STATE OF MARYLAND

MARYLAND PUBLIC SERVICE COMMISSION

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

Direct Testimony of Tyson Slocum On Behalf of Public Citizen, Inc.

December 8, 2014

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I. <u>INTRODUCTION AND PURPOSE OF TESTIMONY</u>

Q Please state your name and business address.

A My name is Tyson Slocum, and I am the Director of the Energy Program for Public Citizen, Inc. ("Public Citizen"). My business address is 215 Pennsylvania Ave SE, Washington, DC 20003.

Q Please describe the history and mission of Public Citizen.

A Founded in 1971, Public Citizen is a 501(c)(3) non-profit, non-partisan consumer advocacy organization based in Washington, DC with over 350,000 members and supporters across the United States. Public Citizen works on a broad array of policy issues dedicated to protecting household consumers and strengthening America's democracy. Our Energy Program promotes affordable, reliable and sustainable energy, which we accomplish through research and advocacy efforts on behalf of its members.

Q Please describe your current responsibilities as Energy Program Director of Public Citizen.

A I direct Public Citizen's Energy and Climate work, with a focus on the regulation of electric power, petroleum and natural gas markets. I cover Federal Energy Regulatory Commission jurisdictional markets, and serve on the U.S. Commodity Futures Trading Commission's Energy and Environmental Markets Advisory Committee. I testify before

Congress, most recently before the U.S. Senate on energy commodity market regulations. I work regularly with Congress on legislative issues, and communicate regulatory with the media on these topics.

Q Please briefly summarize your prior employment and educational background.

I received a Bachelor of Arts degree from the University of Texas at Austin, majoring in Government. After graduation I was hired by the Institute on Taxation and Economic Policy as an Analyst, and was employed there through 2000. In 2000 I switched jobs and was hired by Public Citizen, Inc. as a Research Director working primarily on the California electricity crisis of 2000-01, helping to produce research documenting how deregulation and actions by companies like Enron caused the crisis. After a few years, I was promoted to Director of the Energy Program.

Q What is at issue in this proceeding?

A The Commission will be examining whether or not Exelon Corp's proposed acquisition of Pepco is consistent with the public interest and will provide benefits to consumers.

Q What is the purpose of your testimony?

A There are three issues with the proposed acquisition that raise questions as to whether the proposed transaction is consistent with the public interest and will provide benefits to consumers. First, the structure of the transaction is designed to shift risk away from Exelon Corp's shareholders and onto to captive ratepayers—risk unmitigated by the companies' proposed ring-fencing. Second, the merger will consolidate Exelon's political control of the regional market, PJM, enhancing its already outsized ability to influence the operations of the wholesale market, directly impacting Maryland ratepayers. Third, the merger will chill the ability of state leaders to enact sustainability goals, such as community solar and other clean energy initiatives, as Exelon has opposed such efforts.

II. The Transaction is at odds with the need for long-term distributional utility reform, and in fact will harm consumers.

Q Explain how the proposed transaction increases risk for Pepco customers.

A While both Pepco and Exelon are technically classified as being in the same electric utility industry, in actuality they are radically different companies. Pepco owns no power plants, and therefore derives all of its income from the regulated rate of return it earns purchasing power on the wholesale market and selling that electricity to its customers, as well as maintaining and operating transmission and distribution. As a mere procurer of power, Pepco's business model is inherently well-adjusted to the changes facing the utility industry: namely, the proliferation of affordable distributed generation and flatlining energy consumption.

Exelon, on the other hand, owns power plants—a lot of power plants, it turns out. Exelon owns the largest number of power plants in PJM, with over 25,000 MW. Exelon's control over substantial generation radically transforms Pepco's managerial, profit-motive priorities, moving it away from a facilitator of distributed generation and more towards a receptacle for Exelon's wholesale power sales. If Pepco remains an independent company, unaffiliated with any generation, it will have the political and economic wherewithal to encourage distributed generation. A Pepco enveloped by Exelon will have a remarkably different set of marching orders: opposing any and all efforts to reduce purchases of electrons from the wholesale market, supplied by Exelon's generation. Exelon owns the largest generation fleet in PJM, where its merchant plants have traditionally enjoyed lucrative returns. However, declining natural gas prices, lower power consumption, cheaper renewable energy and increased expenses for Exelon's aging nuclear power fleet have challenged Exelon's bottom line as of late, as Exelon faces significant risk exposure from increasingly volatile wholesale market conditions in PJM.

At the same time that wholesale markets are more volatile and returns less certain, retail market profit margins have been improving in PJM and elsewhere. On various calls with Wall Street analysts, Exelon executives have noted a significant decrease in the number of primary retail competitive suppliers, as well as less aggressive expansion of incumbent utility shopping of retail load. Exelon's CEO told investors: "This acquisition will add further sources of stable regulated cash to our portfolio,"[1] and it "…increases Exelon's utility derived earnings and cash flows, providing a solid base for the dividend and maintaining the upside from a recovery in power markets."[2] Wall Street analysts cheered the acquisition, highlighting the shift of risk away from unregulated merchant assets with more guaranteed cash flow:

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[1] Exelon Corp Q1 2014 Earnings Call Transcript, April 30, 2014, http://seekingalpha.com/article/2179093-exelons-exc-ceo-chris-crane-on-q1-2014-results-earnings-call-transcript

[2] *Sanford C. Bernstein Strategic Decisions Conference*, May 29, 2014, Slide 6, www.sec.gov/Archives/edgar/data/9466/000119312514215344/d733724dex991.htm

The "opportunistic" deal means Exelon would derive almost two-thirds of its earnings from rate-regulated businesses, up from 55-60 percent, CEO Chris Crane said.... Analysts viewed Exelon's move as a distinct shift away from the merchant power business and toward the relative safety of regulated utilities. "We see the latest transaction as firmly re-positioning the company back towards more of a regulated profile... " UBS's Julien Dumoulin-Smith said in a note to clients. Edward Jones analyst Andy Pusateri had a similar view. "The added exposure to regulated utilities should add more stable earnings for a company heavily exposed to nonregulated generation," he said. "We prefer that stream of cash flow. " [3]

Therefore, Exelon's proposed acquisition of Pepco must be seen through the lens of a more volatile and risky wholesale power market with more stable returns from retail operations.

The reason so many Wall Street analysts cheered the proposed acquisition is that Pepco's 1.4 million captive ratepayers within Exelon's PJM footprint handily offset Exelon's increasingly volatile wholesale market operations. In effect, Pepco's ratepayers will be a secure purchaser of Exelon's wholesale sales, delivering guaranteed revenues to Exelon's shareholders.

[3] *Exelon doubles down on regulated assets with Pepco buy,* Jeffrey Tomich and Rod Kuckro, EnergyWire: Thursday, May 1, 2014, www.eenews.net/stories/1059998806

Note that Pepco's retail operations are wholly within PJM: it would make little sense for Exelon to expand its retail footprint outside of PJM. The whole point of the transaction is to mitigate the increasing levels of risk from operating such a large fleet of merchant plants in PJM. And I don't see anything in the transaction that mitigates this risk to Maryland consumers.

III. Regional Consolidation Threatens Maryland Customers

Q Describe how the regional consolidation resulting from the proposed transaction threatens Maryland customers.

A By virtue of having restructured its electric utilities in the late 1990s, coordination and wholesale power pricing is now run by a private Delaware corporation, PJM Interconnection Inc. ("PJM") This private organization has often been directly at odds with various Maryland government mandates and initiatives, and this private corporation has the legal authority, with backing from the Federal Energy Regulatory Commission ("FERC"), to overrule and ignore various Maryland statutes that PJM believes to be at odds with its mission and FERC-approved tariff.

Until 2007, PJM had an internal Market Monitor. That year, the Market Monitor filed a formal complaint with federal officials that PJM management interfered with the Market Monitor's independence, forcing the office to alter reports to be more favorable to PJM management's wishes. One result of the complaint was that FERC forced PJM to spin off the Market Monitoring unit to become a fully independent entity, now called Monitoring Analytics LLC.

In the FERC docket reviewing the proposed acquisition of Pepco by Exelon,[4] the independent Market Monitor raised serious questions about the transaction. Specifically, the Market Monitor identified vertical market power issues related to the significant consolidation of transmission, electric distribution and gas distribution assets under the control of a single owner. From the Market Monitor's FERC filing:

Transmission owners' participation in PJM, or in any other [regional transmission organization] RTO, is voluntary.

Transmission owners have significant leverage over the RTO in which they are a member.

Like any organization, RTOs are concerned with protecting their size, scope and importance. The exit of a transmission member would be a very significant negative for an RTO. The greater the proportion of the RTO's assets represented by the transmission owner, the greater the threat of exit to the RTO and the greater the potential influence of the transmission owner over the RTO governance and processes.

The combination of Exelon and PHI will combine under a single owner a substantial portion of the transmission system. Exelon's transmission assets currently account for 16.8 percent of transmission service credits collected from the PJM market and Pepco Holdings assets currently account for 6.6 percent of transmission service credits collected from the PJM market. The combined company would account for 23.4 percent

[4] EC14-96.

of transmission service credits collected from the PJM market. The combined owner will have substantial and increased influence over decisions that directly relate to competition in PJM among developers of transmission projects. Although the RTO has responsibility for the interconnection process, transmission owners perform interconnection studies for generation.

Having a transmission owner involved in the study process creates a conflict of interest if they are also the developer or potential developer of a project or own competing generation.

The incentive and opportunity exist for transmissions owners to exert vertical market power and influence the interconnection process of potential wholesale competitors, from determining the timeliness, the technical requirements for and the costs of the interconnection.

Transmission owners are responsible for setting the line limits used by the RTO in their network models. It is evident from a recent PJM study of operational and market impacts during a heat wave event, that incorrect or incomplete information on line limits can have significant market impacts.

The concentration of ownership in transmission assets creates a concern about horizontal in addition vertical, market power. A consolidation of transmission companies reduces the pool of companies that have the expertise to compete to build competitive transmission projects, as defined in Order No. 1000. Consolidation will reduce the competition to build competitive transmission projects. A reduction in competition will likely result in higher costs for customers.[5]

[5] "Comments of the Independent Market Monitor for PJM," FERC Docket No. EC14-96, filed July 21, 2014, Pages 6-8.

FERC declined to impose any mitigation to account for these concerns when it approved the merger. At this point, Maryland officials are well aware of a long list of issues where FERC officials have ignored the state's concerns about protecting consumers and having access to a fair and competitive wholesale market. This means that the Maryland Public Service Commission must be even more vigilant to ensure the transaction is in the public interest and provides benefits to consumers. And at this point, the transaction places Maryland at risk because it fails to address Exelon's expanded control and influence within PJM.

Not only will the merger consolidate Exelon's control of PJM, but within Maryland as well. If the merger is approved, Exelon will control 85% of the utility system in Maryland, aggregating the company's political and economic control. Maryland officials didn't have many options when Exelon acquired Constellation in 2012, since then-Constellation CEO Mayo A. Shattuck essentially ran the company into bankruptcy after engaging in highly risky derivatives deals that left the parent company exposed to unsustainable losses. As a result, Exelon's acquisition of Constellation was more akin to a bailout, and the state had little leverage to ensure the transaction was in the public interest.

Exelon's acquisition of Pepco is far different. Pepco's balance sheet is stable and healthy, and the company had multiple suitors. Some of the competing utility bids came from utilities much like Pepco, in that they do not own generation, and therefore do not present the kind of regional and in-state consolidation posed by Exelon's proposed transaction.

There is a related issue: Mayo A. Shattuck currently serves as Executive Chairman of Exelon Corp. Given Mr. Shattuck's poor management performance when he served as Constellation CEO, I am concerned that his role as Executive Chairman provides inadequate independence of the board in overseeing management's Maryland operations.

Q Describe episodes of alleged market manipulation unaddressed by federal regulators.

A In July 2007, Exelon was required to pay a $1 billion settlement stemming from allegations raised by the Illinois Attorney General that the company manipulated the federal-jurisdictional power auction, causing ratepayer bills to skyrocket. The settlement followed allegations raised in a FERC proceeding. Before FERC could act on the market manipulation allegations, Exelon agreed to pay the $1 billion settlement, which was slated to be refunded to consumers.[6]

And Exelon did it again this year. Once a year, PJM operates a Reliability Pricing Model Base Residual Auction (Capacity Auction) as part of a series of remarkably complex market rules, in a constantly-changing effort to assure that generators provide enough power to keep the lights on. The Capacity Auction solicits bids from power providers to provide capacity for a year-long period, three years in advance of the auction date.

Every entity delivering electricity in PJM must pay the locational capacity price for their local zone, as set by the annual Capacity Auction. Therefore, it is end consumers—including Maryland households—who ultimately pay these capacity prices.

[6] Exelon 10-k, www.exeloncorp.com/assets/environment/docs/pdf_EXELONCORP10K.pdf, Page 73.

The Capacity Auction at issue here opened on May 12, 2014, with the results posted on May 23. This May Capacity Auction was to procure power for 2017-18.

The results of the Capacity Auction will be a staggering blow to consumers: $120/MW-day for the 2017-18 period, more than double the amount ($59/MW-day) for 2016-17, with end-consumers ultimately responsible for the $3.7 billion price tag. Anytime a key market indicator (in this case, the Capacity Auction results) rises more than 100% in one year, regulators should scrutinize the aberration. But the Federal Energy Regulatory Commission failed, one again, to protect Maryland consumers. As a result, the auction results stand.

PJM's market monitor, Monitoring Analytics, concluded in its 2014 PJM State of the Market report—issued August 14, 2014—that "[t]he aggregate [PJM Capacity] market structure was evaluated as not competitive. For almost all auctions held from 2007 to the present, the PJM region failed the three pivotal supplier test (TPS), which is conducted at the time of the auction. The local market structure was evaluated as not competitive. For almost every auction held, all [Locational Delivery Area] LDAs have failed the TPS test, which is conducted at the time of the auction… Market design was evaluated as mixed because while there are many positive features of the Reliability Pricing Model (RPM) design, there are several features of the RPM design which threaten competitive outcomes."[7]

[7] Section 5, Capacity Market, page 163, www.monitoringanalytics.com/reports/PJM_State_of_the_Market/2014.shtml

Despite concluding that PJM's Capacity Markets are "not competitive," Monitoring Analytics surmised that "although structural market power exists in the Capacity Market, a competitive outcome resulted from the application of market power mitigation rules."[8]

So, months after the May Capacity Auction, the PJM market monitor concluded that the capacity auction was structurally uncompetitive, but the market monitor's application of "market power mitigation rules" resulted in a competitive outcome.

But I believe the Capacity Auction and its results violated federal anti-manipulation statutes and the requirement that all rates be just and reasonable, because one market participant—Exelon Corp—executed a simple strategy to ensure that a portion of its generation portfolio would submit prices that would be rejected by the auction process, resulting in those assets being withheld from the auction. Capacity withholding is the oldest manipulation trick in the book, and the intentional withholding of power that would otherwise be profitable to supply, in order to intentionally reduce supply and thereby drive up market clearing prices for the owner's remaining fleet, is per se market manipulation under the Federal Power Act and the Commission's regulations and precedent.

A Swiss-based investment bank, UBS, published a research report calculating the "sweet spot" for Exelon to strategically withhold capacity from the PJM Capacity Auction in order to maximize profit, estimating that an Exelon bidding strategy that withheld 4,457 MW of capacity from the auction would deliver maximum financial benefit to the

[8] *Further Thoughts on the RPM Auction*, UBS Equities Research, May 28, 2014.

company: “Withholding 4,457 MW thus results in a reduction of $267M[illion] of revenue but the incrementally $33.25 higher cross on the supply curve results in $1.9B[illion] of revenue for the remaining 20,543 MW fleet that’s bid into the auction for a net uplift of $148M.”[9]

In fact, this is nearly exactly what Exelon did in the May PJM Capacity Auction. It withheld 4,225 MW of capacity (the Quad Cities, Byron and Oyster Creek nuclear units). The withholding of these Exelon units directly resulted in 2017-18 PJM capacity prices clearing at $120/MW-day, more than double the 2016-17 price of $59/MW-day. This doubling of capacity prices results in a doubling of capacity revenues to be collected, eventually, by end consumers: power bills will rise by $3.7 billion.

As Pulitzer-prize winning journalist David Cay Johnston writes: “The math is simple [for Exelon]: collecting $120 for 83 percent of your fleet of electric power plants produces 99 percent more revenue than getting $50 for 100 percent of the fleet.”[10] As the media elsewhere reported, Exelon "Won by Losing" the auction with regard to these three plants.

As a direct result of Exelon’s questionable bidding strategies, consumers forced to buy electricity within PJM will pay $3.7 billion in higher utility bills.

[9] Julien Dumoulin-Smith of UBS, Exelon Research Note, copy on file.
[10] http://america.aljazeera.com/opinions/2014/5/electricity-auctionpricespowerbillsconsumers.html

Indeed, Exelon, knowing that its withholding strategy would result in windfall profits, made sure to notify investors in a May 27, 2014 filing with the US Securities and Exchange Commission that its three nuclear plants in PJM failed to clear the auction. In the days after telling investors that its three plants failed to clear the auction, Exelon's stock price jumped 9.3%, rising from $34.15 on May 23 to $37.34 by June 5.[11]

These market manipulation schemes, unmitigated by federal regulators, raise serious concerns about Maryland's ability to protect consumers under Exelon's proposed acquisition of Pepco.

IV. The Proposed Transaction Threatens Maryland's ability to pursue sustainability and clean energy initiatives.

Q How does the proposed transaction threaten Maryland's ability to pursue sustainability and clean energy initiatives?

A Maryland has an admirable leadership role in promoting sustainability and clean energy. In 2005 the Maryland PSC implemented renewable energy requirements for the state's utilities.[12] The EmPower Maryland Energy Efficiency Act of 2008 established a goal of a 15 percent reduction in per capita electricity consumption by 2015. The Greenhouse Gas Emissions Reduction Act of 2009 places the state in a leadership role to address climate change. And the state formally recognizes that distributed renewable energy like rooftop

[11] www.sec.gov/Archives/edgar/data/1109357/000119312514212345/d731290d8k.htm
[12] http://webapp.psc.state.md.us/intranet/AboutUs/Press/RPS.pdf

solar is in the public interest.[13] These laudable goals appear to be directly at odds with recent actions by Exelon Corp, which threaten to undermine these achievements.

Exelon has been a national, vocal opponent of the federal Production Tax Credit for wind power[14] and is on record as opposing solar power, such as distributed generation:

> *"Exelon Corporation (which owns utilities in three states and is asking regulators to allow it to buy a fourth in the District of Columbia) recently bragged about killing the wind industry and claimed that it would kill the solar industry next: "This year, it's the wind industry," said Exelon Chief Lobbyist Joe Dominguez. "Next year, it will be the solar industry.""*[15]

Just as importantly, the proposed transaction is occurring during a period of dramatic changes for the utility industry. First, a little background. In January 2013, the Edison Electric Institute—the premier national trade association representing the interests of Investor Owned Utilities, and of which both Exelon and Pepco are members—released a white paper: *Disruptive Challenges: Financial Implications and Strategic Responses to a Changing Retail Electric Business*. This paper identified distributed energy resources as one of the major threats to the existing electric utility business model. From the report:

> *"[D]isruptive challenges" arise due to a convergence of factors, including: falling costs of distributed generation and other distributed energy resources*

[13] Maryland General Assembly, Department of Legislative Services, "Senate Bill 595, 2007 Session," Fiscal and Policy note, Page 2.
[14] www.delawareonline.com/story/money/business/2014/08/29/exelon-corp-opposes-renewal-wind-subsidy/14814083/
[15] www.greentechmedia.com/articles/read/Utility-Exelon-Trying-to-Kill-Wind-and-Solar-Subsidies-While-Keeping-Nukes

(DER); an enhanced focus on development of new DER technologies; [and] increasing customer, regulatory, and political interest in demandside management technologies (DSM)...The timing of such transformative changes is unclear, but with the potential for technological innovation (e.g., solar photovoltaic or PV) becoming economically viable due to this confluence of forces, the industry and its stakeholders must proactively assess the impacts and alternatives available to address disruptive challenges in a timely manner...The financial risks created by disruptive challenges include declining utility revenues, increasing costs, and lower profitability potential, particularly over the long-term. As DER and DSM programs continue to capture "market share," for example, utility revenues will be reduced. Adding the higher costs to integrate DER, increasing subsidies for DSM and direct metering of DER will result in the potential for a squeeze on profitability and, thus, credit metrics...While the various disruptive challenges facing the electric utility industry may have different implications, they all create adverse impacts on revenues, as well as on investor returns...these financial pressures could have a major impact on realized equity returns, required investor returns, and credit quality. As a result, the future cost and availability of capital for the electric utility industry would be adversely impacted.[16]

Exelon will control 85% of the utility system in Maryland, aggregating the company's political and economic control. There is nothing in the proposed transaction that would allow Maryland officials to position Pepco and its customers to take advantage of the

[16] Page 1, Executive Summary, www.eei.org/ourissues/finance/documents/disruptivechallenges.pdf

dynamic technology innovations in rooftop solar and energy efficiency that will be necessary for customers to derive benefits. In fact, it seems as though the transaction is structured, at its core, to actively suppress the very structural reforms Pepco needs to embrace in order to effectively serve customers. It appears as though Exelon's entire goal of acquiring Pepco is to shift its current operational risk exposure from wholesale power plant operations onto Pepco's captive customers. In the process, Pepco's current distribution-only utility model, amenable to the proliferation of distributed renewable generation needed to serve consumers in the coming years, will be compromised by Exelon's need to sell its own wholesale electricity to Pepco's customers. This shift represents a radical alteration of Pepco's current corporate structure and business model, and therefore presents risks to the public interest and threatens harm to consumers.

V. RECOMMENDATIONS

Q Please summarize your recommendations.

A The Maryland Public Service Commission must reject the proposed acquisition of Pepco by Exelon Corp, because it fails the requirements that the transaction be in the public interest and provides benefits to consumers.

Q. Does this conclude your testimony?

A. Yes.