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Washington DC Regulators Propose Additional Requirements For Exelon-Pepco Merger

Growing Complexity of Approval Process Demands Flexible Merger Plans

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Policy Brief

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Key Takeaways:

- The Public Service Commission of the District of Columbia (DC PSC) rejected a proposed merger for Exelon Corporation's acquisition of Pepco Holdings, but proposed alternative terms to pave the way for approval
- In its alternative terms, DC PSC requires active participation in renewable energy initiatives and improved cost allocation
- Merger transactions are increasingly likely to depend on addressing infrastructure modernization and environmental goals

Entities Mentioned:

- Energy Information Administration
- Exelon Corporation
- Federal Energy Regulatory Commission
- Maryland Public Service Commission
- New Jersey Board of Public Utilities
- PJM Interconnection
- Pepco Holdings Inc
- Public Service Commission of the District of Columbia

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Insight for Industry – DC PSC Rejects Exelon-Pepco Merger Agreement, Proposes Criteria for Approval

On February 26, 2016, the Public Service Commission of the District of Columbia (DC PSC) rejected a proposed merger for Exelon Corporation's acquisition of Pepco Holdings as not being in the public interest. However, the DC PSC also proposed alternative terms that, if accepted by settling parties, automatically approve the merger and create the largest electric utility holding company in the United States by customer base.

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DC PSC's amendments seek active participation in renewable energy, energy efficiency, and grid modernization initiatives, while improving fund allocation for ratepayer benefits. Washington DC has been the center of opposition to the merger, with DC PSC rejecting the companies' initial merger proposal in August 2015, citing an inherent conflict of interest that could inhibit Washington DC's clean energy goals.

Facing falling prices in PJM markets for its nuclear-powered generation portfolio--the largest in the U.S., Exelon is eyeing Pepco for its stable utility revenue, which could offset the negative effects of low energy prices.

Consumer interests and environmentalists have raised concerns that the proposed merger would create the nation's largest utility with near-monopoly control over the regional energy market, resulting in higher utility bills, less local control, and less energy options for Washington DC ratepayers. Concerns also focus on the exposure of Pepco ratepayers to the financial risks of Exelon's generation portfolio, which includes aging and unprofitable nuclear plants in PJM markets. Given Exelon's history of staunchly opposing policies for solar and wind power, the deal's opponents also raised fears that the merger would reverse Washington DC's renewable energy progress, pointing to a potential conflict between Exelon's commitment to its merchant generation and Washington DC's transition toward increased renewable energy.

The proposed merger, announced in April 2014, has been approved by the Federal Energy Regulatory Commission (FERC) and the public utility commissions in Maryland, New Jersey, Delaware, and Virginia, leaving the District of Columbia as the final jurisdiction to issue regulatory approval. It would bring together Exelon's electric and gas utilities (BGE, ComEd, and PECO) and Pepco Holdings' electric and gas utilities (Atlantic City Electric, Delmarva Power, and Pepco) to create the Mid-Atlantic electric and gas utility.

After the 1992 Energy Policy Act, which set the stage for consolidation in the sector, utilities were initially slow to consolidate. However, in the past ten years, activity in mergers and acquisitions has accelerated, with utilities seeking economies of scale and spreading their costs over a broader customer base. Especially in the past five years, renewable energy and infrastructure modernization have pushed utilities towards consolidation in order to boost their financial capabilities to deal with the new challenges. However, as the protracted process in the Exelon-Pepco case demonstrates, with the growing market power of each merged utility, the firms will increasingly need more

flexible merger plans that could satisfy regulators by reflecting the diverse objectives of infrastructure modernization, renewable energy development, and environmental goals.

DC PSC Denies Exelon-Pepco Merger Approval for Second Time, Proposes Alternative Conditions for Approval

In the 2-1 DC PSC decision, Chairman Betty Ann Kane and Commissioner Joanne Doddy Fort rejected the settlement agreement on the proposed Exelon-Pepco merger, while Commissioner Willie L. Phillips dissented. However, Commissioner Fort proposed alternative terms that would, if accepted by the settling parties, result in the approval of the revised settlement agreement and the merger application without additional action by DC PSC. A 2-1 vote on sending the amended version to the parties served to keep the deal alive, with a 14-day deadline to accept or reject its conditions.

The DC PSC decision to deny the proposal was based on four factors:

- Lack of convincing reason for excluding non-residential ratepayers from the proposed $25.6 million Customer Investment Fund (CIF) for Customer Base Rate Credit relief;
- Assigning roles for Exelon and Pepco – solar development and microgrid construction – that weaken competition and grid neutrality and are inconsistent with Washington DC's restructured market;
- Proposed CIF uses – for sustainability projects and Low Income Home Energy Assistance Program – that neither improve Pepco's distribution system nor advance the DC PSC's objective to modernize its energy systems and distribution grid;
- Proposed method for CIF fund allocation to Washington DC government agencies that deprives DC PSC of the ability to enforce compliance with the agreement terms and ensure that funds are used to improve the distribution system and benefit ratepayers.

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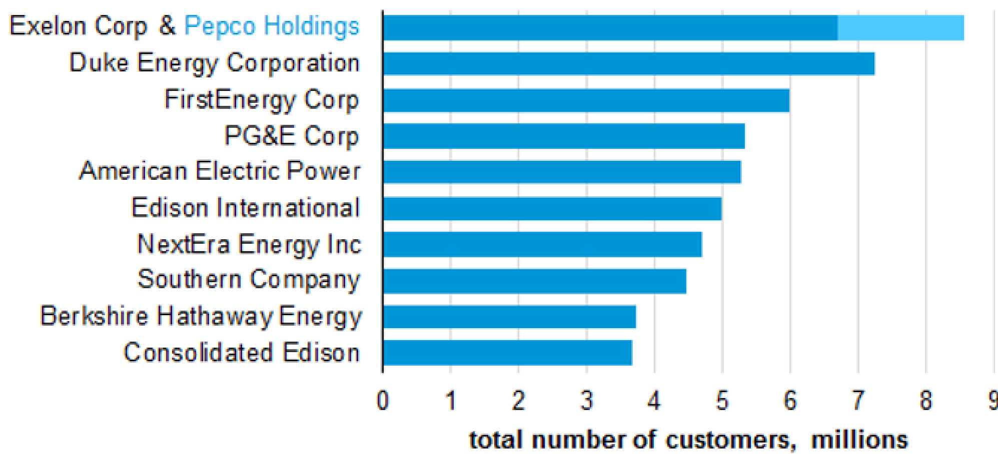
In August 2015, DC PSC rejected the companies' initial merger, citing an inherent conflict of interest that could hinder Pepco, the local distribution company's, clean energy efforts. Among other factors, DC PSC considered out-of-state business operations risks (including Exelon's nuclear operations) and the Commission's ability to regulate the new utility effectively, since Pepco would become a second-tier company, subject to increased management bureaucracy in a larger corporation focused on generation, rather than distribution.

Following DC PSC's negative decision, in October 2015, Exelon reached a settlement with the Washington DC Mayor and other parties including Office of Attorney General and Office of the People's Counsel. The companies said the settlement addressed DC PSC's August 2015 order by including commitments to provide bill credits, low-income assistance, and investments.

According to the Energy Information Administration (EIA), the 6.8 billion Exelon-Pepco merger would create the largest electric utility holding company in the U.S. by the number of customers. EIA projects a combined 8.5 million customers for the post-merger Exelon, surpassing the customer base of its closest follower, Duke Energy, which merged with Progress Energy in 2012 (Figure 1).

Figure 1 – Customers of Largest Investor-Owned Electric Utility Holding Companies, 2014



Source: EIA

Exelon serves 6.7 million customers through three electric utility subsidiaries: Commonwealth Edison in Illinois; PECO Energy in Pennsylvania; and Baltimore Gas & Electric (BGE) in Maryland. Pepco Holdings serves 1.9 million customers through Potomac Electric Power Company (Pepco) – its largest subsidiary – in Washington DC and Maryland; Delmarva Power in Delaware and Maryland, and Atlantic City Electric in New Jersey.

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Proposed Alternative Terms Prioritize Development of Renewables and Improved Fund Allocation

The revised agreement would improve the use of CIF, including direct rate credits to residential customers and support for additional energy conservation and energy efficiency programs, especially for low and moderate income ratepayers. To ensure that CIF and any penalty funds remain under DC PSC's regulatory authority and are not used to alleviate the budgetary pressures of the Washington DC government, the revised agreement proposes changes to fund allocation. Among the key changes, the revised settlement agreement would:

- Defer a decision on the allocation of the $25.6 million Customer Base Rate Credit among Pepco's customers until the next base rate case proceeding;
- Remove the call for Exelon to develop 5 MW of solar generation at Washington DC Water's Blue Plains facility under commercially

acceptable terms, instead requiring Pepco to expedite interconnection to a similar plant, installed by a developer selected by Washington DC Water;
- Require Exelon to transfer the funds to a new Formal Case No. 1119 Escrow Fund to be established by Pepco with two subaccounts:
    - $21.55 million Modernizing the Energy Delivery System for Increased Sustainability (MEDSIS) Pilot Project Fund Subaccount; and
    - $11.25 million Energy Efficiency and Energy Conservation Initiatives Subaccount for programs targeting affordable multifamily units and master metered multifamily buildings which include low and limited income residents;
- Remove provisions assigning Pepco a role to develop public-purpose microgrid projects.

In proposing the alternative terms, Commissioner Fort noted the growing market for solar generation, saying that a commitment that gave Exelon exclusive right to develop solar generation at Blue Plains on vague terms rather than allowing a competitive procurement process was inconsistent with the DC PSC's obligations to foster competitive electric retail markets and service. Commissioner Fort also found that assigning Pepco with microgrid development would prematurely resolve open issues, given that the role of microgrids are currently being discussed as part of Formal Case No. 1130, which was opened in 2015 to explore operational and regulatory changes to modernize the energy delivery system, prepare the grid for increased distributed energy resources, and reduce carbon emissions.

The revised terms would commit Exelon to facilitate and support the pilot projects under the Formal Case No. 1130 Pilot Project Fund and become a more active participant in the development of solar and wind energy consistent with Washington DC's regulatory structure and energy vision. In addition, Exelon and Pepco would have to improve their reliability and safety performance as well as customer satisfaction. The revised settlement agreement would further support the Washington DC economy by retaining headquarters of Pepco and locating co-headquarters of Exelon Corporate Strategy and Exelon Utilities in Washington DC for the next 10 years, along with specific commitments for job retention and new hires.

Commissioner Phillips, who already voted in favor of the settlement agreement, accepted the alternative terms in order to provide the settling parties an avenue towards approval, instead of resulting in an outright denial. Meanwhile, Chairman Kane deemed the alternative terms insufficient to satisfy the public interest requirement and voted against the motion.

Washington DC Remains Final Holdout following Approval by FERC and Four State Regulators

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Power D.C., a coalition of environmental, government, and consumer groups – including Sierra Club, D.C. Environmental Network, and Public Citizen – has strongly opposed the merger, saying that Exelon's corporate interests are not aligned with Washington DC's policy objectives and Exelon's acquisition of Pepco is not in the public interest. Power D.C. members highlight Exelon's history of opposing and undermining renewable energy policies and the potential for such tactics to reverse the District's progress on local renewable energy and energy efficiency. They have also raised concerns that the proposed merger would increase energy bills, lower reliability, and hand decision-making to a corporation's headquarters in Chicago. Critics of the merger also point to Exelon's intention to utilize PEPCO's customer base to protect its nuclear operations. Power D.C. draws attention to Illinois, where Exelon is asking a $580 million per year subsidy for its nuclear plants. As a post-merger Exelon would be the nation's largest utility functioning in the PJM interconnection, there are concerns that Exelon could significantly impact rulemaking in PJM and the states in which it operates.

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Despite the opposition, the proposed merger, announced in April 2014, has already been approved by the Federal Energy Regulatory Commission (FERC) and the public utility commissions in Maryland, New Jersey, Delaware, and Virginia, leaving the fate of the deal in Washington DC's hands. Along the way, utility regulators in other states have added several conditions to their approvals. For example, the February 2015 approval of the New Jersey Board of Public Utilities was based on a settlement that includes provisions for $15 million in efficiency savings to Atlantic City Electric (ACE) and $62 million customer investment fund for direct rate credits to ACE customers within 60 days of closing the merger.

Similarly, the May 2015 approval of the Maryland Public Service Commission (MD PSC) relies on 46 conditions, including higher reliability standards, a $100 rate credit for Delmarva and Pepco residential customers, and $43.2 million for energy efficiency programs in Prince George's and Montgomery Counties and the Delmarva Maryland service territory. A major condition is a requirement that Delmarva and Pepco meet strong reliability performance standards from 2016-2020 under budget targets and subject to non-compliance penalties. However, in June 2015, the Maryland Office of People's Counsel (OPC), which represents residential utility customers, announced it had filed petition to review MD PSC's approval in the Circuit Court of Queen Anne's County, as the merger would concentrate the control over 80 percent of Maryland's residential customers into the hands of one corporation.

Exelon-Pepco Deal Reflects Challenges for Utilities Seeking Growth through Mergers and Acquisitions

In proposing the merger with Pepco, Exelon named cost reductions through increased scale and the companies' geographic proximity as well as similar

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business models as its main reasons. The deal is considered critical for Exelon, as the predictable income of Pepco's utility operations could guard against risks from Exelon's nuclear generation portfolio, which has been challenged by unprofitable market conditions in the PJM region.

Utility mergers and acquisitions have been facilitated by the 1992 Energy Policy Act, which relaxed the 1935 Public Utility Holding Company Act that limited investor owned utilities (IOUs) to a single state and prevented diversification into unregulated types of businesses involving holding corporate structures in the electric power and natural gas utility industries. Utilities have primarily sought mergers and acquisitions for economies of scale, increasing operational efficiency and spreading costs over a broader customer base. Business expansion, coupled with operational diversification, allows utilities to benefit from stable and predictable cash flows, thereby reducing their risk profiles. However, in more recent years, infrastructure modernization, renewable energy, and environmental compliance requirements have pushed utilities to go beyond economies of scale and seek financial support to boost investment capabilities. Utilities are seeking technologies to reduce environmental footprints and improve efficiency. For example, the July 2012 merger of Duke Energy and Progress Energy, which created the currently largest electric utility in the U.S., addressed potential market power concerns in North Carolina and South Carolina through transmission additions that improved generators' access to the new electric system.

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The protracted process in the Exelon-Pepco proposal that requires both stakeholder and regulatory approval from several regulatory bodies involving multiple states has shown significant uncertainties in the approval process. As consolidation continues and individual utility holdings capture an increasing share of market power, utilities will have to face an ever wider array of possibly more suspicious regulators with every additional deal. Given the trend, utilities should prepare merger plans and management structures that reflect the changing utility landscape, incorporating flexibility and adaptability to address diverse objectives of utility regulators.

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