepped its jurisdictional bounds in asserting jurisdiction over those issues. In its order on this proposed merger, however, the FERC clearly said that its concern over the proposed merger's impact on state regulation arises when a state has no authority to act on a merger and when the state raises those concerns at the FERC. *FERC Order,* p. 13. Since the Board has obvious authority to review the proposed merger,[2] it would be unnecessary for the Board to intervene and request the FERC to review the Board's regulatory jurisdiction over the Petitioners. The Petitioners themselves recognized the Board's clear authority when they filed for Board approval of the proposed merger.

Furthermore, the Petitioners' implication that the Ratepayer Advocate (as representative of utility customers) should suffer some prejudice because it did not intervene in the FERC proceeding is irrelevant for the same reasons given *supra*, that the FERC decision itself is not dispositive of this

[2] *N.J.S.A. 48:3-10; 48:2-51.1.*

issue. The FERC proceeding cannot decide this issue in relation to ACE's customers, so it is not dispositive that neither the Ratepayer Advocate nor the Board intervened there. For all these foregoing reasons, I FIND that the Petitioners' reliance on the *FERC Order* does not support the merger approval.

Additionally, the prefiled testimony of the Ratepayer Advocate expert witnesses, Messrs. Biewald and Schlissel, goes into detail about why the FERC's ruling is insufficient to decide this issue from the perspective of the New Jersey market. Their testimony demonstrates that the FERC's limited review of wholesale market power issues through the Herfindahl-Hirschman Indices ("HHI")[3] calculations does not capture the potential implications of the Petitioners' control over a significant segment of the generation market in PJM.[4]

Messrs. Biewald and Schlissel state that the FERC (and the DOJ) use the HHI as a "screening tool" to identify whether market power might be a problem and that the FERC specifically notes that the HHI screening tool is not infallible and in some cases may not detect certain market power problems. *RP-16*, p. 7, l. 13-16. The HHI is only a rough illustration of relative market concentration, based on a limited set of "snapshots" of the markets examined. *Id.*, p. 7, l. 17-21. Messrs. Biewald and Schlissel also state five additional reasons that the HHI as a measure of market concentration and market power could understate the degree of market power in relevant markets:

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[3] The HHI is the sum of the squares of individual firms' market shares. The higher the index number the greater the level of concentration and the more likely that market power will be a problem. *RP-16*, p. 7, l. 9-12.

[4] As of June 2001, Conectiv had 1,140 MW which is 12% of the 9,500 MW of the mid-merit capacity in PJM. *RP-16*, p. 13, l. 1-2.

(1) Due to the very limited ability to store large quantities of electricity, the supply of electricity and the demand for it must balance over very short time intervals, which could allow other companies, in the short run, to take advantage of shortages in a way that could not occur if other suppliers or purchasers could readily and inexpensively store some inventory of the product. (2) It is difficult to substitute other energy sources for electricity in the short term to help customers reduce their dependence on electricity at times of high prices. (3) The dynamic nature of electricity markets can change dramatically over a few hours and create opportunities for the exercise of market power even though the market may be relatively competitive under most other circumstances. (4) In current electricity markets, there are limited programs for real-time demand response that could allow customers to reduce their demand quickly in response to high electricity prices and thereby decrease their exposure to exercises of market power. (5) There are a limited number of existing transmission facilities that electricity can flow over and new generation and transmission facilities are very capital intensive and require long lead times to bring into operation. *RP-16*, p. 9, l. 22 to p. 10, l. 12. All these factors create openings for the exercise of market power that are not apparent from an HHI analysis.

The HHI's most significant failure is its inability to recognize strategic bidding behavior or the withholding of available generation to increase market clearing prices. *RP-16*, p. 7, l. 23 to p. 8, l. 2. This type of strategy has been examined by the California Independent System Operator ("CAL ISO") which is the entity that operates and manages the California transmission grid system.

As stated by Messrs. Biewald and Schlissel, the CAL ISO has concluded that, in 98% of the hours from May 2000 through November 2000, the bidding profiles of five large generators displayed patterns of withholding generation leading to inflated market prices. *RP-16*, p. 11, l. 14-17.

According to CAL ISO, in the ten months from May 2000 to February 2001, the market power observed in California wholesale markets had driven up electricity prices more than $6.2 billion. *Id.*, p. 11, l. 22 to p. 12, l. 4. The importance of this issue is underscored by the California experience. While the PJM market is operated much differently than the California market, market power remains a vital concern in this case. The New Jersey legislature made competition and market power a mandatory issue to be examined in utility mergers. *N.J.S.A. 48:2-51.1.* On the other hand, the Petitioners' witness, Dr. Pace, prepared an HHI analysis of the California energy markets in 2000 for Pacific Gas & Electric Company and that HHI analysis led him to conclude that the markets were "relatively unconcentrated." *RP-16*, p. 10, l. 13-18. His conclusions of no market power concerns in California when others reviewing those markets clearly proved large patterns of market power abuse call into question the reliability of Dr. Pace's conclusions in this case.

Messrs. Biewald and Schlissel also found realistic concerns over market power and competition raised by the proposed merger due to the Petitioners' ownership of generation plants in significant segments of the PJM market, namely the mid-merit and peaking segments. ACE's parent, Conectiv, Inc., has had the strategy of retaining, operating and increasing its share of the mid-merit generation business in PJM.[5] *Id.*, p. 12, l. 7-8. The mid-merit plants' ability to ramp up electric output quickly allows the plants to capture value in the wholesale market. *Id.*, p. 10, l. 14-15.

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[5] Mid-merit generation plants are units that can quickly increase or decrease their electricity output to match the expected demand in electricity markets. According to Conectiv and Pepco, mid-merit plants are generally operated during times when the demand for electricity rises, in contrast to base load electric generating plants, which are designed to run almost continuously to supply the base level of demand. *RP-16*, p. 12, l. 8-14. Periods of higher demand are also the periods when customers who need the electricity face higher prices for it.

Conectiv has repeatedly prepared and distributed documents for investors to show that Conectiv has been able to use these plants to set the market price in PJM for 40% of the hours of the year. *Id.*, p. 13, l. 2-3. Dr. Pace attempted to contradict Conectiv's written presentations to investors by testifying that he had received oral representations from Conectiv employees that Conectiv informed investors that its mid-merit plants had not in fact set market prices for 40% of the year, but that mid-merit plants in general, including those of other companies, had done so. *P-33*, p. 6, l. 21 to p. 7, l. 6 and T955:L10 to T956:L16. The Petitioners refused to produce any direct evidence of that allegation and never attempted to produce the employees for cross-examination who would say under oath that this was the case. Dr. Pace's second-hand testimony does not contradict the fact that Conectiv made the assertion that its mid-merit assets set market prices 40% of the year in several written presentations and continued to distribute that statement.

The Petitioners apparently argue that those presentations were not meant to be read literally.

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This concern is not only a wholesale market problem. It is a problem in the retail electric market as well. Marketers of electricity to retail customers often must purchase their energy in the wholesale market to provide to their retail customers. If the Petitioners can set market prices in the wholesale market for such a significant period, then those wholesale prices must be passed through to retail customers in New Jersey who then carry the burden of higher electric bills. That is a matter of concern in this case. Furthermore, because the retail prices for ACE and the three other investor-owned electric utilities in New Jersey are capped through July 31, 2003, retail competitors must be able to obtain energy at prices lower than the capped rates to make any profit on the sale of energy. The Petitioners' ability to raise market prices higher than the capped rates can make it impossible for a retail marketer to enter the New Jersey market. As discussed below, currently only 0.2% of New

Jersey electric customers have found a retail marketer able to serve them. Wholesale market prices play a large role in the bleak condition of the New Jersey electric market, which further indicates how important market power concerns are in this case.

The merged companies have an incentive to raise market clearing prices to increase their profits earned by selling energy or the profits of affiliates involved in energy futures or options markets even if New Jersey ratepayers had to bear higher prices. *RP-16*, p. 13, l. 12-15. The merger would add Pepco's 806 MW of peaking generation plants to Conectiv's mid-merit plants and exacerbate market power issues. Peaking plants operate on the margin of electricity demand that create the highest prices. Adding Pepco's peaking plants to Conectiv's mid-merit plants would plainly increase New RC's market power. Even if one assumes that 806 MW is small compared to the 50,000 MW in PJM, the ability of those peaking units to set market prices in the hours when prices are already high should be a reason to scrutinize the market power issues with great care.[6] Also, if the peaking capacity continues to be owned by a competitor, it can play an important role in moderating the ability of mid-merit generation to raise market prices. *RP-18*, p. 2, l. 11-13. If the merger is completed and this peaking capacity is co-owned by the owner of the mid-merit plants, then the ability of those plants to moderate prices would disappear.

Furthermore, Conectiv has expressed an intention of "accelerating [its] market-leading, mid-merit position in PJM" by tripling its mid-merit and peaking capacity by 2004. *Id.*, p. 13, l. 18-20. Accordingly, <u>I FIND</u> that the merger could further enhance New RC's control of mid-merit and

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[6] In addition to the times when there is incentive to raise market prices, there might also be hours when the merged companies might want to lower market clearing prices in order to adversely affect competitors. *RP-16*, p. 13, l. 15-17. In these latter cases, a generator could decide to act to lower prices to reduce the revenues of other competitors whose plants would then garner lower prices.

peaking capacity within PJM and also might enhance its ability to profit from the activities of unregulated affiliates in the energy futures and options markets. *Id.*, p. 13, l. 20-24.

The Petitioners also allege, without factual foundation, that the proposed merger raises no vertical market power concerns. *P-32*, p. 27. Dr. Pace apparently believes that the loss of one competitor that would result from the merger is too small to be of concern, since the "potential market" is broad and "many other suppliers" are available to serve the market. He obviously ignores the dismal statistics in New Jersey for the retail electric market. As of October 31, 2001, only 8,509 out of 3,556,749 electric customers, or 0.2%, in the "potential market" of New Jersey have switched to the "many other suppliers" of electricity.[7] For Conectiv customers, the situation is even worse. Only 676 out of 507,152 Conectiv customers in New Jersey, or 0.13%, have found an alternate supplier. With such a minuscule response by these other competitors, it is foolish to ignore the loss of even one competitor. Dr. Pace's reliance on allegedly ample opportunities for customers to find alternate suppliers flies in the face of the reality of New Jersey's electric market where customers have been unable to find suppliers willing to serve them, and therefore, I RECOMMEND that the Board not rely on Dr. Pace's analysis of this issue.

As stated above, the Petitioners have not proved that the merger will benefit ratepayers and promote competition in the New Jersey electric market or even that ratepayers and competition will at least not be harmed by the merger. I FIND that the Petitioners' reliance on the HHI and Dr. Pace's conclusory testimony does not meet the burden of proof required. The Petitioners should not be

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[7] Information from the BPU website (copy attached). The Ratepayer Advocate requested that I take official notice of this information which was not entered into the record at the evidentiary hearings. *N.J.A.C. 1:1-15.2*. I grant that motion and hereby take official notice of this information.

permitted to proceed with the merger until they have met this burden. As testified by Messrs. Biewald and Schlissel, before considering to approve the proposed merger, the Board should require the Petitioners to present a more detailed assessment of market concentration and market power. This assessment would require the use of an electric system simulation model to look at the hourly behavior of the market under a wide variety of physical conditions, contractual situations and bidding behaviors which is what the HHI cannot do. *RP-16*, p. 8, l. 3-8. Such a simulation model is more realistic and would provide better insight into potential market power concerns than just a formalistic HHI calculation.

Dr. Pace objects to such a simulation model as "expensive, time consuming, and controversial." *P-33*, p. 9, l. 3-4. However, the complexity of this issue is not a reason to proceed with the proposed merger despite the Petitioners' wholly inadequate analysis of market power. I FIND that such a model is justified and I RECOMMEND that the Board require the Petitioners to use such a model and present its results and workpapers to the parties in this case, if the Petitioners want to proceed with the merger. Market power is one of the four vital issues that must be exhaustively examined in a utility merger proceeding. Complexity and controversy are not good reasons to shy away from this review. As stated by Messrs. Biewald and Schlissel, the energy costs to customers from one anti-competitive hour-long event in the PJM market could easily exceed the cost of conducting an appropriate analysis of market power. *RP-18*, p. 6, l. 25-27. Rather than providing a reason not to do it, the complexity of the market bidding situations that such a simulation model can analyze instead argues strongly for its use.

POINT I

THE PROPER STANDARD FOR REVIEW OF THE PROPOSED MERGER IS THE "POSITIVE BENEFITS" STANDARD

The Board has broad and sweeping powers over all aspects of public utilities subject to its jurisdiction. *See N.J.S.A.* 48:2-13; *Township of Deptford v. Woodbury Terrace Sewerage Corporation*, 54 *N.J.* 418, 423, 255 A.2d 737, 739 (1969); *In re Public Service Electric and Gas Company*, 35 *N.J.* 358, 371 (1961). Since Joint Petitioners propose to merge Conectiv and Pepco into a new holding company that will acquire control over both entities, the transaction falls within the jurisdiction of the Board. *N.J.S.A*. 48:2-51.1 provides that:

> [n]o person shall acquire or seek to acquire control of a public utility directly or indirectly through the medium of an affiliated or parent corporation, or through the purchase of shares, the election of a board of directors, the acquisition of proxies to vote for the election of directors, or through any other manner, *without requesting and receiving the written approval of the Board of Public Utilities*.

(Emphasis added).

Furthermore, under its statutory mandate, the Board is required to "evaluate the impact of the acquisition on competition, on the rates of ratepayers affected by the acquisition of control, on the employees of the affected public utility or utilities, and on the provision of safe and adequate service at just and reasonable rates." *Id.* The Board must be "fair to all elements concerned, keeping in mind the board's primary responsibility is to the public interest." *I/M/O New Jersey Resources Corporation and New Jersey Natural Gas Company v. NUI Corporation and Elizabethtown Gas Company*, BPU Docket No. 8312-1093 (*Decision and Order on Motions for Emergent Relief*, January 31, 1984) ("*New Jersey Resources*"). Historically, the Board has chosen one of two different

standards in order to determine if a proposed merger is in the public interest: the "positive benefits" standard, or the "no harm" standard.

The "positive benefits" standard, also known as the "best interest of the public" or "of positive benefit to the public interest" standard, has its origins in merger or "takeover" cases "affecting the internal structure of existing New Jersey utilities." *I/M/O Public Service Electric and Gas Company for Authorization Pursuant to N.J.S.A. 48:3-10*, BPU Docket No. EM8507774 (*Order Authorizing Transfer of Capital Stock and Approval of Merger*, January 17, 1986, at p. 7) ("*PSE&G Authorization*"). Under this standard, the Board requires petitioners to demonstrate that benefits would accrue to ratepayers if a proposed transfer of control is approved.

Historically, the Board has applied the "no adverse impact" standard in cases in which the proposed acquisition did not significantly affect the internal structure of a utility. *See I/M/O Atlantic City Electric Company*, BPU Docket No. EM8608886 (January 5, 1987)(The Board finds that "the proposed restructuring will have no adverse impact upon the rates charged to...ratepayers, the employees of the utility or upon Atlantic's ability to render safe, adequate and proper service." *at* 9); *PSE&G Authorization* ([T]he Board is of the opinion that the use of a positive benefits test is not required in the matter now pending." at 8); *I/M/O Elizabethtown Water Company*, BPU Docket No. WM8502238 (August 9, 1985) ("The Board is of the opinion that with the implementation of the following provisions, the Plan of Merger will not be detrimental to the public or to the ratepayers and, therefore, is not contrary to the public interest." *at* 5).

Recent merger cases represent somewhat of a departure from the standards articulated in past transfer of control cases. In recent merger cases involving electric utilities, the Board articulated the "no adverse impact" standard as the basis for its findings, even when the proposed merger did affect

the internal structure of an existing New Jersey utility. *See I/M/O Atlantic City Electric Company and Conectiv, Inc., for Approval of a Change in Ownership and Control*, BPU Docket No. EM97020103 (*Order*, January 7, 1998) ("*Conectiv Merger Order*"); *I/M/O Orange and Rockland Utilities, Inc. for Approval of the Agreement and Plan of Merger and Transfer of Control*, BPU Docket No. EM98070433 (*Order*, April 1, 1999) ("*Rockland Merger Order*"). In the *Conectiv Merger Order*, the Board clarified its position, noting that it was not bound as a matter of policy to use the "positive benefits" standard in all circumstances where changes are made in the internal structure of a utility." *Conectiv Merger Order,* p. 5.

However, the Board has required a merging electric utility to flow positive benefits to its customers as a prerequisite of merger approval, regardless of what standard of proof it has stated it applied in its review. For example, in the Conectiv/Atlantic City Electric Company merger case, the Board ordered ACE to flow through 75% of the net estimated merger savings to its customers as a rate decrease implemented at the merger's closing date. *Conectiv Merger Order*, pp. 7-8. The Board also ordered significant protections for ACE's employees. *Id*. at 11-12. Similarly, in the Rockland Electric Company ("Rockland")/Consolidated Edison ("Con-Ed") merger case, the Board ordered Rockland to pass through 75% of the net merger savings to its customers and provided for a minimum staffing level for Rockland's New Jersey operations. *Rockland Merger Order*, pp. 17-18.

The Board has determined the circumstances where each of the more specific standards are to be applied. The Board noted that it would apply the "positive benefits" standard in merger cases "affecting the internal structure of existing New Jersey utilities." *PSE&G Authorization* at 7. Moreover, in considering the merger in *New Jersey Resources*, the Board specifically called for the

application of the more stringent "of positive benefit to the public interest" standard, as opposed to the less stringent "adverse impact" standard, holding:

> [w]e conclude that the basic standard that must be established is that the planned merger is of positive benefit to the public interest and not merely that it would not adversely affect the ability of the merged utilities to provide safe, adequate and proper service at reasonable rates. (emphasis added) *New Jersey Resources* at p. 8.

The proposed merger of Conectiv and Pepco into New RC falls within the category of mergers where the "positive benefits" standard serves as the standard of review. The internal structure of Conectiv will be directly and significantly affected by the proposed merger, particularly by its under-representation on the New RC Board of Directors. Furthermore, the proposed merger of Conectiv, Pepco and New RC greatly impacts the management and control of Conectiv, and thereby ACE. If the merger is approved, New RC will be the newly-structured, registered public utility holding company and New RC will acquire Conectiv, Pepco, and hence their subsidiaries, for a total consideration of approximately $2.2 billion in cash and stock. *P*-1, section II, subsection B, paragraph 13. Conectiv common stockholders will have the option to receive either $25.00 in cash or New RC's shares, subject to proration, such that the aggregate consideration paid to all Conectiv shareholders will be 50% cash and 50% stock. Conectiv Class A shareholders will receive 86.8% of the per share value received by common stockholders, or $21.69, also subject to proration. *Id.* The Joint Petitioners estimate that Conectiv stockholders will own approximately 33% of the common equity of New RC. *Id*. at paragraph 14. Although Conectiv will continue operations from its Wilmington, Delaware corporate offices, parent company New RC's corporate offices will be located in Washington, D.C. *Id*. at paragraph 2.

The Legislature addressed the factors that must be considered by the Board in a utility merger by enactment of *N.J.S.A.* 48:2-51.1. In considering a request for approval of an acquisition of control of a public utility, the Board is statutorily required to perform a four-part analysis, evaluating the impact of the acquisition "[1] on competition, [2] on the rates of ratepayers affected by the acquisition of control, [3] on the employees of the affected public utility or utilities, [4a] and on the provision of safe and adequate utility service [4b] at just an reasonable rates." *N.J.S.A.* 48:2-51.1. This analysis is consistent with the legislative intent of the Electric Discount and Energy Competition Act ("EDECA"), *N.J.S.A.* 48:3-49 *et seq.*, in which the Legislature declares that the policy of the State is to "[m]aintain adequate regulatory oversight over competitive purveyors of retail power...to assure that consumer protection safeguards inherent to traditional public utility regulation are maintained, without unduly impeding competitive markets." *N.J.S.A.* 48:3-50.

Based on its prior decisions, legislative intent, and the facts of this case, the Board should employ the "positive benefits to the public interest" standard. However, even if the Board chooses to use the less stringent "no adverse impact" standard, the factors enumerated above and in the testimony of Ratepayer Advocate witness David Peterson, discussed *infra*, would still be appropriate for use by the Board in its evaluation of whether the instant merger is "in the public interest." However, as noted above, given the unique characteristics of this merger and the concurrent unprecedented restructuring of the State's electric industry, the Ratepayer Advocate asserts that the more rigorous "positive benefits" standard should apply to assess whether the proposed merger is "in the public interest."

POINT II

THE EVIDENTIARY STANDARD FOR MERGER TRANSACTIONS SHOULD BE CLEAR AND CONVINCING

As the final year for transition to a fully-competitive market approaches, New Jersey has seen an unprecedented surge in utility mergers. Seeking regulatory approval of contemplated mergers, utilities within and outside of New Jersey have petitioned the Board, alleging that the economies of scale and scope will allow them to compete more effectively in the restructured market and bring competitive benefits to consumers.

However, with restructuring comes an increased need for regulators to ensure that, as competition increases, adequate safeguards remain in place to protect ratepayers and utility employees without stifling competitive growth. Indeed, this is a statutorily mandated policy. *N.J.S.A.* 48:3-50(a)(3). A merger may entice management's attention away from utility operations to merger-related activities, and pressure from shareholders following a merger may tempt management to sacrifice service quality and reliability to cut costs. To guard against this, firewalls must be in place to preserve the integrity of the utility and ensure that the proposed merger does not adversely affect utility employees or ratepayers.

With this in mind, it has become imperative to revisit "traditional" standards by which mergers are analyzed. One critical way in which this can happen is by raising the evidentiary bar that the utilities must jump in order to show to the satisfaction of Your Honor and the Board that the merger will be in the best interest of the citizens of New Jersey.

N.J.S.A. 48:2-13 gives the Board "general supervision and regulation of and jurisdiction and control over all public utilities." It is well-settled that this statutory grant of authority is to be liberally

construed and should be interpreted broadly. Courts have uniformly held that the Legislature intended for the Board to have the widest range of regulatory power over public utilities. Provisions of New Jersey Title 48 are to be liberally construed, and powers delegated by the Legislature to the Board are to be read broadly. *County of Bergen v. Dept. of Public Utilities*, 117 N.J. Super. 304, 312, 284 A.2d 543, 547 (1971) ("*Bergen*"); *Daaleman v. Elizabethtown Gas Company*, 142 N.J. Super. 531,535, 362 A.2d 70, 72 (1976) ("*Daaleman*"); *I/M/O Public Service Electric and Gas Company's Rate Unbundling*, 167 N.J. 377, Util. L. Rep. P. 26,777, 771 A.2d 1163 (2001) ("*PSE&G*"). This is because there is "a legislative recognition that 'public interest in proper regulation of public utilities transcends municipal or county lines, and that a centralized control must be entrusted to an agency whose continually developing expertise will assure uniformly safe, proper and adequate service by utilities throughout the State.'" *Bergen* at 312, *citing In re Public Service Electric and Gas Co*., 35 N.J. 358, 371, 173 A.2d 233, 239 (1961). "At the core of [the] regulatory scheme is a legislative recognition that the interest of the general public in the proper regulation of these industries classified as public utilities transcends the relatively parochial interests of any subdivision of the public...". *Daaleman* at 535.

Not only has the Board been entrusted with regulatory authority over the utilities, but the natural consequence is that the Board has also been entrusted with a specific element of the well-being of the public. Indeed, the courts of New Jersey have recognized that the "Board's primary responsibility is to the public interest." *I/M/O New Jersey Resources Corporation and New Jersey Natural Gas Company v. NUI Corporation and Elizabethtown Gas Company*, BPU Docket No. 8312-1093 (*Decision and Order on Motions for Emergent Relief*, January 31, 1984 at p. 5) ("*New Jersey Resources*").

To this end, the Board must now utilize its authority in a way that takes into account the new deregulated world and the new challenges and issues that will arise from restructuring, while at the same time ensuring that the needs of the public are met. Fortunately, it is also well-settled that "[a]dministrative agencies possess the ability to be flexible and responsive to changing conditions." *PSE&G* at 13 *citing Texter v. Dept. of Human Services*, 88 N.J. 376,285, 443 A.2d 178 (1982). "This flexibility includes the ability to select those procedures most appropriate to enable the agency to implement legislative policy." *Id.*; *See N.J.S.A.* 52:14F-7(a) (2001).[8] Therefore, as New Jersey enters the deregulated world, the Board should use its expertise to modify its decision-making process so that its Orders reflect the changing needs of both the public and the utilities. Indeed, the Legislative findings of the recently-enacted Electric Discount and Energy Competition Act, N.J.S.A. 48:3-49 *et seq.*, implicitly state that in the new restructured market, the Board not only could but should use its expertise to analyze the balance between electric competition and the best interest of the ratepayers. In relevant parts, *N.J.S.A.* 48:3-50 reads:

> a. The Legislature finds and declares that it is the policy of this State to:
> ...
> (3) Maintain adequate regulatory oversight over competitive purveyors of retail power and natural gas supply and other energy services to assure that consumer protection safeguards inherent to traditional public utility regulation are maintained, without unduly impeding competitive markets; [and]
> ...
> (8) Authorize the Board of Public Utilities to approve alternative forms of regulations in order to address changes in technology and the structure of the electric power and gas industries; to modify the regulation of competitive services; and to promote economic development.

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[8] This case is a rate case in which the utility sought review of the Board's final decision on rate unbundling, stranded costs and restructuring filings. The Supreme Court affirmed the Board Order and discussed at length the authority of the Board to be flexible and responsive to changing conditions in order to fulfill its statutory mandate.

Unlike that of some other states, the New Jersey legislature has not seen fit to statutorily mandate the evidentiary standard that applies to merger transactions.[9] Although the silence on this matter by the Legislature could be inferred as evidence that the usual 'preponderance' standard should be used[10], this silence could also be interpreted as evidence that the legislators intended for the agency "experts" to have the latitude to manage the cases as they see fit pursuant to the individual circumstances of the case. Indeed, the legislature has stated that the Board is not even bound by the technical Rules of Evidence. *N.J.S.A*. 48:2-32.

The Ratepayer Advocate asserts that the appropriate burden of proof for a utility merger transaction should be "clear and convincing." Generally, in state administrative agency cases, the standard of proof has been one of a fair preponderance of the evidence. *Polk* at 560. However, it is not unheard of for a higher evidentiary burden to be utilized by an agency, that of "clear and convincing" proof. For example, when the Board heard railroad rate cases, it held that clear and convincing proofs of costs to be allocated must be offered in a rate case. *See Re Increased Railway Freight Rates and Charges, unpublished*, 1969 WL 11399 (N.J.B.P.U.). The Ratepayer Advocate

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[9] *See, e.g.* Section 854(e) of the California Public Utilities Code [CA PUB UTIL § 854(e)], which states that "[t]he person or corporation seeking acquisition or control of a public utility organized and doing business in this state shall have the burden of proving by a preponderance of the evidence that the requirements of subdivisions (b) and (c) are met." Subsections "b" and "c" set out specific requirements that must be met regarding economic benefit to the public and competition before the California Board will approve a merger transaction. In New Jersey, the "burden of proof is not found explicitly in any general statute governing proceedings in contested cases before State administrative agencies...". *I/M/O Polk*, 90 N.J. 550,560, 449 A.2d 7, 12 (1982).

[10] "Given the long history of the preponderance standard, together with the total lack of any indication in the language of the statute or in its legislative history of an intent to alter that standard, it is reasonable to conclude that the Legislature was content to continue [the standard] at the agency hearing level. *Polk* at 561, FN1.

supports that this higher standard of proof should be required in the context of a utility merger because of the unique relationship that a utility company has to its customers. Indeed, a utility company does not merely sell a product; it sells a vital component of the well-being of the citizens of New Jersey. Electric and gas utilities sell light, warmth, health and comfort; telecommunications companies sell safety and the ability to communicate with loved ones, and; water utilities sell cleanliness and pure and safe drinking water. Considering the role that utility companies play in the lives of each and every one of us, the evidentiary burden should be far greater than 51%.

Instruction may be found in the Federal arena, for the burden is occasionally higher than preponderance of the evidence. Although the traditional standard of proof in a Federal administrative or civil proceeding is the preponderance of the evidence standard[11], the clear and convincing standard has "traditionally been imposed in cases involving cases of civil fraud." *Collins Securities Corporation v. Securities and Exchange Commission*, 562 F.2d 820,824, 183 U.S.App.D.C. 301, 305 ("*Collins*"), citing *Woodby v. Immigration and Naturalization Service*, 385 U.S. 276, 285, 87 S.Ct. 483, 488 ("*Woodby*"). In fact, "[t]here are literally hundreds of cases decided by the United States courts of appeals in which the standard applied in fraud situations has been 'clear and convincing.'" *Collins* at 824.

Of course, this is a merger case, not a fraud case. In the present case, we request that the Joint Petitioners be held to this higher evidentiary standard, as they are the ones who carry the burden

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[11] *See Sea Island Broadcasting Corporation v. FCC*, 627 F.2d 240, 243, 200 U.S. App.D.C. 187, 190, *cert. denied* 101 S.Ct. 105, 449 U.S. 834. This court also notes that the 'preponderance' standard is the one contemplated by the Federal Administrative Procedure Act, 5 U.S.C. § 556(d), and references the legislative history at H.R. Rep. No. 1980, 79th Cong., 2d Sess. 37 (1946) *reprinted in* S.Doc. No. 248, 79th Cong., 2d Sess., Administrative Procedure Act Legislative History 271 (1946).

of proof. However, the reasoning by the Court for the use of this evidentiary standard in a fraud case is both instructive and applicable to its use in a utility merger case. The *Collins* court notes that (specifically, in this case, the SEC), "we have an administrative agency with a charter for protection of the public, and the function of evaluating with sensitivity the conduct of those operating in a regulated industry. Two elements appear relevant to the standard we should impose here: (1) the type of case (fraud); (2) the heavy sanction (deprivation of livelihood). Given those elements, typical of many SEC cases, and given the type of circumstantial proof on which the SEC most often must rely, it appears to us that the "clear and convincing evidence standard is the proper standard here...". *Collins* at 305.

The elements stated by the *Collins* court are directly comparable to the ramifications of a utility merger. First, similar to a fraud case, mergers have the potential to affect not only company shareholders, but the public at large. Second, the heavy sanction may not be one person deprived of a corporate position, but the potential that hundreds of thousands of New Jersey ratepayers from all walks of life being deprived of the potential benefits of a merger (*e.g.,* competition leading to lower rates) unless the Board ensures otherwise. The advent of deregulation makes it even more important for the Board to carefully monitor the changes so that ratepayers are protected.

Similar to the SEC, when deciding merger cases, the Board is not always relying on strictly factual evidence; it must use its business acumen in order to analyze and predict the impact of the merger on the rate paying public. Also, like the SEC, the Board is charged with an element of protection of New Jersey ratepayers, which is the key factor as to why the Board should require these and future petitioners to provide evidentiary proof above and beyond the 51% preponderance standard for utility merger transactions.

The Joint Petitioners will undoubtedly point to any number of cases that hold that the preponderance of evidence standard should apply in administrative cases, including Board cases, because that is what has always been done. However, New Jersey is entering the new world of electric deregulation, so it is time to revisit what has always been done to decide if it will work for the changing future. Mergers, by their nature, may be viewed as "anti-competitive." In order to prove that a merger transaction will not adversely affect the competition that the Legislature wholeheartedly endorses, the merging entities should have to meet a higher standard so that they clearly and convincingly prove that the merger is in the best interest of the competitive marketplace and New Jersey ratepayers.

POINT III

IMPACT ON CUSTOMER RATES

THE PROPOSED MERGER IS NOT IN THE PUBLIC INTEREST BECAUSE ATLANTIC'S CUSTOMERS WOULD NOT RECEIVE ANY MERGER-RELATED COST SAVINGS UNDER THE JOINT PETITION, AND THEREFORE, YOUR HONOR AND THE BOARD SHOULD NOT APPROVE THE MERGER WITHOUT THE CONDITION THAT ATLANTIC ACCURATELY QUANTIFY AND PASS ALL OF THE FORECAST NET MERGER SAVINGS TO ITS CUSTOMERS BY WRITING-OFF ALL OR PART OF THE DEFERRED BALANCE.

As discussed in Point I, the Board must determine whether the proposed merger will result in a positive benefit to the public interest. Even under the more lenient "no harm" standard, the Board must determine that the merger would be "in the public interest" and would not adversely affect Atlantic's customers, rates, service or employees. With respect to Atlantic's rates following the merger, the Board is required to "evaluate the impact of the acquisition on . . . the rates of ratepayers affected by the acquisition of control . . . and on the provision of safe and adequate service at just and reasonable rates." *N.J.S.A.* 48:2-51.1. Notably, the Joint Petitioners did not seek a review of Atlantic's current base rates in conjunction with the merger Petition. Likewise, the Board did not determine that it would undertake such a review in conjunction with its consideration of the merger.

There is no dispute that under traditional rate base/rate of return regulation, Atlantic's customers are entitled to all cost reductions that result from the merger. In fact, Joint Petitioners' have conceded this point. *P-1* at p. 12, (Derrick and Shaw Direct), *P-3* at pp. 5-6 (Shaw rebuttal); *P-4* at pp. 7-8 (Wathen rebuttal). The result should be no different merely because Joint Petitioners have chosen not to ask for a base rate review in this matter. Therefore, it is clear that the merger will

not meet the applicable public interest standard (either the "positive benefits" or "no adverse impact" standard) unless the Board conditions its approval upon Atlantic passing all net merger savings to its customers by writing-off all or part of its deferred balance effective on the date the merger is consummated.[12]

A. Pursuant to *N.J.S.A.* 48:2-51.1 and its Comprehensive Regulatory Authority, the Board Has the Jurisdiction to Condition its Approval of the Proposed Merger on Petitioners' Passing Through an Appropriate Merger-related Rate Reduction to Atlantic's Customers.

Under the Board's general jurisdictional powers as set forth in *N.J.S.A*. 48:2-1 *et seq*., it is the clear intent of the Legislature that the Board have regulatory power over New Jersey public utilities to ensure that the public interest is protected and does not adversely affect the provision of safe and adequate utility service at just and reasonable rates. *New Jersey Resource Corp. v. NUI Corp*. 57 *PUR 4th* 709, 714 (January 31, 1984). Moreover, as the courts of this State have consistently held, the Legislature has granted the Board the widest possible jurisdiction over public utilities. *Township of Deptford v. Woodbury Town Sewerage Corporation*, 54 *N.J.* 418 (1969). The Board is free to use its discretion and to call upon its expertise in an attempt to balance the needs of ratepayers and shareholders. *See In re Jersey Central Power and Light Co.*, 85 *N.J.* 520 (1981). Based on this wide-ranging jurisdiction and its more specific authority under *N.J.S.A*. 48:2-51.1 and 48:3-10, it is clear that the Board is vested with the authority to make the approval of the merger of any New Jersey utility contingent upon the pass through of the merger savings to the ratepayers.

[12] Of course, as discussed *infra*, Joint Petitioners have presented no meaningful or reliable calculation of merger savings nor have they proposed to share any savings with customers. *P-2* (Derrick and Shaw Direct) at p. 12.

As discussed *supra*, Joint Petitioners have not asked the Board to review the reasonableness of Atlantic's rates in conjunction with the merger Petition; nor has the Board determined to undertake such a review on its own accord. Therefore, in this case, the adequacy of Atlantic's current rates, including its appropriate capital structure, return on equity, and overall rate of return, has not been examined as it would have been in a base rate case filing. Moreover, Atlantic's rates are currently subject to a cap, lasting through July 31, 2003 under the Board's restructuring order.[13] *I/M/O Atlantic City Electric Company -- Rate Unbundling, Stranded Costs and Restructuring Filings*, BPU Docket Nos. EO97070455, EO07070456 and EO97070457, Order dated March 30, 2001.

The Board's established precedent in recent electric merger cases is to require the New Jersey utility to pass through net merger savings via a rate reduction effective with the closing date of the merger. *Conectiv Merger Order* at 7-8; *Rockland Merger Order* at 15; Moreover, in the most recent electric merger case between FirstEnergy and GPU, the Board approved a stipulation which passed on 75% or $300 million of estimated net merger savings to decrease deferred charges. *I/M/O the Joint Petition of First Energy Corp. And Jersey Central Power & Light Company, d/b/a GPU Energy, for Approval of a Change in Ownership and Acquisition of Control of a New Jersey Public Utility and Other Relief,* ("GPU merger") October 9, 2001, BPU Docket No: EM00110870 OAL Docket No: PUCOT01585-01N, Order at 20; Stipulation Dated August 24, 2001, Attachment A page 4.

In the *Conectiv* merger, the Board ordered Atlantic to reduce its rates by 75% of the estimated merger savings, effective with the date the merger reached financial closing. *Conectiv*

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[13] As discussed *infra*, the rates established through July 2003 are capped, not frozen. Therefore, a merger-related reduction to these rates, including the regulated distribution rate, is completely permissible under both the EDECA and the Board's restructuring order.

Merger Order at 7, 8, and 22. Similarly, in its Order in the RECo/ConEd merger, the Board ordered RECo to reduce its rates by 75% of the net merger savings anticipated. *Rockland Merger Order* at 15. In the most recent merger case in New Jersey, the Board approved a stipulation in the GPU merger which provided 75% of the net present value of the total estimated merger savings to ratepayers noting that "this split of synergy savings between ratepayers and shareholders is generally consistent with this Board's decision in '*I/M/O Atlantic City Electric and Conectiv, Inc. for Approval of a Change in Ownership and Control.*'" *GPU merger* at p. 20.

Thus, the Board's precedent and policy is clearly to require the New Jersey electric utility that is merging (or being acquired, as Atlantic is by Pepco) to pass through a significant portion of the calculated savings, to the ratepayers, commensurate with the date the merger closes. The precedential value of the Board's decisions in the *Conectiv,* and *Rockland* merger cases is compelling, because both were fully litigated cases. Furthermore, the Board approved the *GPU merger* settlement which passed on a significant portion of the synergy savings based on its decision in the *Conectiv* merger case.

Many other state utility commissions have also ordered rate reductions as conditions of merger approval, in both settled and litigated cases. While the regulatory and statutory requirements in other jurisdictions do not necessarily equate with those in New Jersey, these cases are illustrative, particularly because many state commissions have ordered that customers are entitled to a large portion of the projected merger savings. For example, in the recent merger case reviewed by the Oregon Public Utilities Commission involving Enron Corp. and Portland General Electric Company ("PGE"), the Oregon Commission decided that the stipulation signed by the parties agreeing to pass through 100% or $141 million of the merger savings to the ratepayers is in the public interest. *I/M/O*

the Application of Enron Corp. for an Order Authorizing the Exercise of Influence Over Portland General Electric Company, 177 PUR 4th 587, 595-596 (June 4, 1997). Similarly, in an order approving the merger of Baltimore Gas and Electric Company (BG&E) with Potomac Electric Power Company (Pepco), the Public Service Commission in Maryland deemed it appropriate to decrease customer rates by 75% of the first year's net merger savings. *Re: Baltimore Gas and Electric Company*, 176 PUR4th 316, 336 (April 16, 1997). In ordering the rate decrease, the Maryland Commission specifically stated that the customers should share in the net merger savings through lower rates and such benefits should be shared with customers as soon as possible. *Id.*[14] In California, there is a statutory mandate that a minimum of 50% of the net short and long-term net economic benefits of a utility merger must go to the merging utilities' customers. *See* Cal. Pub. Util. Code § 854(b) (1996). Moreover, as discussed *supra*, the Board itself required both Atlantic and Rockland to reduce their base rates as a condition of merger approval.

Under its statutory mandate, the Board is required to "evaluate the impact of the acquisition on . . . the rates of ratepayers affected by the acquisition of control . . . and on the provision of safe and adequate service at just and reasonable rates." *N.J.S.A.* 48:2-51.1. Given this empowering language, the Board's broad regulatory jurisdiction over public utilities, the Board's own precedent, and recent, nationwide-precedent for passing merger savings to customers through an immediate base rate decrease, the Board clearly has jurisdiction to condition its approval of the merger on a specific percentage allocation of the forecast merger savings flowing to Atlantic's customers.

[14] The planned BGE/Pepco merger never reached closure and was abandoned.

B. Atlantic's Customers, Not Shareholders, Are Entitled to Receive All of the Net Merger Savings.

There are several reasons why it is both unreasonable and unlawful for Joint Petitioners to retain any of the net merger savings for the benefit of the Companies' shareholders. Therefore, the Board should only approve the merger upon the condition that Atlantic flows through all of the net merger savings to its ratepayers. In New Jersey, rates have historically been set equal to the costs of providing utility services, plus an appropriate return on rate base. *See N.J.S.A.* 48:2-21. If the utility's costs of providing service increase or decrease, changes in such costs are fully reflected in a base rate proceeding. Therefore, when there is a decrease in costs, as is likely in this merger, ratepayers should receive the full benefit of utility cost reductions, just as cost increases are reflected in the rate setting process.

In this respect, Joint Petitioners have provided absolutely no legal or factual justification for allowing shareholders to receive and retain all of the merger-related cost reductions until the time Atlantic files its next base rate case. This is particularly important in the case of Atlantic, whose rates are capped until August 1, 2003. *P-1* at, p. 9. Because Joint Petitioners have not proposed to share any merger-related cost savings with customers, the Companies would clearly retain all of the merger savings for the foreseeable future. Moreover, Atlantic's earnings will not be adversely impacted by the Ratepayer Advocate's proposal that all of the savings should go to reduce the restructuring deferred balance. Atlantic's net earnings will not change if the deferred balance is reduced to the same extent that costs will be reduced as a result of the merger. Your Honor and the Board should reject Joint Petitioners' blatant attempt to retain all of the merger-related cost savings for the shareholders' benefit, and instead adopt the Ratepayer Advocate's recommendations with regard to merger savings.

C. Joint Petitioners Have Utterly Failed to Quantify the Net Merger Savings Associated with the Proposed Merger.

In order for Your Honor and the Board to make the determination that any merger should be approved, the applicants must show that the merger will benefit and not harm the ratepayers. Unlike the *GPU, Conectiv* and *Rockland* mergers, Joint Petitioners in this case have completely failed to provide evidentiary support for Atlantic's costs to achieve its merger or the expected level of merger savings. Joint Petitioners filed no synergy study of merger savings, or any detailed estimates of Atlantic's transaction or transition costs. In short, Joint Petitioners utterly failed to sustain their burden of proving that the merger will either result in a positive impact on Atlantic's rates, or that it will not have an adverse effect on its customers' rates.

Joint Petitioners' claimed rationale for failing to document expected merger savings or expected merger-related costs is that this merger is not driven by merger savings and they do not expect, "substantial, immediate rate reduction opportunities." *P-2* (Joint Testimony of Derrick and Shaw) pp. 11-12. The Company goes on to request that Atlantic be permitted to track merger costs so that they are able to recover the same at some future date. *P-1* at 17. At the time of the hearings, the transaction costs to complete the merger were estimated to be $45.8 million. *RP-2*, p. 22. To enter into a merger agreement that will cost ratepayers millions of dollars without any quantifiable benefits by way of rate decreases is against the Board's existing policy with respect to utility mergers and plain bad business judgement.

The Board must weigh the costs and benefits of any merger proposal to protect the interest of the ratepayers of New Jersey. A synergy study is a critical piece of evidence that the Board requires to make a thorough analysis of the proposed merger. In fact, both Pepco in its filing to

merge with BGE and Atlantic with its petition to merge with Conectiv provided comprehensive synergy studies to regulators in their respective merger applications. T61:L24 - T62:L6. The Board uses a synergy study to not only identify the level of rate decrease that the ratepayers should be provided from the consummation of the merger but also to determine whether the merger is in the best interest of New Jersey ratepayers in light of the cost/benefit analysis. The Joint Petitioners concede that a synergy study could have been produced in this case but they elected not to do so. T76:L1-12. When asked whether a synergy study could have been produced in this case Messrs. Derrick and Shaw testifying as a panel responded as follows:

> A. Derrick: I think we've previously said we could have done something.
>
> A. Shaw: And I'd add, nothing prevented us from doing that other than our judgement that wasn't the right thing to do in this case.
>
> *[Id.]*

Nothing prevented the Joint Petitioners from submitting a synergy study but their misunderstanding of what is required for the Board to approve a merger. As one equity analyst reported with respect to the present merger:

> Given the problems Potomac (Pepco) experienced when trying to merge with what was Baltimore Gas & Electric Co. several years ago, both Potomac and Conectiv are not discussing the size of the savings expected from the merger. This is unlikely to fool regulators (nor do we think anyone has deliberately tried to hide these so-called synergies) and we note that this may be unique in that savings are not being discussed at all.

RP-6, Attachment NJRAR-R 1-58, "The Janney Montgomery Scott LLC."

In the present case, the Joint Petitioners claimed that merger savings will not materialize in the short term. However, a comprehensive cost/benefit analysis to support such a conclusion was

never produced. Instead, the Joint Petitioners based their conclusion on the fact that they do not plan to have substantial reduction of employees due to the merger. *P-2,* p. 14. The Joint Petitioners fail to acknowledge that labor cost reductions is not the only means to achieving merger savings. A synergy study could have identified cost savings this merger has the potential of producing other than through reductions in the labor force. Surely shareholders have demanded such information.

Because Joint Petitioners have quantified neither side of the equation (costs to achieve or actual savings), Your Honor and the Board are left with little to support an approval of the merger. With a $45.8 million transaction cost estimate and no merger savings, merger-related costs will most likely subsume all merger-related savings for Atlantic. Thus, because the record is utterly silent on merger savings and costs to achieve savings, Your Honor and the Board are in the untenable position of having to decide whether the merger is in the public interest based upon a blank sheet of paper. Assuming that the Joint Petitioner's claims are correct that no merger savings will be achieved in the short run, there is nothing to sway the Board that such a costly endeavor should be approved. As discussed extensively in the previous section, the Board's established precedent in electric merger cases is to require the utilities to pass through merger savings to ratepayers. *Conectiv merger Order* at 7-8; *Rockland merger Order* at 15. *GPU merger* Order at 20. What the Joint Petitioners have failed to recognize is that their business decision to enter into a merger agreement that they allege provides little, if any, cost savings to New Jersey ratepayers does not change the burden of proof that the Joint Petitioners must carry before the Board to demonstrate that the merger is in the public interest. Moreover, without a synergy study, the Board cannot be certain whether the merger will produce short term as well as long term savings that can be passed on to the ratepayers. The Board should give little deference to Joint Petitioners' flagrant attempt to circumvent sharing any portion

of the merger-related cost savings with Atlantic's customers by simply failing to quantify anticipated savings.

The failure to file a cost benefit analysis with the Board not only ignores past Board practices in merger cases but violates good business practices as well. Generally, when any business undertakes a project that requires a substantial commitment of the company's resources, a cost benefit analysis is undertaken. Both the CEO of Pepco, Mr. Derrick and COO of Conectiv, Mr. Shaw, conceded that when making business decisions on major Operations and Maintenance ("O&M")projects, both companies commission a comprehensive cost benefit analysis before undertaking such tasks. T57:L10-23. On cross by Ratepayer Advocate's Assistant Deputy, Ms. Morita, regarding the importance of cost benefit analysis, Messrs. Shaw and Derrick responded as follows:

A. Derrick: But for those things that are totally discretionary --- for those things for which a cost benefit is, in fact, appropriate, let's put it that way, in my judgment, speaking for Pepco, then if it did not show a positive cost benefit, it would not be done, yes.

A. Shaw: I would agree with that answer substantially. That is the way I would address it.

Q. So in other words, you would require your employees to produce a cost benefit analysis for a $10 million budget item, let's say, if that project was discretionary and not required by a safety or government regulation?

A. Derrick: Yes.

A. Shaw: Correct.
T60:L10-25.

On redirect, Mr. Shaw again conceded that cost benefit analyses is an important factor in making O&M decisions:

Q. (Mr. Genzer) Do you think those cost benefit type analyses are appropriate for reliability improvements?

A Shaw: Yes.
[T204:L4-7].

So, in fact, the Joint Petitioners' internal procedures requires a cost benefit analysis to be undertaken before a substantial "discretionary" project is approved by their Board of Directors yet they claim that a synergy study was not warranted in this merger proceeding. No government agency or reliability issues require the Joint Petitioners to merge. This merger, projected to cost more than $45 million was entered into voluntarily by the two companies. The failure to produce a synergy study clearly violates their own internal mechanisms for decision making on projects of this magnitude.

In sum, Joint Petitioners' have failed to provide any record evidence as to whether there will be any merger-related savings. They have similarly failed to provide any evidence on what the merger-related costs will be -- either transaction costs or transition costs. Faced with this record, the Board cannot determine whether Pepco's proposed acquisition of Conectiv will result in benefits or harm to customers. Accordingly, Your Honor and the Board should not approve the merger unless and until Joint Petitioners file a detailed analysis of merger-related savings and costs, and the Board and parties to this case have the opportunity to review and respond thereto in an evidentiary hearing process.

D. Your Honor And The Board Must Direct Joint Petitioners to Fully Quantify Net Merger Savings, and thereafter, Require Atlantic to Reduce Its Deferred Balance By 100% Of The Allocable Share of the Annualized Net Savings.

It has become nearly routine practice in the utility industry for the merging utility to file a detailed study of expected merger savings with the regulatory commission as part of its petition for merger approval. In New Jersey, both Atlantic (in the Conectiv merger case) and Rockland Electric filed such merger savings estimates as part of their petitions, and FirstEnergy supplemented the record to provide merger savings estimate for settlement purposes. *Conectiv merger Order* at 7-8; *Rockland merger Order* at 15; *GPU merger Order* at 20; Stipulation Dated August 24, 2001, Attachment A page 4. As the Board acknowledged in its Order in the *Conectiv* merger, the standard industry practice is to examine expected synergy savings over the ten-year period following the merger. *Atlantic Merger Order* at 6. Such a detailed synergy study provides an analysis of *both* the expected costs to achieve the merger[15] and the expected cost savings. The expected ten-year savings[16] is then annualized, and converted into a "revenue requirement" basis for ratemaking purposes. This type of ten-year synergy study was used in both the Conectiv and Rockland mergers. *Conectiv merger Order* at 6-7; *Rockland merger Order* at 7.

As discussed in detail in the direct and surrebuttal testimony of Ratepayer Advocate witness, David Peterson (*RP-6* and *RP*-7), Joint Petitioners have completely failed to provide any meaningful or reliable calculation of estimated merger-related costs or savings. Similarly, they have not provided a plan to share any portion of any realized savings with customers, nor have they proposed any Board-authorized mechanism to track merger savings for the future benefit of customers. However,

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[15] Merger costs include both transaction costs (e.g., legal and consulting fees) and transition costs (e.g., costs to integrate the two merging companies).

[16] In the *Conectiv merger* case, Board Staff recommended that the Board use a fifteen-year forecasting period for cost savings, rather than the ten-year period petitioners used. *See Conectiv merger Order* at 7.

the Joint Petitioners have asked the Board's permission to track merger-costs and defer the decision regarding the proper ratemaking treatment of such costs. *P-1* p. 17.

Ratepayer Advocate witness Mr. Peterson explained why it is critical that the Board have the detailed merger savings and integration team analyses *prior* to reaching its decision here:

> Without a careful assessment of merger costs and benefits in this proceeding the Board cannot reasonably conclude the merger is in the public interest. Consider, for example, a situation where the Board followed what Mr. Wathen seems to be suggesting and ignored any consideration of merger savings and costs until after a merger had been approved. Also assume that the utility was later unable to show benefits to ratepayers, but that there were substantial costs incurred in the merger. In such a situation, the Board would be left in an untenable position. Obviously, the Board could deny recovery of merger related costs in that instance. But, cost disallowance alone probably would not rectify the harm caused by a merger that should have never taken place in the first instance. The Board would have a difficult, if not impossible, time several years down the road unraveling the adverse effects of a merger that was contrary to the public interest from its inception. The Board cannot wait several years, as Mr. Wathen suggests, to learn what types of benefits can be expected and how much it will cost to achieve those benefits. In my example, the harm that would result to ratepayers, to employees, and to the general public would be beyond the Board's ability to effectively remedy.
>
> Where Mr. Wathen and I may agree is that it is premature to assume that any merger related costs would ever be recoverable in rates. I agree with Mr. Wathen that merger benefits should be shown to exceed transition costs before such costs are considered in rates. However, in addition to showing a positive net benefit, Atlantic City Electric should be required to prove the transition costs incurred were necessary, prudent and reasonable. None of these showings have been made in this proceeding.[*RP*-7 (Peterson surrebuttal testimony) at 4-5].

Your Honor and The Board should swiftly and soundly reject the Joint Petitioners' "approve it now, and we'll fill in the details later" approach, and instead require Joint Petitioners to fully quantify all merger-related savings, via a detailed synergy study of merger-related costs and savings over a ten-year period following financial closing. Thereafter, if based on this review (and its review of the balance of the record), the Board determines that the merger meets the public interest standard

under *N.J.S.A.* 48:2-51.1, it could then grant approval. However, any grant of merger approval should be conditioned on Atlantic passing all (100%) of the merger-related cost savings through to its customers as an immediate reduction to its deferred balance. The fact that Atlantic's rates are capped under the Board's restructuring order is irrelevant for several reasons, most notably that the rates are capped not frozen.

Under Joint Petitioners' proposal, the utility would retain all cost savings until Atlantic's base rates are next reset. This is simply unjust -- particularly when Conectiv's shareholders will have already received an aggregate "bonus" of $493.5 million[17] in the purchase premium paid by Pepco.

To avoid this unjust and unreasonable result, the Your Honor and Board should:

1. Direct the Joint Petitioners to submit a comprehensive study of anticipated merger-related costs and savings; and

2. If, after the Board and all parties to this case have the opportunity to review (and respond to) this additional analysis (including evidentiary hearings), the Board determines that Joint Petitioners have demonstrated that the merger would result in

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[17] Dave Peterson has testified that Pepco's offer to pay $25 per share purchase price for Conectiv's common stocks and $21.69 per share for Conectiv's Class A stocks means that shareholders receive a 30 percent premium on common stocks and 14 percent premium on Class A stocks if the merger is consummated. *R.-6*, p. 10. To calculate the "bonus" shareholders in the aggregate will receive, multiply the premium by the total number of shares outstanding of each shares of stock (82.9 million shares of common stock and 5.7 million shares of class A). *R.-3* (Joint Proxy Statement), p. 105.

<u>Common Stock</u> + <u>Class A</u>
[$25 - ($25/1.3) * 82.9 million] + [$21.69 - ($21.69/1.14) * 5.7 million] = $493.5 million

a net positive benefit to New Jersey ratepayers (and if it meets all other statutory criteria for approval), the Board should then condition merger approval on the pass through of 100% of the annualized savings as a reduction to Atlantic's deferred balance contemporaneously with the closing of the merger transaction. [*See RP*-6, at 42].

UNDER NO CIRCUMSTANCES SHOULD JOINT PETITIONERS BE ALLOWED TO CHARGE ATLANTIC'S CUSTOMERS FOR, OR OFFSET MERGER SAVINGS BY, THE ACQUISITION PREMIUM OR THE GOLDEN PARACHUTES

A. Acquisition or "Goodwill" Premium

An acquisition premium arises in this proposed merger because the price Pepco has offered to pay for Conectiv's stock, plus estimated transaction costs, far exceeds Conectiv's current fair market value. *RP-6*, p. 27. The Joint Petitioners estimate a $543.1 million goodwill premium will be recorded on Pepco's books as a result of this transaction.[18] *RP-6* (Peterson Testimony), p. 28.

Due to recent changes in the generally accepted accounting procedures ("GAAP"), the Joint Petitioners no longer need to amortize goodwill assets over forty-years. *RP-6* (Peterson Testimony), p. 28. Therefore, the Board should rule that Atlantic be prohibited from reducing merger savings by a portion of the goodwill premium. Moreover, in the *Conectiv* merger decision, the Board ruled that the acquisition premium could not be passed through to ratepayers in any form. *I/M/O Petition of Atlantic City Electric and Conectiv, Inc. for Approval of a Change in Ownership and Control*, ("Conectiv"), January 7, 1998, BPU Docket No. EM97020103, OAL Dkt. No. PUC 4935-97, Initial

[18] Response to NJRAR-R-1-32, attached to *RP*-6.

Decision, p. 9.[19] Other commissions have also denied recovery of acquisition premiums in merger cases. *See*, *e.g., I/M/O The Application of Enron Corp. for an Order Authorizing the Exercise of Influence Over Portland General Electric Company*, 177 *PUR 4th* 587, 595-596 (June 4, 1997); *Re: Maui Elec. Co., Ltd.*, 99 PUR 4th 280, 286 (1988); *Re: Entergy Corporation*, 146 PUR 4th 292, 333-334 (1993).

B. Golden Parachute

It is often common in mergers that senior executives of the merging companies agree to retire either immediately or soon after the merger is consummated. It is also common that such executives receive "separation payments," usually referred to as "golden parachutes", in conjunction with the merger agreement. In this matter, Joint Petitioners have not identified which of the Conectiv's and Pepco's officers and managers with executive separation packages will leave after the merger except for Mr. Howard E. Cosgrove, Chairman and Chief Executive Officer of Conectiv. *P-1* at 5. Nor have Joint Petitioners definitively stated whether they will seek to recover the costs of such payments from ratepayers. As Ratepayer Advocate witness David Peterson testified:

> Golden parachutes refer to severance payments made to executives who will lose their current positions as a result of the merger. Severance compensation packages offered to key officers generally exceed the level of compensation that is offered to the rank and file employees that also may be displaced because of the merger. Since it is the executives who are largely the driving force in this merger and who will define post-merger resource requirements, those executives should not be allowed to promote their self interests at the expense of ratepayers. Golden parachute costs should not be deemed a recoverable merger expense. This is consistent with the Board's treatment

[19] In the Rockland/ConEd merger, petitioners did not seek recovery of the acquisition premium.

of golden parachute costs in the 1998 Conectiv Merger.[20] [*RP-6* (Peterson testimony), at p. 27].

The Board denied recovery of "golden parachute" type expenses in its decision in both the Conectiv merger and the Rockland merger. *Conectiv merger Order* , Initial Dec. at p. 10; *Rockland merger Order* at p. 13. Moreover, the Board's policy has long-disfavored allowing utilities to recover executive bonus packages through rates. *See, e.g., I/M/O Petition of Jersey Central Power & Light Co. for an Increase in Base Rates*, BPU Docket No. ER91121820J, Orders dated February 26 and June 15, 1993. Thus, the Board should definitively rule that any such "golden parachute" payments will never be recoverable in rates, or as an offset to any merger savings. Any special executive separation payments, including bonuses, enhanced retirement or severance costs for executives, or post-employment "consulting" arrangements should be included in this category of non-recoverable costs.

C. New Service Company and Cost Allocation Formulas

CRP, Conectiv's subsidiary is currently its service company pursuant to a service agreement filed with the Board. The Joint Petitioners have indicated that they plan to form a new, as yet unnamed Pepco service company temporarily designated as "New Service Company" after the merger closes and is considering transferring CRP's service functions to New RC. RP -*6* (Peterson Testimony), p. 39. At this time the Joint Petitioners have not indicated the details of the plan including where New Service Company will be located or what functions it will provide but

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[20] *I/M/O Petition of Atlantic City Electric and Conectiv, Inc. for Approval of a Change in Ownership and Control*, Order dated January 7, 1998, Docket No. EM97020103, Initial Decision, p. 10.

presumably, the New Service Company will provide the usual range of corporate support services to Atlantic and the other regulated and unregulated subsidiaries of the new *Pepco* parent company. *P-1* page 5.

The Joint Petition is literally silent on any specifics of the New Service Company. There is no evidence on either the structure of the service company, what functions it will perform, or what cost allocation formulas Pepco might propose. In the absence of any detailed information, the Board clearly cannot assess whether the proposed merger would affect the ability of the merged company to provide service at "just and reasonable" rates. Undoubtedly, service company costs allocated to Pepco's New Jersey operations will ultimately impact rates for customers in its New Jersey service territory. Furthermore, in its evaluation of the merger, the Board is statutorily obligated to consider the impact of the merger on the ability of the merged company to provide service at "just and reasonable" rates. *N.J.S.A*. 48:2-51.1. Whether the resulting rates are "just and reasonable" turns, in part, upon the proper allocation of service company costs.

Moreover, the Board must retain jurisdiction to review both the proposed service company structure and associated cost allocation formulas to guard against cross-subsidization. The potential for cross-subsidization of competitive services by regulated functions, or of Washington, DC regulated costs by New Jersey rates, will be increased in a multi-state holding company structure such as that proposed by Joint Petitioners. The Board recognized the potential for cross-subsidization in a previous multi-state electric utility merger case. Among the conditions placed by the Board on its approval of the *Conectiv merger* was that Conectiv "shall abide by Board decisions related thereto [to the service company agreement and cost allocation manual] for purposes of utility rates and services." *Conectiv Merger Order*, pp. 16-17.

Without specific facts and cost allocation information, the Board has no basis to evaluate the impact of the service company costs on the rates to be paid by New Jersey customers. Moreover, as Ratepayer Advocate witness David Peterson testified, the transfer of corporate offices and the service company to Washington, DC will complicate the Board's regulation of Atlantic and will likely increase both the cost and the frustration of regulation for all parties concerned. *RP-6*, p. 39. Therefore, the Ratepayer Advocate recommends that the Board condition any merger approval upon the requirement that Joint Petitioners: 1) file for Board approval the transfer of service company functions from CRP to the new, post-merger service company; and 2) subject themselves to Board jurisdiction for filing, review, and approval of any service company agreement and cost allocation manual or formulas that the new service company will use, in addition to any other regulatory approvals that may be required. *See RP-6*, at p. 40 and 43.

There is ample precedent for such a requirement. In both the Conectiv and Rockland merger cases, the Board conditioned its approval of the merger on the filing of a service company agreement and cost allocation manual for BPU review and approval. *Conectiv Merger Order*, pp. 17, 22; *Rockland Merger Order*, pp. 12, 19. The Board should follow its own precedent and order Pepco and Atlantic to submit to the Board's jurisdiction and approval of the service company agreement and all cost allocation formulas.

D. Impact on Employees

The ALJ And The Board Should Adopt The Ratepayer Advocate's Recommendations to Mitigate The Potential Adverse Impacts of The Merger on Atlantic's Employees And on The New Jersey Economy.

1. The Board Has a Statutory Obligation to Protect Atlantic's Employees and, as a Matter of Policy, Should Consider the Impact of the Merger on The New Jersey Economy.

It is well settled that under the operative statutes in this proceeding, the Board, in making its overall determination of whether the merger will result in a positive benefit to the public interest, has a statutory obligation to ensure that the merger does not negatively impact the employees of Atlantic. *N.J.S.A.* 48:2-51.1 and 48:3-10. The relevant sections of these provisions provide in pertinent part:

> In considering a request for approval of an acquisition of control, the board shall evaluate the impact of the acquisition . . . on the employees of the affected public utility . . . . [*N.J.S.A.* 48:2-51.1].
>
> Where, by the proposed . . . transfer . . ., it appears that the public utility . . . may be unable to fulfill its obligation to any employees thereof with respect to pension benefits previously enjoyed, whether vested or contingent, the board shall not grant its authorization unless the public utility seeking the board's authorization assumes such responsibility as will be sufficient to provide that all such obligations to employees will be satisfied as they become due. [*N.J.S.A.* 48:3-10].

Moreover, as matter of policy, the Board should also consider the impact the merger may have on the New Jersey economy as a whole. While the relevant statutes do not expressly require the Board to consider the entire New Jersey economy as part of its review, considering the Board's broad jurisdictional powers to protect the public interest in general (*N.J.S.A.* 48:2-1 *et seq.*), as a matter of policy the Board should ensure that the merger does not adversely impact the State's economic well-being.[21] The corporate presence of a major electric utility in the State, with many

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[21] Indeed, the economic vitality of the State of New Jersey has become an increasingly important issue to the Legislature, as demonstrated in its more recent pronouncements. For example, in its legislative findings and declarations on alternative forms of regulation, the Legislature stated as follows:

> The Legislature finds and declares that it is the policy of the State to implement programs which effectuate the economic development goals of attracting and retaining business, maintaining and creating jobs and enhancing the economic vitality of the State. [*N.J.S.A.* 48:2-21.24].

executives and employees, should also surely be a matter of concern in any consideration of the economic impact of the merger on the State. Furthermore, the impact of the merger on over 2,000 New Jersey-based Atlantic employees will undoubtedly affect the State's economy, particularly in those areas where Atlantic operates.

2. The ALJ And The Board Should Condition the Merger on the Joint Petitioners' Maintaining Employment Levels Substantially As They Are Today For A Minimum of Five Years And That There Are Few, If Any, Involuntary Terminations

Witnesses on behalf of the Joint Petitioners have testified that the Atlantic will have substantially the same number of employees as they have today and the merger will have few if any involuntary terminations. *P-2*, p. 4 and 12. The Joint Petitioners have also stated that any decrease in employees would likely be addressed largely through attrition (*RP-6*, NJRAR-R, 1-40, 1-42, 1-43, 2-68 attachments) and all collective bargaining and other employment agreements will be honored. *RP-6*, p. 36. However, in addressing the employment issue, Mr. Shaw has also testified in his rebuttal testimony that no company can predict how its operations will be structured in the future hinting at the possibility of changes in the level of employees post merger. *P-3*, p.4. Absent more concrete information and adequate protective measures, the proposed merger may adversely impact Atlantic's New Jersey employees and have an unreasonable adverse impact on the New Jersey economy. The Ratepayer Advocate applauds the Joint Petitioners commitment to maintain the current level of employees in New Jersey post merger and believe that they should be held accountable for such representations. Therefore, the Ratepayer Advocate respectfully request that the Board condition the merger on no significant changes in employees or employment in New Jersey for a minimum of five years.

3. The ALJ And The Board Should Require that Conectiv Have the Right to Appoint a Proportionate Number of Members to the New RC Board of Directors, to Ensure that New Jersey-specific Issues are not Bypassed by Washington, DC-based Corporate Parent.

Pursuant to the Agreement of Merger, Conectiv will nominate at least two out of twelve members of the New RC Board of Directors subject to Pepco's approval. *P-1, Exhibit A* (Agreement and Plan of Merger) p. 42 paragraph 5.2. The Joint Petitioners have agreed that Pepco will nominate ten members leaving Conectiv with the minimum allowable seats under the Merger Agreement. *RP-6*, p. 37. If Conectiv is allocated only two seats while Pepco is allocated ten, there is a significant concern that Conectiv's interest will be under-represented. As Ratepayer Advocate witness Peterson testified:

> The 10-Pepco/2-Conectiv mix results in disproportionate representation on the board when one considers that Conectiv's shareholder will contribute approximately 33 percent to the initial ownership of New RC. Conectiv and ACE bring considerable assets and value to this transaction, if the Joint Petitioners' claims are to be believed. Yet, New Jersey's interests, as well as the interests of Conectiv throughout its service territory, may suffer because of the disproportionate representation of Conectiv on New RC's Board. In fact, it was for this very reason that one of Conectiv's present board member, Mr. Cyrus Holley, voted against the merger. [*Id*].

As the following chart from Mr. Peterson's testimony reveals, the unequal Board representation is contrary to the approximately equal size of the assets and revenues of Atlantic, Conectiv and Pepco:

($Millions)

	Conectiv		
	ACE	Delmarva	Pepco
Customers	497,000	471,000	711,000
Revenue	$ 956	$ 1,560	$ 2,201
Assets	$ 2,573	$ 2,428	$ 6,585
Long-term debt	$ 1,075	$ 1,092	$ 2,103

In sum, the proposed composition of the Board of Directors, along with the lack of information as to the management structure,[22] will unreasonably limit Atlantic's (and Conectiv's) voice in the management and operations of the combined company. If this results, the interests of its New Jersey ratepayers may be adversely affected. Conectiv shareholders bring approximately 33% of the combined companies' assets and the Board membership should reflect this substantial contribution to the company. Nothing in the Merger Agreement or any other document limits the number of Conectiv seats on the New RC Board. *RP-6*, page 38; See also, *RP-6* Attachment (NJRAR-R 1-41). Therefore, to remedy this adverse impact, the Board should adopt the Ratepayer Advocate's recommendation that Conectiv be permitted to appoint four members to the New RC Board of Directors. *See RP-6*, p. 37.

4. The ALJ And The Board Should Condition Any Merger Approval Upon Atlantic Maintaining a Corporate Headquarters in New Jersey, Staffed by an Adequate Number of Senior-level Executives.

Similar to the commitments made by the Joint Petitioners with respect to maintaining the current number of employees, witnesses on behalf of the Joint Petitioners have testified that Atlantic will have substantially the same corporate structure as it does today (*P-1* page 4). However, the New RC's corporate headquarters will be located in Washington, DC. *RP-2*, p. 3. Mr. Shaw's testimony that no company can predict how its operations will be structured gives little assurance that shortly after the merger, the structure can be substantially changed. *P-3*, p.4. Therefore, based on the testimonies, how long Pepco will maintain its commitment of a corporate presence post merger in

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[22] At the time of the evidentiary hearings, the only top executive to have been offer a position is Messrs. Shaw and Derrick. No other executive have been offered a permanent position with the merger company. T79:L10-23.

New Jersey is unclear. The Joint Petitioners' general statement that "there are no plans to reorganize the operating utility companies" is insufficient to protect New Jersey's economic interests or the Board's regulatory powers. *P-1* at 4. In order to ensure that decision-makers with knowledge of local issues and New Jersey regulatory policy are available in New Jersey after the merger closes, the Board should condition any merger approval on Pepco's commitment to maintain Atlantic's corporate headquarters in New Jersey, staffed with an adequate number of senior-level executives knowledgeable in New Jersey issues and regulatory policy. *See RP*-6 (Peterson Testimony), p. 40. This commitment from the Joint Petitioners is more important than ever in the new restructuring environment. Regulators as well as legislators must have access to high level decision makers who are easily accessible within the State.

POINT IV

ENFORCEABLE SERVICE QUALITY AND RELIABILITY STANDARDS SHOULD BE A CONDITION OF MERGER IN ORDER TO MAINTAIN SAFE AND ADEQUATE SERVICE FOLLOWING THE MERGER AND TO ENSURE THAT PROMISES MADE BY JOINT PETITIONERS CONCERNING ENHANCED SERVICE ARE KEPT

In reviewing the proposed merger, the Board must consider the impact on "the provision of safe and adequate service at just and reasonable rates." *N.J.S.A*. 48:2-51.1. The Joint Petitioners have claimed as a merger benefit an improvement or enhancement in system reliability and customer service. *P*-11, p. 6. To deliver on this benefit, the Joint Petitioners state that, in particular, three aspects of the merger that will "significantly enhance [the Companies] ability to provide outstanding service quality." *Id.* These three aspects are: 1) regional proximity of the

service territories of the Companies will facilitate the sharing of resources and technology; 2) no disruption of service or re-branding confusion since the Companies will operate as separate utilities; and 3) the Companies will share "best practices." *Id.* The first two aspects are practical, considering the geography and structure of the merger plans. However, with regard to the last point, the Joint Petitioners have chosen not to identify any specific "best practices" that they will implement in ACE's service territory. In order to ensure that safe and adequate service is not only maintained, but enhanced as the Joint Petitioners have assured, it must be proven to the satisfaction of Your Honor and the Board that these promises are not merely placating words without substance.

A. Reliability and Customer Service Issues Are Relevant to the Merger Proceeding.

The lack of any specificity to accompany the Joint Petitioners' promises is exacerbated by the risks of deterioration of service quality and reliability that may occur as a result of the approval of the merger. As Ratepayer Advocate expert witness Barbara Alexander testified, although there has not been any "official" promise of any particular level of merger savings, the merger "will drive the participating companies to reduce costs and find savings that can pay for the costs incurred to bring about the merged companies." *RP*-9, p. 10. Shareholders will be watching the balance sheets and income statements in order to determine if the merger was in their best interest. This may lead to efforts to increase savings in ways that adversely affect service quality and reliability for New Jersey customers, especially if there is no longer a corporate presence in New Jersey. *Id.* Hence, the merger, as proposed (*i.e.*, without any enforceable service quality or reliability standards), does not even meet the lower "no adverse impact"standard of review

applied to service factors set out in *N.J.S.A.* 48:2-51.1. The implementation of an enforceable Customer Service Quality and Reliability Index with restitution provisions, as proposed by the Ratepayer Advocate, will "temper management's zeal" in order to maintain the service promises made by Joint Petitioners. *Id*. at 11.

In rebuttal testimony, the Joint Petitioners question the appropriateness of Ms. Alexander's proposed Customer Service Quality and Reliability Index ("SQI"), claiming that the SQI is contrary to the Interim Electric Distribution Service Reliability and Quality Standards, *N.J.A.C.* 14:5-7, established by the Board on November 28, 2000. P-4, p. 11, l. 9-24. The Board's reliability review is an ongoing process, with permanent standards to be developed as of September 2002. *P*-12, p. 11. Joint Petitioners' arguments are incongruous. With respect to reliability, Ms. Alexander's testimony focused on establishing appropriate customer service and reliability indices to ensure that the merger benefits promised by the Joint Petitioners actually materialize for the benefit of New Jersey customers. Moreover, much of Ms. Alexander's testimony responds directly to the service reliability claims that Joint Petitioners made first in the Petition, and later in the testimony of Company witness HasBrouck.

Furthermore, the Joint Petitioners' allegation that Ms. Alexander's testimony is contrary to or interferes with the Board's existing reliability standards is also unsupported. *Id*. Nowhere in Ms. Alexander's testimony does she recommend that the existing reliability standards be ignored. Her recommendations are, however, designed to reflect the promises of the Joint Petitioners to <u>improve</u> reliability of service to New Jersey customers should the merger be approved. *RP*-11, p. 11. If the merger is supposed to provide real tangible benefits to New Jersey customers, there

should be measurable and enforceable standards of performance that provides restitution to New Jersey ratepayers should the Companies' service performance become substandard.

It is generally acknowledged that the Ratepayer Advocate's SQI standards are considered stricter than those established by the Board. T790:L21-24, *RP*-11, p. 12, l. 4-13. As Ms. Alexander stated in her testimony, the promises made by the Joint Petitioners to improve reliability of service resulting from this merger were not before the Board at the time the Interim standards were established. Her recommendations respond to particulars concerning this merger, and therefore the SQI is appropriately designed for these particulars, rather than generic standards crafted without a merger in mind. *Id.* at 12. Of course, when this issue is re-visited by the Board in September 2002, it may impose even stricter standards that what the Ratepayer Advocate proposes in this merger proceeding. However, the concern here is legitimate that merger-induced shareholder pressures to increase savings will negatively impact the service quality and reliability provided to New Jersey customers. With this in mind, Ms. Alexander recommends that the Board implement additional safeguards by establishing a measurable and enforceable SQI as a condition of any merger approval. The absence of enforceable system-wide service standards of reliability performance is particularly troubling because, given the potential for significant merger savings, the management of the merged company will be under tremendous pressure from shareholders to achieve these cost savings. Additionally, new competitive pressures and other demands will be placed on the merged company's finite resources. Therefore, without a <u>verifiable</u> commitment to customer service and service reliability, New Jersey customers of the merged company are at risk.

The Ratepayer Advocate's recommendations are appropriate supplements to the Board's Interim Reliability Standards in response to the specific promises of improved reliability to New

Jersey ratepayers. Therefore, reliability and customer service issues are not only relevant to this merger proceeding, but must be addressed in a manner specific to this merger situation.

B. Individual And System-wide Reliability Promises Made by Joint Petitioners Must Contain Restitution Enforcement Provisions to Protect New Jersey Ratepayers From Degraded Service.

The Joint Petitioners have offered to implement what they call a "service quality guarantee." This is

> a public commitment to customers to provide a specified level of customer service. Service quality guarantees are characterized by full public disclosure regarding performance and are generally backed up by an agreement to take prompt corrective action to address deficiencies or a commitment to compensate customers for their inconvenience if a guarantee is not met. *P*-11, p. 7.

The service quality guarantee will have two components: 1) customer service guarantees; and 2) reliability guarantees. *Id*. at 11. The Ratepayer Advocate recommends implementation of the SQI in tandem with the Joint Petitioners' plan. By adding the recommendations of Ms. Alexander, the Joint Petitioners would truly commit to fulfill the promises they have made regarding the provision of safe and adequate service to New Jersey ratepayers. As proposed by Ms. Alexander, the SQI should have: 1) specific baseline performance standards; and 2) customer restitution payments for failure to maintain these performance standards. *RP*-9, p. 22, l. 11-14.

Regarding the reliability component of the Joint Petitioners' service quality guarantee, Messrs. Derrick and Shaw promise that, "The merger should enhance the reliability of the electric transmission and distribution systems of the operating companies." *P*-2, p. 6, l. 16-18. Mr. HasBrouck stated that ACE's proposed service quality guarantee program "is designed to *ensure* that service quality is maintained or *enhanced* for *all* customers." (emphasis added) *P*-11, p. 5, l. 15-17. The two system-wide reliability indices are the Customer Average Interruption Duration

Index ("CAIDI")[23], which measures the duration of customer interruptions and the System Average Interruption Frequency Index ("SAIFI")[24], which measures the frequency of interruptions experienced by customers.

With respect to CAIDI and SAIFI, the Joint Petitioners recommend that in the event either index has resulted in greater than two (2) standard deviations from the historical mean, per the Board interim regulations[25], a requirement to file plans and their respective deadlines with the Board in order to correct the problem is triggered. *P*-2, pp. 14-15. However, no penalty or rebate is associated with this deterioration in service that has affected all ratepayers. Also, the Companies will rank all circuits according to SAIFI results, and Joint Petitioners assert that no circuit will be ranked in the bottom 2% of the list for more than two years in a row. Again, there are no penalties or rebates associated with this poor service; rather, corrective plans of action will be filed and progress on the action will be addressed in the annual report that is submitted to the appropriate regulatory agency. *RP*-9, p. 15. The only reliability guarantee that will result in any sort of customer restitution is that if a metered customer loses electric service, that service will be

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[23] Specifically, CAIDI is the sum of sustained customer interruption durations divided by the total number of sustained customer interruptions. "Sustained" duration means longer than five (5) minutes.

[24] Specifically, SAIFI is the total number of sustained customer interruptions divided by the total number of customers served.

[25] Regarding performance levels, the interim standards state that "[e]ach [electric distribution system ("EDC")] shall take reasonable measures to perform better than the minimum reliability levels." N.J.A.C. 14:5-7.3(a). The standards also state that "the minimum reliability level to be assigned to each operating area shall be reviewed and may be adjusted for subsequent years after consideration of various factors," which include multi-year comparisons of internal CAIDI and SAIFI performance, the relative performance of an EDC as compared to other local EDC's, as well as compared with statewide and industry-wide performance.N.J.A.C. 14:5-7.10(c)(1-7).

restored no more than 24 hours after service was lost. If service restoration takes longer than 24 hours, the individual affected customer's account will be credited $50. *P*-11, p. 14.

The Ratepayer Advocate asserts that CAIDI and SAIFI are extremely important measurements, and that the CAIDI and SAIFI indices should result in system-wide customer restitution in the event they indicate system-wide service deterioration. Indeed, when CAIDI and SAIFI numbers show deterioration, it means that customers throughout the entire service territory have been adversely affected. *RP*-9, p. 28. In Ms. Alexander's surrebuttal testimony, she states that:

> Mr. HasBrouck appears to have overlooked the situation in which system-wide service quality failures have occurred and system-wide standards have been violated. At this point, a different purpose is served by a penalty in the form of a rebate or credit to all customers. Such a penalty is a means by which the Board should reduce the revenues allowed to be collected from all customers by ACE in response to a deterioration of service quality and reliability that is determined to be significant. This is the role played by service quality standards. Since rates are paid by all customers, the penalty should be returned to all customers. The penalty is a substitute for a proceeding in which civil penalties are assessed on a utility, thus reducing the allowed revenues that contribute to earnings or profits. These two purposes are distinctly different. ...[I]t is Mr. HasBrouck that is unfair in suggesting that New Jersey should embrace the proposed merger with Pepco with promises that are not enforceable or that are meaningless." *RP*-11, p. 18.

Ms. Alexander's testimony also noted the importance of indices not just to measure the point at which the deterioration is significant to all customers, but also bring to management's attention any deterioration in service so it can take the appropriate action. *RP*-9, p. 27.

ACE gathers and reports CAIDI and SAIFI data for its entire New Jersey service territory as well as by sub-region within New Jersey. The 1990-2000 data indicates that ACE's CAIDI performance averaged 85.22 minutes, with a high of 137 minutes in 1996 and a low of 60.66 minutes in 1990. *R.*-9, p. 14, l. 19-21. In the last three years, the CAIDI has averaged about 91

minutes. *R.*-9, p. 15, l. 1. The interim CAIDI standard set by the Board is 131 minutes. This standard would represent a 45% deterioration in service compared to how Company has performed in the last three years. In other words, New Jersey customers could experience almost a 50% decrease in service with no Company accountability, even though customers were unequivocally promised that post-merger service would be better than ever. *Id.*

ACE's SAIFI performance has averaged .77 interruptions per customer per year, with a high of 1.03 and a low of .56. Only in 1994 did its SAIFI rise over one (1) interruption per year. *R.*-9, p. 15; *see Exhibit C.* The SAIFI interim standard set by the Board of 1.13 has not been reached in the past ten years by the Company, and if this were the standard to which the Company is held, it could result in New Jersey customers experiencing double the number of service interruptions than they do now -- and again, there would be no Company accountability. *Id.* Therefore, the Ratepayer Advocate proposes that the Joint Petitioners be held to a higher CAIDI standard of 100 minutes per customer and a SAIFI standard of 1.0 interruptions per customer.

In order to achieve Company accountability, Ms. Alexander proposes a methodology that assigns points to each reliability performance area and assigns restitution amounts to each area based on whether the Company has achieved the necessary points for that area. R.-9, p. 30-32. Specifically, the SQI should be structured so that a pre-established dollar amount is at risk if a performance standard is not met in any given year. This amount would be a reasonable percentage of ACE's regulated distribution operations and maintenance ("O&M") expenditures. For the year 2000, the Ratepayer Advocate recommends a maximum ratepayer reimbursement of 5% of O&M expenditures. The effect of this reimbursement would be that the distribution company's rate of return would be altered to reflect the less-than-adequate service quality

delivered to ratepayers. *Id*. at 30. This system-wide ratepayer restitution for inadequate system-wide service is the primary difference in the reliability guarantee proposed by the Joint Petitioners and the SQI proposed by the Ratepayer Advocate.

Finally, regarding reliability, the Ratepayer Advocate recommends that MAIFI data be collected. MAIFI is the Momentary Average Interruption Frequency Index, and measures interruptions that are shorter than five (5) minutes in length. ACE currently does not have the capability of providing meaningful MAIFI numbers. *P*-12, p. 15, l. 15-16. However, this type of data becomes much more important as all industries, technological and otherwise, increasingly rely upon sensitive high-tech equipment.[26] *R*.-9, p. 15.

The Ratepayer advocate urges the Board to condition the merger on the implementation of SQI standards that includes system-wide restitution for system-wide service deterioration as measured by CAIDI and SAIFI reliability indices. Customer restitution is not a penalty; it is merely returning money to the ratepayers when they do not get that for which they have paid. The Joint Petitioners call their plan a service *guarantee* program (emphasis added); however, Mr. HasBrouck later calls the plan a "good faith proposal." *P*-12, p. 4. It can't be both. The Joint Petitioners have promised to enhance and improve post-merger service and reliability through the shared knowledge of both successful companies, and this promise should be enforced as a

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[26] "Two examples easily illustrate this concept. Plate thickness at a steel-rolling mill is controlled by microprocessors. A brief power interruption can cause rollers to misalign, making it necessary to reheat and reprocess the product. Computer failure at a paper mill can create clutter that requires two work shifts to clean up. It is apparent from these examples that a power interruption may result in an enormous amount of wasted product, employee time, and company resources." Ruth K. Kretschmer and Kennety E. Hundreiser, *Energy Requirements of a Digital Economy: A Brief History of Reliability*, PUBLIC UTILITIES FORTNIGHTLY, Nov. 1, 2001, at 14.

condition of merger. Without adopting Ms. Alexander's recommendations, the Board has only the Joint Petitioners vague assurances that improvements will be made, while the risk of deterioration of service quality and reliability is left squarely on the ratepayers' shoulders. The Board should reject the Joint Petitioners' attempt to shift the burden of the merger to the New Jersey customers by adopting Ms. Alexander's recommendations with respect to service quality and reliability.

CAIDI and SAIFI are the only customer service metrics for which the Board has established standards, interim or otherwise. Both the Joint Petitioners service guarantee program and the Ratepayer Advocate's SQI program contain customer service guarantees in addition to the reliability standards addressed by the Board. The Joint Petitioners' service guarantee program contains five customer service standards to enhance customer service, to be implemented 90 days after the merger closing. *P*-11, p. 13. These are:

Performance Area	**Performance Standard**
Appointments	Scheduled in 4-hour window. $25 credit if Company fails to honor.
New connections	Energize residential service within 10 days of the request. $100 credit if Company fails to honor.
Residential billing accuracy, regulated portion of bill	If not corrected prior to customer inquiry, $5 credit over and above adjusted amount.
Call center	70% answered within 30 seconds, using combined statistics of Companies. Corrective action plan if Company fails to meet the standard.
Call abandonment	Less than 10% abandonment, using combined statistics of Companies. Corrective action plan if Company fails to meet the standard.

P-11, p. 12-13.

Ms. Alexander's customer service recommendations are as follows:

Performance area	Proposed Annual Baseline Performance Standard
Call center	80% answered within 30 seconds.
Call center busy rate	<3%
Disconnection Ratio (per 1000 customers)	To be established.
Installation of Service	95% within 10 days.
BPU Complaint Rate (per 1000 customers)	2.0

R.-9, p. 23.

ACE has proposed customer-specific restitution payments for certain of its performance areas. The Ratepayer Advocate supports these proposals. This individual outreach allows the Company to repair its relationship with the individual customer who has experienced a service failure. *R.*-9, p. 27. Regarding the consequences of a performance failure, the other service guarantees proposed by Joint Petitioners do nothing more than promise to file a report with the Board. Therefore, these performance areas (individual circuit performance, call center speed of answer, abandoned call rate) are not enforceable promises since affected customers receive no restitution for poor service quality.

The Ratepayer Advocate recommends that a disconnection ratio be included as a performance area due to the possibility that ACE may engage in an extremely high rate of

disconnections in order to improve its uncollectible expense situation. This recommendation is based on ACE's high disconnection rates in the 1990's, followed by a complete lack of disconnections in 2000 and early 2001. *R.*-9, p. 26.

Finally, the BPU customer complaint ratio is suggested not because it means that ACE is doing anything "wrong" that must be measured; rather, it is to ensure that the complaint ratio does not increase due to any merger-related cost-savings initiatives, which has the potential to reduce customer service quality. Tracking this number would ensure that ACE would take steps in order to resolve complaints in a satisfactory manner before they referred customers to the Board as the final step. Having a baseline standard for this performance area recognizes that some level of complaint will occur, no matter what steps ACE takes to respond to customer complaints. *R.*-9, p. 25.

Based on data provided by the Joint Petitioners, call center performance has not been adequate until recently. *R.*-9, at 24. Ms. Alexander also recommends that the SQI include a maximum busy rate of 3% in order to ensure that ACE does not seek to improve call performance by increasing the number of calls that encounter a busy signal at the customer call center. Instead, ACE will have to design its call center to be able to handle call volume appropriately in addition

to maintaining well-trained service personnel to handle calls in a timely and efficient manner.[27] *R.*-9, p. 24.

Finally, in her testimony, expert witness Alexander provides numerous examples of different utilities with reliability and service guarantees that surpass the scope and nature of those offered by the Joint Petitioners, including programs that include system-wide restitution plans implemented as a condition of merger. *R.*-9, p. 3; *see Exhibit B*. Joint Petitioners are patently unwilling to support their promises of improved reliability and customer service with any enforceable standards or even specific new programs that they will implement upon completion of the merger. In order to bring the promised service quality and reliability benefits to New Jersey ratepayers and to prevent any deterioration of services, the Ratepayer Advocate recommends that the approval of this merger be contingent upon, among other things, the Board implementing Ms. Alexander's SQI at specific levels to ensure that service quality and reliability improve as the Joint Petitioners have solemnly promised.

C. Implementation of a Universal Service Fund Should Be Required by The Board as a Condition of Merger in Order to Ensure That Low-income Customers Are Assured of "Safe And Adequate Service at Just And Reasonable Rates."

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[27] Call center management and the necessary integration of Internet initiatives into call center service programs are hot topics among utility industry professionals. A recent trade publication devotes an entire article to the importance of understanding the customer when crafting call service center practices. "[W]hat looked like a simple evolution in customer service has been anything but. What energy companies face now is far more challenging: developing a completely engineered 'contact center.'" Robbin Christianson, *Re-Engineering the Call Center*, FORTNIGHTLY'S ENERGY CUSTOMER MANAGEMENT, Winter 2001, at 44. It is generally agreed that what will be needed is an "integrated system that allows you to really understand the customer inquiries that are coming in, route them to the right place and have the customer data when you need it." *Id*. at 49. By implementing stricter standards of call center and service performance now, the Joint Petitioners will position themselves favorably to prevent future service deterioration as they work with new and additional customer service mediums.

Implementation of a Universal Service Fund ("USF") Program should be a necessary condition of merger to ensure that rates and services provided to low-income customers are not negatively impacted. The Board is required to evaluate the impact of a utility acquisition on competition, rates, employees, and on the provision of safe and adequate service at just and reasonable rates. *N.J.S.A*. 48:2-51.1 As a matter of public policy, the Board must also determine whether the merger is contrary to the public interest. *See In re E'Town Corp*., 2000 WL 1736898 (N.J.B.P.U., Oct. 10, 2000)(NO. WM99120923)("*E'Town*"); *In re Lyonnaise American Holding, Inc*., 2000 WL 1289328 (N.J.B.P.U., Jul. 20, 2000)("*Lyonnaise*"); *In re QWest Communications Corp*., 2000 WL 1055418 (N.J.B.P.U., Jun. 28, 2000)("*QWest*"). Both *E'Town* and *Lyonnaise* note that, "The Board must determine whether this transaction can be accomplished without any adverse impact on the four areas specified in [*N.J.S.A*. 48:2-51.1], and that it is not contrary to the public interest." *E'Town slip copy* at 3, *Lyonnaise* at *2. In *QWest*, the Board notes as part of its findings that the merger "is in accordance with law and is not contrary to public interest." *QWest* at *4. In *QWest*, the Board mentioned particularly that the Federal Communications Commission had commented "with specific regard to the public interest benefits of the merger," particularly those concerning the advancement of telecommunications services. *QWest* at *3.

Utility companies have a special role in society; not only are they corporations with a fiduciary obligation to shareholders, but they play a vital role in the well-being of our citizens in the most basic way. For most of us, heating and cooling our houses, even in extreme New Jersey weather, is simply a matter of paying the bill each month and flipping a switch. For the infirm, the elderly, and the working poor, however, the decision to heat or cool may have to be weighed

against the decision to eat or purchase medication. Therefore, an energy provider has a social obligation that must be considered as a relevant component of the reality of doing business. Ignoring or only partially fulfilling this obligation is contrary to the public interest. *See Electric Discount and Energy Competition Act ("EDECA"), N.J.S.A*. 48:3-50(b)(8); *N.J.S.A*. 48:3-60(b). An effective USF program truly impacts the health and well-being of those in need, and shall be incorporated as a necessary condition of any merger.

1. **Implementation of a Universal Service Program will protect low-income customers from potential negative rate and service impacts that may be a consequence of the merger**

In addition to being plagued by financial worries, low-income customers often are subject to more frequent power outages and degraded service because of the lack of investment in distribution facilities in lower-income areas. *RP*-9, p. 34, l. 3-5. Therefore, these customers are more likely to need assistance from customer service centers to report power failures, to arrange bill payment plans or to inquire about State and Federal financial assistance programs for which they may be qualified. *RP*-9, p. 5, l. 16-19. This important customer service foundation may be adversely affected during the turbulence of a merger.

For example, the types of changes common to mergers that could negatively impact customer service include: 1. the use of lower-paid and less experienced customer service personnel in order to save staffing costs; 2. the transfer of corporate offices, resulting in fewer local decision-makers and employees; 3. coordinating procedures and processes from the merged companies, causing temporary (yet confusing) errors in computerized billing and accounting systems; 4. generalized reduction in programs (such as service training programs) as a cost-saving measure; and 5. closure of satellite customer service centers that add to the inconvenience or

inability of customers to rectify their service problems. *RP*-11 p. 4, l. 12-15, p. 5, l. 1-9. The fulfillment of the public interest obligations using a USF program may help to prevent common merger problems of the type listed above before they even start. As we all know, an ounce of prevention is worth a pound of cure.

2. **ACE should implement a percentage of income assistance program in order to benefit the public and provide the Board with valuable data prior to the establishment of a permanent Universal Service Fund**

Although Joint Petitioners assert that it is "inappropriate" to include the issue of a USF program in a merger proceeding (*P*-4, p. 11, l. 10), the importance of this issue is evident in the press release statement made by New Jersey Board of Public Utilities ("BPU") President Connie O. Hughes after the Board voted for an Interim USF proposal for this year, to be implemented during the winter of 2002. In the press release, President Hughes states that, "While we are working to establish a long-term Universal Service Fund, there is a *critical* need for *immediate* assistance." (emphasis added) (BPU press release #24-01, dated October 25, 2001).

ACE does participate in some financial programs, but does not sponsor any bill payment assistance plan to provide ongoing regular financial help to its low-income customers. *RP*-9 p. 36, l. 9-11. ACE is a member of the New Jersey Statewide Heating Assistance and Referral for Energy Services ("NJSHARES") program, and ACE participates in the Federal Low Income Energy Assistance Program ("LIHEAP") and the New Jersey Lifeline Program ("Lifeline"). None of these programs, however, are integrated bill payment assistance plans. NJSHARES is a crisis tool to prevent disconnection, usually on a one-time basis, and LIHEAP is limited to elderly and disabled customers and the fixed-sum benefit is not integrated into the customer's ability to pay

the utility bill. *RP*-9, p. 43, l. 3-10. Lifeline is also limited to a one-time benefit. ACE states that it already intends to implement a Residential Low income Program that introduces a debt forgiveness credit component to its current Weatherization Assistance program. *P*-4 p. 13, l. 4-24. However, the permanent USF program will "build upon already existing utility assistance programs." (BPU press release #24-01, dated October 25, 2001). More importantly, the program recommended here by the Ratepayer Advocate [similar to one recently approved by the Board in the GPU/FirstEnergy merger, *I/M/O the Joint Petition of FirstEnergy Corp. and Jersey Central Power & Light Company, D/B/A GPU Energy, for Approval of a Change in Ownership and Acquisition of Control of a New Jersey Public Utility and Other Relief*, BPU Docket No. EM00110870, OAL Docket No. PUC 1585-01 (Oct. 9, 2001), "*FirstEnergy*")] is an ongoing 'percentage of income' ("PIP") program, not tied to any conditions (such as weatherization) and not just a one-time subsidy.

A PIP plan is one in which the amount of the bill payment assistance provided to a low-income customer is based on the annual household electric consumption in monetary terms as a percentage of the annual household income. The plan consists of two components: 1) a percentage of income-based monthly subsidy component; and 2) a debt forgiveness component. *RP*-9, p. 38, l. 17-18. Financially troubled customers with a gross household income at or below 150% of federal poverty guidelines receive both a monthly subsidy and debt forgiveness for pre-program arrears. Those with a gross household income between 151% and 200% of federal poverty guidelines will not be eligible for the monthly subsidy, but will receive debt forgiveness on a one-time basis. In either case, it must also be established that the customer is "payment troubled," meaning that there is less than $100 in disposable household income after expenses.

The percentage of income to be allocated to the payment of the electric bill is determined using income guidelines for 'Non Heat Accounts' and 'Heat Accounts.' *RP*-9 p. 39, l. 8-17. The balance left after the percentage payment is the amount of the subsidy. This benefit is portable, for the monthly subsidy benefit is allocated first to the transmission and distribution portion of the bill, followed by the generation part of the bill. *RP*-9, p. 39, l. 1-24.

Regarding the debt forgiveness part of the plan, a payment made prior to its due date results in an automatic monthly forgiveness equal to 1/24 of the total amount of arrearage at the time of the customer's initial enrollment in this program. *RP*-9, p. 40, l. 3-5. Customer enrollment in this plan would be coordinated by local community organizations that are already involved in LIHEAP and other financial assistance programs. *RP*-9, p. 39. L. 1-3.

Implementation of a PIP program is not equivalent to a handout. Rather, it is a way in which low- income citizens are provided assistance with management of utility payments but are able to retain a sense of dignity. In fact, a report by the Pennsylvania Public Utility Commission's ("PA PUC") Bureau of Consumer Services has found that its Consumer Assistance Program, which is a form of PIP, is a win-win program that has "generally increased customer payments and met the cost effectiveness criteria of the Pennsylvania PUC's rules." *RP*-9 p. 40, l. 9-11. Indeed, the Board found that the Stipulation of Settlement in the GPU/FirstEnergy merger that addressed societal benefits including the PIP pilot program was "in the public interest." *FirstEnergy* at 33.

This proactive program recently received further endorsement by policy makers in the recent interim USF Board Order, which found that the "implementation of this PIP Pilot program will provide the Board with valuable data and experience regarding the administration, funding

levels, and rate impacts of such programs. The Board will then be able to use that experience in the development of the permanent statewide USF program." *I/M/O the Establishment of a Universal Service Fund Pursuant to Section 12 of the Electric Discount and Energy Competition Act of 1999*, Interim Order, Docket No. EX00020091, at 20 (Nov. 21, 2001). Indeed, the Board ordered that "GPU Energy implement its PIP Pilot program without modification." *Id*. at 24.

3. The Universal Service Plan recommended by the Ratepayer Advocate is a program that is administratively comprehensive yet helps low-income customers according to their individual circumstances

The Joint Petitioners categorically assert that a universal service program can't simply be imported from one state to another, because the legislation funding and administering these programs differs from state to state. *P*-4, p. 14, l. 9-16. There are certainly logistical differences from state to state (and company to company), but this reasoning misses the point. Although procedural elements of implementation may be different from state to state, the mandate is essentially the same.

Pursuant to EDECA, the Societal Benefits Charge ("SBC") is already statutorily authorized to reimburse the company for costs associated with a USF. *N.J.S.A*. 48:3-60(b). The SBC is a non-bypassable charge that is imposed on all electric and gas public utility ratepayers to allow the electric and gas public utilities to recover costs associated with social programs. *N.J.S.A* 48:3-60(a). Social programs are those which are established to assist disadvantaged customers and provide consumer protection. *N.J.S.A*. 48:3-51. The Ratepayer Advocate recommends that ACE apply the net program costs of the USF program to the SBC in order to recoup the expenses that are in excess of the expected savings in collection costs. *RP*-9 p. 45, l. 8-13. Administratively, ACE should be responsible to create and manage enrollment procedures

to target its low-income customers, using information already gathered from the agencies that administer LIHEAP and Lifeline (*RP*-9, p. 41, l. 6-10), supplementing this information with that which is gathered during education and community outreach efforts. *RP*-9, p. 42, l. 10-18. Any procedure would, of course, be subject to further Board action regarding a permanent USF program.

Therefore, with the special needs of the low-income population in mind, the Ratepayer Advocate proposes a PIP program modeled on the Customer Assistance Program ("CAP") that proved successful in Pennsylvania and to be implemented in New Jersey according to the GPU/FirstEnergy Stipulation of Settlement at paragraph 23, approved by Board Order. *FirstEnergy* at 23.

Additionally, the Ratepayer Advocate recommends that Conectiv's current hot weather moratorium program[28] be approved as a formal condition of the merger, as well as an aggregation plan for those customers who participate in the low-income programs. *RP*-9 p. 41, l. 15-17. The hot weather moratorium suspends disconnection of service during periods of extreme high temperature. The Conectiv hot weather policy is to suspend disconnections of residential service for non-payment when the forecast calls for three (3) consecutive days when "the daily high temperature and average percent humidity readings combine[d are] greater than or equal to 180." Termination is suspended for the first day of the 3-day period, and may be extended based on the

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[28] Indeed, certain California electric utilities have hot weather disconnection moratoriums as part of their policy, and Texas has a statutorily mandated hot weather disconnection moratorium: "An electric utility cannot disconnect a customer anywhere it its service territory on a day when the NWS issues a heat advisory for any county in the electric utility's service territory, or when such an advisory has been issued on any one of the preceding two calendar days." 16 TAC § 25.29(i)(2).

long-range forecast. *RP*-9 p. 41, *NJRAR-SQ* 3-44. Low-income aggregation would benefit not only the low-income customers, but ratepayers as a whole, for lower rates as a result of aggregation will translate into lower subsidy amounts paid by all ratepayers through the societal benefits charge. *Id*. at 42, l. 15-17.

In New Jersey, section 2(a)(4) of EDECA states that one of the purposes of the Act is to "...[e]nsure universal access to affordable and reliable electric power and natural gas services." N.J.S.A. 48:3-50(a)(4). The implementation of this USF plan would be an efficient and proactive way to gather information and monitor the positive impact that the plan has on low-income consumers, complementing the Board-mandated Interim USF plan. The Ratepayer Advocate's plan would generate positive attention and goodwill for the merging companies as well, proving to all customers, especially low-income customers, that they will not be forgotten by the corporations whose services they desperately need.

The Board would not be charting unknown territory. The PIP plan that the Ratepayer Advocate proposes has already been successfully established in Pennsylvania and is poised for introduction to New Jersey via the GPU/FirstEnergy merger. As Commissioner Butler stated at the October 25, 2001 BPU meeting regarding the establishment of an interim USF, "As with all or much of public policy, it's good to walk before you run. But there has been a long period of crawling here, and I think today we are going to start walking and hopefully next year we will be at a full run." Board Meeting Transcript, Oct. 25, 2001, Late Starter A-Energy, Docket No. EX00020091, page 19. Implementation of a USF plan should be a condition of merger, for it would mean we are walking in the right direction.

POINT V

CAPTIAL STRUCTURE

THE BOARD SHOULD NOT APPROVE THE PROPOSED MERGER WITHOUT PLACING CONDITIONS ON THE POST-MERGER REGULATED UTILITY SUBSIDIARY'S CAPITAL STRUCTURE FOR RATEMAKING PURPOSES AND ITS REPORTING REQUIREMENTS

If the merger is consummated as proposed, then Pepco and Conectiv will become first tier subsidiaries of the holding company, New RC. ACE and Delmarva will remain subsidiaries of Conectiv. New RC has applied with the SEC to register as a holding company under the Public Utility Holding Company Act of 1935. As stated by the Ratepayer Advocate's witness, James A. Rothschild, holding company structures can add to the complexity of determining the proper capital structure to use for ratemaking purposes. As a company's structure becomes increasingly more complex, the greater the chance that the capital structure of a regulated subsidiary might not reflect the true capital structure that is or should be financing the regulated operations of the company. RP-8, p. 4. In this case, the structure of the post-merger New RC can complicate the ratemaking for ACE, the New Jersey regulated utility.

The merged company's complexity can make it more difficult for the Board to discover ACE's true earnings in a base rate case if the capital structure proposed by the utility in a rate case does not reflect any cost savings from the holding company's consolidated capital structure. These cost savings could come from a lower percentage of equity in the actual consolidated capital structure than the percentage of equity in the utility's proposed capital structure for ratemaking. The cost of equity is usually higher than the cost of debt. T457:L19-23. If the lower cost of capital from the consolidated capital structure is not passed through to regulated utility customers so that they share in the benefits coming from the merger, then those utility customers

could effectively subsidize the operations of other affiliated companies under the holding company structure. The Ratepayer Advocate proposes several conditions that should be made mandatory before the Board would grant approval of the merger. These procedures as outlined below will minimize the chance that the company can use capital structure to (1) mask the true level of earnings being achieved by its regulated New Jersey operations and (2) force New Jersey ratepayers to subsidize any of the numerous other companies in the New RC combined operations.

As outlined in this initial brief, *supra*, the Board should reject this proposed merger unless the Petitioners can prove that the merger will provide positive benefits to New Jersey ratepayers. The Petitioners have made a filing with the SEC showing a capital structure for New RC with 31% common equity which is much less than the 36.7% common equity reported by ACE in its 10Q report to the SEC. *RP-8*, pp. 4-5. If it holds true that New RC will have less equity in its capital structure than ACE post-merger, then using the consolidated capital structure in ACE's base rate cases will save the ratepayers money. However, as pointed out by Mr. Rothschild, it is possible that the reduction in common equity levels could be done in a way that will not be visible to the Board because the cost savings benefits of the lower common equity ratios appear at the parent level, not at the regulated subsidiary level. *RP-8*, p. 5. If the merger is completed, the increased complexity of the combined companies could obfuscate the impact of future changes to the consolidated capital structure. For ratepayers to benefit from this revised, more cost competitive capital structure, this new reality of how the merged entity is being financed has to be factored into the regulatory process. Accordingly, Mr. Rothschild recommended that, concurrent

with completing the merger, the Board should require New RC to implement certain safeguards. *Id.*

The Board should not approve this merger unless it determines that, in future rate proceedings, it will set the overall cost of capital for ACE based upon either the capital structure of the consolidated company or the regulated subsidiary, using whichever has the lower percentage of common equity. In that way, New Jersey customers will share in the positive benefits that may come from the proposed merger.

This should be done unless the Board sees convincing proof in future rate proceedings that a different method will provide the greatest benefits to New Jersey customers. Mr. Rothschild recommended that ACE (and any other party) be allowed to propose whatever capital structure it believes to be appropriate, including the reported "actual" capital structure of the regulated subsidiary. However, he also recommended the company should be required to demonstrate that the capital structure it proposes is the most beneficial to New Jersey ratepayers. *RP-8*, p. 6 and T421:L20-25. If ACE does not propose to use the consolidated actual capital structure as the basis for the overall cost of capital computation, then the justification for any other capital structure should include an analysis of why it is better for New Jersey ratepayers than if the consolidated capital structure were used. As stated by Mr. Rothschild:

> A primary goal of the capital structure selection should be the use of a capital structure that will minimize the overall cost of capital IN THE LONG-RUN.

Id.

While the Petitioners have referred to a recent case wherein the Board adopted the capital structure of the regulated subsidiary for ratemaking,[29] the Board has even more recently adopted Mr. Rothschild's recommended use of the consolidated capital structure in the case, *I/M/O the Board's Review of Unbundled Network Elements Rates, Terms and Conditions of Bell Atlantic-New Jersey, Inc.*, BPU Docket No. TO00060356. The order in this telephone matter has not yet been issued, but at its November 20, 2001 public agenda meeting, the Board adopted Staff's recommendation to use Mr. Rothschild's weighted cost of capital that used the consolidated capital structure.

Another mandatory condition for merger approval should be to require ACE to file annual reports showing the returns on equity or returns on rate base calculated in two different ways. One method should be based on the capital structure of the regulated utility and the other method should be based on the capital structure of the post-merger New RC. These reports should be sent to the Ratepayer Advocate at the same time they are sent to the Board.[30]

The purpose behind these reports would be twofold. One purpose would be to identify the positive benefits that could be attributed to the merger in an improved capital structure. The reports would provide a mechanism for the timely review of the impact of actual capital structure

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[29] *I/M/O Middlesex Water Company*, BPU Docket No. WR00060362, Order dated June 6, 2001, pp. 34-35.

[30] While Mr. Rothschild's initial recommendation was to supplement existing earnings surveillance reports filed by ACE, it was subsequently stated by Board Staff that the Board no longer required regular filing of earnings surveillance reports. T1079:L14-21. However, the Ratepayer Advocate avers that the reasons supporting the filing of such reports by ACE are still relevant and persuasive. Therefore, if Your Honor and the Board should consider approving the proposed merger, the Ratepayer Advocate urges Your Honor and the Board to require these reports as a condition of merger approval.

changes implemented by the New RC. RP-8, p. 5. Another purpose would be for the Board to have this information readily available to best evaluate the actual earnings rate and to give the Board guidance as to what capital structure it finds to be most beneficial to New Jersey customers in future rate proceedings. Failing to pass this benefit of the lower overall cost of capital on to ratepayers could result in the regulated subsidiary subsidizing New RC's unregulated subsidiaries. The more subsidiaries a company has, the more careful the Board should be to protect ratepayers from potential capital structure abuse. *Id.*

The abuse of capital structure can be visited on utility ratepayers when the utility files its post-merger base rate cases. As stated by Mr. Rothschild, "There is a very strong tendency for utility companies to be able to justify a higher revenue requirement as its percentage of common equity in the capital structure increases." *RP-8*, p. 10, l. 17-19. The utility's management may want to keep costs down, but at the same time may want to use a base rate case to increase revenues more than is likely to be allowed by a utility commission. This creates a conflict of interest for the utility management, *i.e.,* wanting to use less equity to contain excess costs (and increase net utility income between rate cases), but proposing a capital structure in a rate case that uses more equity to maximize revenue requirements. *RP-8*, p. 10, l. 19-23.

In contrast, the consolidated capital structure of the holding company is not generally subject to a conflict of interest because the consolidated capital structure is an actual capital structure that reflects full arms-length transactions between the public debt and equity investors. *RP-8*, pp. 10-11. Because regulated utility services are among the least risky businesses, it is likely that the operations of other subsidiaries, both regulated and unregulated, that will be owned by the New RC will be equally or more risky than the utility operations in New Jersey. *Id.*, p. 11,

3-6. As noted by Mr. Rothschild, using the consolidated capital structure as an estimate of the actual capital structure of the regulated New Jersey operations produces a conservatively high estimate of the percentage of common equity in financing New Jersey regulated electric operations because the consolidated capital structure has to finance the entire company's business risk, not just the business risk of the regulated utility company. For these reasons, New RC's consolidated capital structure should be a factor in the Board's review of ACE's capital structure. *Id.,* p. 11, l. 6-13.

Moreover, the Petitioner's witness, J. Mack Wathen, testified that if New RC's capital structure presented additional risk for ACE's customers, "when it comes to ratemaking, the Board of Public Utilities ultimately controls and can manage that risk that becomes apparent to customers of Atlantic Electric" (T253:L3-7) and that if "they [the Board] feel that for whatever reason the capital structure is out of kilter from what they believe to be reasonable, they can make adjustments." T255:L17-20. In his prefiled rebuttal testimony, Mr. Wathen said:

> Importantly, however, for ratemaking purposes, the Board will retain full authority to determine the appropriate capital structure for ratesetting regarding ACE's utility operations.

P-4, p. 9, l. 12-16. However, Mr. Wathen said that he believed the issue need not be dealt with in this case. T265:L6-15 and T266:L25 to T268:L6.

Rather than relying solely on the Board's broad authority to set appropriate rates at some point in the future after the merger is completed, as Mr. Wathen suggests, the Ratepayer Advocate recommends that the Board, in this proceeding, mandate that, as an explicit condition of merger approval, it will affirmatively examine using the consolidated capital structure in future rate proceedings if that structure should be the one most beneficial to New Jersey customers.

Also, the Board should require ACE to report annually its return on equity or return on rate base using both capital structures so that the utility's true earnings level is apparent between rate cases as well. Since the Petitioners seek to make the structure of the company much more complicated through this merger, it is important to recognize the merger's effect on ACE on an ongoing basis, rather than having to be determined only in discovery well after a rate case is underway. In this manner, the Board and ratepayers can identify some of the benefits that may arise due to the merger and also avoid discovering some of the merger's complications only after the fact in a subsequent rate case.

Likewise, the firm that audits the financial statements of both Conectiv and Pepco, PricewaterhouseCoopers, LLP, recognizes the importance of this issue. *RP-8*, p. 11. Prior to the merger that formed PricewaterhouseCoopers, LLP, a partner of the accounting firm Price Waterhouse in June 1997 advised one of the firm's other clients (the Long Island Power Authority) that:

> … whenever you have a situation where you have a holding company, it is important to have provision for hypothetical cap structure **because a holding company can capitalize its operating companies any way it wants**, a hundred percent equity or anything else in between, a hundred percent debt or anything else in between.

(Emphasis added) (Footnote omitted). *RP-8*, p. 12. The flexibility open to the holding company makes it incumbent on a utility commission to have the ability to use a hypothetical capital structure for the regulated utility to protect its captive customers. As affirmed by Mr. Rothschild at the November 14 evidentiary hearing:

> My concern is that what can happen, not necessarily will happen, but can happen, if the board [sic] doesn't look to that consolidated

> capital structure, the new perhaps more efficient lower equity capital structure might not work it's [sic] way into the benefit of ratepayers.

T429:L18-24.

If approved and completed, the proposed merger will make the new company more complex and more impacted by unregulated operations. Therefore, the Board needs to be all the more careful about how it uses computations based on the reported capital structure of the regulated New Jersey operations. Old procedures that used to provide some presumption that the capital structure of the regulated entity was chosen by management to be reasonable lose their meaning in the new, complex combination of Pepco and Conectiv because there is increased likelihood that the capital structure of a regulated subsidiary might be allocated, for book purposes, more than its appropriate share of the equity needed by the entire consolidated entity. *RP-8*, pp. 12-13.

As testified by Mr. Rothschild, the New RC holding company has substantial incentive to reduce the cost of capital on a consolidated basis, but it does not have the same incentive to reduce the overall cost of capital for ACE for ratemaking. *RP-8*, pp. 13-14. As long as New RC believes its subsidiary capital structure might be used for ratemaking, the holding company has an incentive to keep ACE's common equity ratio relatively high. This would tend to increase the revenue requirements found in a base rate case. This is especially true because the New RC holding company structure gives the holding company substantial ability to borrow funds to repurchase common stock and thereby lower the overall cost of capital. A regulated subsidiary such as ACE can and does provide cash flow to service more debt than it currently has outstanding and that cash flow could be used either to increase borrowing at the New Jersey

subsidiary level or at the consolidated level. Since ACE's extra cash flow could be used to finance a higher proportion of debt at the parent level rather than at the subsidiary level, it is important to implement regulatory procedures to protect against the situation wherein the percentage of equity in ACE's capital structure remains high and increases the revenue requirements in a base rate case, even though the overall debt/equity ratio of the consolidated company is brought to more cost effective levels. The unfairness of that kind of action by New RC is readily apparent. Therefore, the Board should condition any merger approval on the implementation of the recommendations of the Ratepayer Advocate as to capital structure used in rate proceedings and the above mentioned reporting requirements.

POINT VI

IMPACT ON COMPETITION

THE ALJ AND THE BOARD SHOULD REJECT THE MERGER AS PROPOSED BECAUSE THE PETITIONERS HAVE NOT PROVED THAT THE MERGER WILL PROVIDE POSITIVE BENEFITS FOR COMPETITION IN THE NEW JERSEY MARKET

The Petitioners allege the proposed merger will not detrimentally affect competition since the combined companies "would not have any market power that could be used to adversely affect competition." *P-1*, p. 9, ¶23A. However, as shown elsewhere in this initial brief, the standard of review for the merger is that the Petitioners must prove the merger would provide positive benefits for competition in the New Jersey electric market. The Petitioners have not alleged that they meet that standard and for this reason alone, Your Honor and the Board should reject the merger as proposed. Furthermore, as proved by the testimony of the Ratepayer

Advocate witnesses, Bruce E. Biewald and David A. Schlissel, the Petitioners have not met the burden of proving that the merger will not harm competition. *RP-16*, p. 4, l. 1-4.

The entirety of the evidence presented by the Petitioners in their original prefiled testimony on competition and market power was the conclusions of their witness, Joe D. Pace, that the combined companies would not own enough generation plants to exercise market power in the wholesale electric markets and that in the retail markets there are other competitors who could serve that market. *P-32*, p. 26, l. 19 to p. 27, l. 4. Dr. Pace later tried to shore up this glaring deficiency by supplementing it with more conclusions from his prefiled rebuttal testimony. *P-33*. The bulk of the support for his conclusions was apparently contained in his testimony and attachments filed at the Federal Energy Regulatory Commission ("FERC") which the Petitioners did not even present for the record in the instant proceeding. *Id.*, pp. 2-4. Since this alleged evidence does not exist for the purposes of the record before Your Honor and the Board, the alleged conclusions based on those documents should be disregarded as wholly unsupported by facts in this record. It avails the Petitioners nothing to cite to documents that they did not present for examination to Your Honor and the Board. As will be seen below, the Petitioners' reliance on those documents is misplaced in any case since they do not prove that the proposed merger will either provide positive benefits for competition or that the merger will not harm competition.

A. The Petitioners' Argument That The ALJ And The Board Should Look For Guidance to Other Agencies' Review of Market Power Is Irrelevant And Should Be Rejected

The Petitioners rely heavily on the fact that other regulatory agencies, *i.e.*, the FERC and the U.S. Department of Justice ("DOJ") have cleared the merger. *P-33*, p. 3, l. 7 to p. 4, l. 3. In this part of Dr. Pace's rebuttal testimony, he also cites for support that the Ratepayer Advocate

did not intervene at the FERC, as if that were the only agency whose decision really matters. Your Honor and the Board should reject this disregard of the Board's vital role in protecting and promoting competition in the New Jersey electric market. The decisions by the FERC and DOJ do not relieve the Board of the obligation to make its own independent decision on whether the proposed merger will provide positive benefits for competition in New Jersey. *See, N.J.S.A. 48:2-51.1.*

The Petitioners' reliance on the FERC decision approving the merger does not support the approval of this merger. The FERC's opinion on wholesale market power does not prevent Your Honor and the Board from reviewing the issues as they relate to this merger in New Jersey. In fact, the FERC specifically noted that no state public utility commission had requested that the FERC review the proposed merger's impact on retail rates in their jurisdictions. *Section III.B.4 of the FERC Order, 96 FERC ¶ 61,323, Docket No. EC01-101-000, dated September 26, 2001, p. 13* ("*FERC Order*"). (Copy attached) Therefore, the FERC ruling cannot prevent Your Honor and the Board from reviewing these issues despite the Petitioners' intimation that the ruling should justify truncating the review of the competition issue here. Indeed, the FERC specifically found that the proposed merger does not adversely affect the state commissions' regulation over the Petitioners. *Id.*

By citing to the FERC decision, the Petitioners' witness, Dr. Pace, seems to suggest that the FERC's ruling on wholesale market power somehow should preempt Your Honor and the Board from examining the issue as it relates to retail competition and retail rates in New Jersey. *P-33*, pp. 3-4. Contrary to this suggestion, the division between federal and state jurisdiction is hardly as clear as the Petitioners have suggested. In fact, the grey area between federal and state

jurisdiction is further clouded by an appeal to the Supreme Court of the United States concerning the FERC's Orders 888 and 889 on open transmission access which questions the federal preemption issue. *New York v. FERC, No.00-568 (U.S., argued October 3, 2001).*[31] That case involves the conflict over the FERC's claimed jurisdiction over unbundled transmission of electricity for retail sales, utility retail stranded costs due to competition and the use of local distribution facilities for wholesale electricity sales. The Petitioners in that proceeding argue that the FERC overstepped its jurisdictional bounds in asserting jurisdiction over those issues. In its order on this proposed merger, however, the FERC clearly said that its concern over the proposed merger's impact on state regulation arises when a state has no authority to act on a merger and when the state raises those concerns at the FERC. *FERC Order,* p. 13. Since the Board has obvious authority to review the proposed merger,[32] it would be unnecessary for the Board to intervene and request the FERC to review the Board's regulatory jurisdiction over the Petitioners. The Petitioners themselves recognized the Board's clear authority when they filed for Board approval of the proposed merger.

Furthermore, the Petitioners' implication that the position of the Ratepayer Advocate should suffer some prejudice because we did not intervene in the FERC proceeding is irrelevant for the same reasons given *supra* that the FERC decision itself is not dispositive of this issue. The FERC proceeding cannot decide this issue in relation to ACE's customers, so it is not dispositive

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[31] That matter before the U.S. Supreme Court is the appeal of the following case, *Transmission Access Policy Study Group v. FERC*, 225 F.3d 667 (D.C.Cir. 2000) (copy attached).

[32] *N.J.S.A. 48:3-10; 48:2-51.1.*

that neither the Ratepayer Advocate nor the Board intervened there. For all these foregoing reasons, the Petitioners' reliance on the *FERC Order* should be rejected.

Additionally, the prefiled testimony of the Ratepayer Advocate expert witnesses, Messrs. Biewald and Schlissel, goes into detail about why the FERC's ruling is insufficient to decide this issue from the perspective of the New Jersey market. Their testimony demonstrates that the FERC's limited review of wholesale market power issues through the Herfindahl-Hirschman Indices ("HHI")[33] calculations does not capture the potential implications of the Petitioners' control over a significant segment of the generation market in PJM.[34]

Messrs. Biewald and Schlissel state that the FERC (and the DOJ) use the HHI as a "screening tool" to identify whether market power might be a problem and that the FERC specifically notes that the HHI screening tool is not infallible and in some cases may not detect certain market power problems. *RP-16*, p. 7, l. 13-16. The HHI is only a rough illustration of relative market concentration, based on a limited set of "snapshots" of the markets examined. *Id.*, p. 7, l. 17-21. Messrs. Biewald and Schlissel also state five additional reasons that the HHI as a measure of market concentration and market power could understate the degree of market power in relevant markets:

(1) Due to the very limited ability to store large quantities of electricity, the supply of electricity and the demand for it must balance over very short time intervals, which could allow

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[33] The HHI is the sum of the squares of individual firms' market shares. The higher the index number the greater the level of concentration and the more likely that market power will be a problem. *RP-16*, p. 7, l. 9-12.

[34] As of June 2001, Conectiv had 1,140 MW which is 12% of the 9,500 MW of the mid-merit capacity in PJM. *RP-16*, p. 13, l. 1-2.

companies, in the short run, to take advantage of shortages in a way that could not occur if other suppliers or purchasers could readily and inexpensively store some inventory of the product. (2) It is difficult to substitute other energy sources for electricity in the short term to help customers reduce their dependence on electricity at times of high prices. (3) The dynamic nature of electricity markets can change dramatically over a few hours and create opportunities for the exercise of market power even though the market may be relatively competitive under most other circumstances. (4) In current electricity markets, there are limited programs for real-time demand response that could allow customers to reduce their demand quickly in response to high electricity prices and thereby decrease their exposure to exercises of market power. (5) There are a limited number of existing transmission facilities that electricity can flow over and new generation and transmission facilities are very capital intensive and require long lead times to bring into operation. *RP-16*, p. 9, l. 22 to p. 10, l. 12. All these factors create openings for the exercise of market power that are not apparent from an HHI analysis.

The HHI's most significant failure is its inability to recognize strategic bidding behavior or the withholding of available generation to increase market clearing prices. *RP-16*, p. 7, l. 23 to p. 8, l. 2. It is this type of strategy that the Ratepayer Advocate has been trying to examine in this matter. It is also this type of strategy that has been examined by the California Independent System Operator ("CAL ISO") which is the entity that operates and manages the California transmission grid system.

As stated by Messrs. Biewald and Schlissel, the CAL ISO has concluded that, in 98% of the hours from May 2000 through November 2000, the bidding profiles of five large generators displayed patterns of withholding generation leading to inflated market prices. *RP-16*, p. 11, l.

14-17. According to CAL ISO, in the ten months from May 2000 to February 2001, the market power observed in California wholesale markets had driven up electricity prices more than $6.2 billion. *Id.*, p. 11, l. 22 to p. 12, l. 4. The importance of this issue is underscored by the California experience. While the PJM market is operated much differently than the California market, and the Ratepayer Advocate does not allege that similar problems are on the horizon for PJM, market power remains a large concern not only of the Ratepayer Advocate, but of the New Jersey legislature, which made competition and market power a mandatory issue to be examined in utility mergers. *N.J.S.A. 48:2-51.1.* On the other hand, the Petitioners' witness, Dr. Pace, prepared an HHI analysis of the California energy markets in 2000 for Pacific Gas & Electric Company and that HHI analysis led him to conclude that the markets were "relatively unconcentrated." *RP-16*, p. 10, l. 13-18. His conclusions of no market power concerns in California when others reviewing those markets clearly proved large patterns of market power abuse call into question the reliability of Dr. Pace's conclusions in this case before Your Honor and the Board.

B. The Proposed Merger Raises Legitimate Market Power Concerns That Justify Rejecting This Merger.

Messrs. Biewald and Schlissel also found realistic concerns over market power and competition raised by the proposed merger that Your Honor and the Board should carefully consider. ACE's parent, Conectiv, Inc., has had the strategy of retaining, operating and increasing its share of the mid-merit generation business in PJM.[35] *Id.*, p. 12, l. 7-8. The mid-

[35] Mid-merit generation plants are units that can quickly increase or decrease their electricity output to match the expected demand in electricity markets. According to Conectiv and Pepco, mid-merit plants are generally operated during times when the demand for electricity rises, in contrast to base load electric generating plants, which are designed to run almost

merit plants' ability to ramp up electric output quickly allows the plants to capture value in the wholesale market. *Id.*, p. 10, l. 14-15.

Conectiv has repeatedly prepared and distributed documents for investors to show that Conectiv has been able to use these plants to set the market price in PJM for 40% of the hours of the year. *Id.*, p. 13, l. 2-3. Dr. Pace attempted to contradict Conectiv's written presentations to investors by testifying that he had received oral representations from Conectiv employees that Conectiv informed investors that its mid-merit plants had not in fact set market prices for 40% of the year, but that mid-merit plants in general, including those of other companies, had done so. *P-33*, p. 6, l. 21 to p. 7, l. 6 and T955:L10 to T956:L16. The Petitioners refused to produce any direct evidence of that allegation and never attempted to produce the employees for cross-examination who would say under oath that this was the case. Dr. Pace's second-hand testimony does not contradict the fact that Conectiv made the assertion that its mid-merit assets set market prices 40% of the year in several written presentations and continued to distribute that statement.

The Petitioners apparently argue that those presentations were not meant to be read literally. **{CONFIDENTIAL INFORMATION STARTS HERE}**

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continuously to supply the base level of demand. *RP-16*, p. 12, l. 8-14. Periods of higher demand are also the periods when customers who need the electricity face higher prices for it.

{END OF CONFIDENTIAL INFORMATION.}

This concern is not only a wholesale market problem. It is a problem in the retail electric market as well. Marketers of electricity to retail customers often must purchase their energy in the wholesale market to provide to their retail customers. If the Petitioners can set market prices in the wholesale market for such a significant period, then those wholesale prices must be passed through to retail customers in New Jersey who then carry the burden of higher electric bills. That should be a matter of concern to Your Honor and the Board. Furthermore, because the retail prices for ACE and the three other investor-owned electric utilities in New Jersey are capped

through July 31, 2003, retail competitors must be able to obtain energy at prices lower than the capped rates to make any profit on the sale of energy. The Petitioners' ability to raise market prices higher than the capped rates can make it impossible for a retail marketer to enter the New Jersey market. As will be shown below, currently only 0.2% of New Jersey electric customers have found a retail marketer able to serve them. Wholesale market prices play a large role in the bleak condition of the New Jersey electric market, which further indicates how important the market power concerns should be in this case.

The merged companies have an incentive to raise market clearing prices to increase their profits earned by selling energy or the profits of affiliates involved in energy futures or options markets even if New Jersey ratepayers had to bear higher prices. *RP-16*, p. 13, l. 12-15. The merger would add Pepco's 806 MW of peaking generation plants to Conectiv's mid-merit plants and exacerbate market power issues. Peaking plants operate on the margin of electricity demand that create the highest prices. Adding Pepco's peaking plants to Conectiv's mid-merit plants would plainly increase New RC's market power. Even if one assumes that 806 MW is small compared to the 50,000 MW in PJM, the ability of those peaking units to set market prices in the hours when prices are already high to begin with should be a reason to scrutinize the market power issues with great care.[36] Also, if the peaking capacity continues to be owned by a competitor, it can play an important role in moderating the ability of mid-merit generation to raise market prices. *RP-18*, p. 2, l. 11-13. If the merger is completed and this peaking capacity is co-

[36] In addition to the times when there is incentive to raise market prices, there might also be hours when the merged companies might want to lower market clearing prices in order to adversely affect competitors. *RP-16*, p. 13, l. 15-17. In these latter cases, a generator could decide to act to lower prices to reduce the revenues of other competitors whose plants would then garner lower prices.

owned by the owner of the mid-merit plants, then the ability of those plants to moderate prices would disappear.

Furthermore, Conectiv has expressed an intention of "accelerating [its] market-leading, mid-merit position in PJM" by tripling its mid-merit and peaking capacity by 2004. *Id.*, p. 13, l. 18-20. Accordingly, Messrs. Biewald and Schlissel found that the merger could further enhance New RC's control of mid-merit and peaking capacity within PJM and also might enhance its ability to profit from the activities of unregulated affiliates in the energy futures and options markets. *Id.*, p. 13, l. 20-24.

The Petitioners also allege, without factual foundation, that the proposed merger raises no vertical market power concerns. *P-32*, p. 27. Dr. Pace apparently believes that the loss of one competitor that would result from the merger is too small to be of concern, since the "potential market" is broad and "many other suppliers" are available to serve the market. He obviously ignores the dismal statistics in New Jersey for the retail electric market. As of October 31, 2001, only 8,509 out of 3,556,749 electric customers, or 0.2%, in the "potential market" of New Jersey have switched to the "many other suppliers" of electricity.[37] For Conectiv customers, the situation is even worse. Only 676 out of 507,152 Conectiv customers in New Jersey, or 0.13%, have found an alternate supplier. With such a minuscule response by these other competitors, it is foolish to ignore the loss of even one competitor. Dr. Pace's reliance on allegedly ample opportunities for customers to find alternate suppliers flies in the face of the reality of New

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[37] Information from the BPU website (copy attached). The Ratepayer Advocate requests that Your Honor and the Board take official notice of this information which was not entered into the record at the evidentiary hearings. *N.J.A.C. 1:1-15.2*.

Jersey's electric market where customers have been unable to find suppliers willing to serve them and proves that reliance on Dr. Pace's analysis would be grossly inadvisable.

C. The ALJ And The Board Should Reject The Proposed Merger Until The Petitioners Provide a Reliable Study of Market Power Using an Energy System Simulation Model as Recommended by The Ratepayer Advocate

As shown above, the Petitioners have not proved that the merger will benefit ratepayers and promote competition in the New Jersey electric market or even that ratepayers and competition will at least not be harmed by the merger. The Ratepayer Advocate has shown that the Petitioners' reliance on the HHI and Dr. Pace's conclusory testimony does not meet the burden of proof required. The Petitioners should not be permitted to proceed with the merger until they have met this burden. As testified by Messrs. Biewald and Schlissel, before considering to approve the proposed merger, the Board should require the Petitioners to present a more detailed assessment of market concentration and market power. This assessment would require the use of an electric system simulation model to look at the hourly behavior of the market under a wide variety of physical conditions, contractual situations and bidding behaviors which is what the HHI cannot do. *RP-16*, p. 8, l. 3-8. Such a simulation model is more realistic and would provide better insight into potential market power concerns than just a formalistic HHI calculation.

Dr. Pace objects to such a simulation model as "expensive, time consuming, and controversial." *P-33*, p. 9, l. 3-4. However, Dr. Pace would use the complexity of this issue as a reason to proceed with the proposed merger despite his wholly inadequate analysis of market power. The Ratepayer Advocate cannot agree that such a model is unjustified. Market power is

one of the four vital issues that must be exhaustively examined in a utility merger proceeding. Complexity and controversy are not good reasons to shy away from this review. As stated by Messrs. Biewald and Schlissel, the energy costs to customers from one anti-competitive hour-long event in the PJM market could easily exceed the cost of conducting an appropriate analysis of market power. *RP-18*, p. 6, l. 25-27. Rather than providing a reason not to do it, the complexity of the market bidding situations that such a simulation model can analyze instead argues strongly for its use.

CONCLUSION

At the commencement of the evidentiary hearings and throughout this brief, the Ratepayer Advocate has consistently stated that the proposed merger between ACE, Pepco and New RC should only be approved if positive benefits to New Jersey ratepayers can be demonstrated. As has been argued at length in this brief, the Joint Petitioners have failed to meet their burden of proof under either the positive benefits or no harm standard. Therefore, the Ratepayer Advocate respectfully requests that the proposed merger only be approved by Your Honor and the Board if all of the recommendations summarized below, and as discussed in the brief, are made explicit conditions of approval:

- The Joint Petitioners must submit a comprehensive study of anticipated merger-related costs and savings. If, after the Board and all parties to this case have the opportunity to review and respond to this additional analysis, including evidentiary hearings, the Board determines that Joint Petitioners have demonstrated that the merger would result in a net positive benefit to New Jersey ratepayers and if it meets all other statutory criteria for approval, the Board should then condition merger approval on the pass through of 100% of the annualized savings as a reduction to Atlantic's deferred balance contemporaneously with the closing of the merger transaction.
- No reduction of merger savings by a portion of the goodwill premium.
- No recovery of "golden parachute" payments in rates, or as an offset to any merger savings. Any special executive separation payments, including bonuses, enhanced retirement or severance costs for executives, or post-employment "consulting" arrangements should be included in this category of non-recoverable costs.

- Joint Petitioners must: 1) file for Board approval the transfer of service company functions from CRP to the new, post-merger service company; and 2) subject themselves to Board jurisdiction for filing, review, and approval of any service company agreement and cost allocation manual or formulas that the new service company will use, in addition to any other regulatory approvals that may be required.
- No significant changes in employees or employment in New Jersey for a minimum of five years.
- Conectiv be permitted to appoint four out of the twelve members to the New RC Board of Directors.
- Joint Petitioners must maintain Atlantic's corporate headquarters in New Jersey, staffed with an adequate number of senior-level executives knowledgeable in New Jersey issues and regulatory policy.
- With restructuring comes an increased need for regulators to ensure that adequate safeguards remain in place to protect ratepayers and utility employees with out stifling competitive growth.
- Implementation of a Customer Service Quality and Reliability Index ("SQI"), as proposed by the Ratepayer Advocate, will appropriately supplement the service guarantee program suggested by the Joint Petitioners. In this way, the Joint Petitioners would truly commit to fulfilling the promises they have made regarding the provision of safe and adequate service to New Jersey ratepayers.
- The merger should be conditioned upon the implementation of SQI standards that includes system-wide restitution for system-wide service deterioration as measured by

CAIDI and SAIFI reliability indices. This is not a penalty provision; rather, it is merely returning money to the ratepayers when they do not get that for which they have paid.

- The merger should also be conditioned up on the establishment of additional measurable parameters of service performance, including a disconnection ratio and a BPU Complaint Rate in addition to the parameters suggested in the Joint Petitioners' service quality guarantees. It is necessary to evaluate the impact of a utility acquisition on competition, rates, employees, and on the safe and adequate service at just and reasonable rates.
- As part of a Universal Service Fund ("USF") program, a Percentage of Income plan be implemented as a condition of merger, providing bill payment assistance based on the annual household electric consumption in monetary terms as a percentage of the annual household income.
- The Board should specify that, absent convincing proof to the contrary, it will set the overall cost of capital for a regulated subsidiary of the merged company based upon either the capital structure of the consolidated company or the regulated subsidiary, using whichever of the two has the lower percentage of common equity. Deference should be given to the capital structure that contains the lower amount of common equity. The company or any other party should remain free to propose whatever capital structure it believes to be appropriate, including the reported "actual" capital structure of the regulated subsidiary. If the consolidated actual capital structure is not proposed by the utility as the basis for the overall cost of capital computation, then the justification for any other capital structure should include an analysis of why what is proposed is better for New Jersey ratepayers than if the consolidated capital structure were used.

- ACE should be required to file annually with the Board a report showing the returns on equity or returns on rate base calculated two different ways. One way should be based upon the capital structure of ACE and one should be based upon the capital structure of the consolidated company. Copies of these reports should be sent to the Ratepayer Advocate at the same time they are sent to the Board.
- The Petitioners have not proved that the merger will provide positive ratepayer benefits by promoting competition in the New Jersey electric market or that competition and ratepayers will at least not be harmed by the merger. Before approving the proposed merger, the BPU should require the Petitioners to present a more detailed assessment of market concentration and market power. This analysis would require the use of an electric system simulation model to look at the hourly behavior of the market under a wide variety of physical conditions, contractual situations and bidding behaviors.
- If the BPU does approve the merger, it should require full on-going disclosure of the activities of the Petitioners' affiliates in the energy markets (including forward contracts and options) and create a mechanism for addressing market power if and when it arises.

For all the forgoing reasons, the Ratepayer Advocate respectfully requests that the merger petition be denied as filed.

Respectfully submitted,

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N.J. DIVISION OF THE RATEPAYER ADVOCATE

By: ______________________________
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Dated: December 19, 2001

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