

ANALYSIS OF PROPOSED EXELON-PEPCO MERGER AND PUBLIC OWNERSHIP OF ELECTRICITY DISTRIBUTION

I. SUMMARY

(1) Billions of dollars and key public policy goals are at stake in the decision of who provides electricity to DC and on what terms. PEPCO DC annual operating revenues are close to one half billion dollars.¹ Electricity is a vital service whose costs and reliability are central to public safety, economic development and fairness among ratepayers, including those with low incomes. Moreover, the generation and provision of electricity significantly affects several DC environmental sustainability objectives to which DC has committed significant funds, as well as economic development and business stimulus objectives.

(2) A Pepco-Exelon, or similar, merger with a dominant owner of electricity generation would likely be highly detrimental to DC residents and businesses. Notwithstanding the recent PSC decision finding that the proposed Exelon-Pepco merger is not in the public interest,² it is known that Exelon and Pepco (PHI Holdings) are presenting a revised proposal to salvage the merger. Moreover, Pepco has shown itself to be oriented against broad public interests and primarily dedicated to the interest of its shareholders by agreeing to the Exelon proposal. Even if the proposal that was rejected by the PSC is not salvaged, Pepco most likely will seek another takeover applicant to allow itself and its management to profit from a sale above current stock and book values.

(3) Consideration of alternatives to private commercial delivery of electricity must not be deferred. The DC City Council should oppose any revised Exelon-Pepco merger proposal, conduct a serious exploration of public power alternatives to Pepco or other private company electric utility ownership, and commence a process leading to public power distribution.

II. BACKGROUND

(1) BOTH AS IT WAS PRESENTED AND AS IT MIGHT BE REVISED, THE EXELON-PEPCO MERGER IS CONTRARY TO THE PUBLIC INTEREST, ANTICOMPETITIVE AND ECONOMICALLY AND ENVIRONMENTALLY DISADVANTAGEOUS

The leading edge of electricity innovation from both cost and environmental standpoints is from local “distributed” generation and the management of customer electricity use. Solar, wind, distributed storage, conservation, and other technologies, now effectively compete with large central station generators to provide electricity. These new technologies often are owned and managed by non-utility companies and electricity users, thereby providing alternatives to major utility-owned generation.

In this context, it is noteworthy that Exelon owns the largest number of nuclear generating plants in the country and is among the largest central station utility generators. At the same time, Exelon owns customer-serving utilities from New Jersey to Maryland as well as serving Chicago in Illinois.

If Exelon is successful in acquiring Pepco, it will act to shape distributed generation and load management policy to protect the profitability of its central station generation. This is inherent in Exelon’s economic

¹ The D.C. Public Service Commission reports Pepco Operating Revenues of \$442,681,000 for the calendar year ending 2012, which amounts would have since increased. Formal Case No. 1103, *In the Matter of the Application of the Potomac Electric Power Company for Authority to Increase Existing Retail Rates and Charges for Electric Distribution Service*, Order No. 17424 (March 26, 2014) Sch. 1, p. 228).

² □ FORMAL CASE NO. 1119, *In the Matter of the Joint Application of Exelon Corporation, Pepco Holdings, Inc., Potomac Electric Power Company, Exelon Energy Delivery Company, LLC and New Special Purpose Entity, LLC for Authorization and Approval of Proposed Merger Transaction*, Order No. 17947 (August 27, 2015) (“Merger Case Order”)

model because of the billions of dollars that Exelon has invested in generation, whose costs must be recovered through sales. However, this generating output is sold into competitive or semi-competitive markets, making distributed generation a competitive threat to Exelon. Recent D.C. PSC findings recognize the concern that Exelon control of Pepco may be used to protect against distributed generation competition.³ Further, Exelon has acted in Illinois to support legislation to allow it control of local grids and distributed generation and to provide for rates that make customer-owned solar power uneconomic. The discretion that utilities have over utility management is such that given Exelon's incentives to control and shape District distributed generation and load management to protect its generation, the Public Service Commission cannot provide effective control.

Thus, a Pepco merger with Exelon would create significant problems for the development of competing power supplies. DC has spent money and effort to promote local solar electricity generation. Under Exelon control, Pepco will be able to advance Exelon's self-interest through policies on: rates; limitations on distributed generation connections to distribution lines; limitations on generation and appliance applications, approvals, and credits for customer supplied power; charges for backup power and ancillary services; tough penalties; and more. These policies will block competing generation and load management, thereby limiting competitive development of distributive generation and load management resources. An Exelon merger can wipe out the value of public and residential investments that already have been made.

Even more importantly, the proposed merger would prevent the city from shaping its own policies in these areas. The limiting of competition would tend to increase residential electricity costs. And, of significant public importance, limitations on distributed generation and load management would have substantial, negative environmental consequences, including likely causing greater carbon emissions.

These problems are built into the merger. They are structural and cannot be cured by a different merger proposal. If Exelon owns Pepco, it will have the incentive to kill independent D.C. distributed generation. Based on its history and company statements, Exelon can be expected to shape policies to do so.

³ Merger Case Order at P 10: ("Pepco will become a second tier company in a much larger corporation whose primary interest is not in distribution, but in generation.... We are also concerned about the inherent conflict of interest that might inhibit our local distribution company from moving forward to embrace a cleaner and greener environment.") Although the merger was not rejected on these grounds at PP 341-342, the Merger Case Order states: "But the record shows that Exelon has been less than enthusiastic about embracing distributed generation and has taken positions on net metering and community net metering programs that are contrary to programs that promote the use of renewable resources that have already been enacted into law in the District or that are reflected in the Sustainable DC policy adopted by the Mayor.... The lack of any commitments by the Joint Applicants for the advancement of the statutory and policy agendas that have been set in the District for the incorporation of a growing amount of renewables and distributed generation within our local distribution system, combined with Exelon's documented history of opposing certain programs that promote renewables, leaves us uneasy concerning the District's smooth transition to clean and green fuel sources if this Proposed Merger is approved." See Dissenting Opinion of Comm'rs. Harold D. Williams and Anne E. Hoskins, *Exelon Corporation And Pepco Holdings, Inc.*, Md. PSC Case NO. 9361, Order No. 86990 (May 15, 2015): "Exelon's economic interests to shield that fleet from emerging distributed energy technologies and other competitive threats are inherently misaligned with the interests of the customers of Pepco and Delmarva, who are predominantly concerned with efficient, cost-effective and reliable electric service.... Exelon's conflict relating to distributed energy resources and other threats to its generation assets is evident from the documents contained in its Strategic Plan... For example, in its Hybrid model, Exelon examined the potential impact of distributed energy resources, observing that the model "will seek to insulate our centralized generation from the increased threat of DG." (footnotes omitted). We would be pleased to provide further evidence that Exelon would tailor its actions with respect to distributed generation to support its central station generation and its actions in Illinois to block independent distributed generation.

The second built-in problem with an Exelon acquisition of Pepco stems from the presumed purposes underlying the acquisition. As a distribution utility with an assured customer base, Pepco would provide Exelon with an assured cash flow. Because of the substantial de-regulation of generation, Exelon is subject to a great market risk (and potential market gains) from its generation. Having a large and secure source of cash flow ameliorates the market and other risks to its nuclear and other generation. But the benefit to Exelon of being able to export cash from D.C. takes money and cash – jobs - away from the District. Exelon’s need to have cash available on a corporate level to protect itself against generation losses also would affect the desirability of it making expenditures in D.C. for reliability and distributed generation, making those expenditures subject to the perceived needs of a Chicago-based corporation and its outside investors. Finally, the very large premium that Exelon has offered for Pepco – estimated at well over \$1.5 billion – strongly suggests that Exelon recognizes the cash flow advantage and intrinsic market power of acquiring Pepco. These advantages to Exelon will not help DC.⁴

(2) PUBLIC POWER HAS BEEN DEMONSTRATED TO BE SAFE, EFFICIENT, AND ECONOMICALLY BENEFICIAL FOR CONSUMERS.

Because of particular antitrust and other problems that are associated with an Exelon takeover of Pepco, almost any other private utility would probably be preferable, even though other private utility acquisitions could raise similar concerns to the Exelon proposal. Moreover, Pepco has expressed a desire to sell, presumably to the highest bidder that can get Commission approval. These factors mandate that a public power option be considered. Under public power, policies on matters like distributed generation are made locally based upon public needs and preferences. And electricity revenues, profits and expenditures stay at home to a greater extent than with geographically spread, dividend paying companies. Under public power, utility profits can be used as public policies dictate to improve the utility, reduce rates or meet other city needs. Further, local expenditures and use of profits locally have an economic multiplier effect.

Cities across the United States distribute electricity as a municipal public service. Many self-generate in whole or in part while some do not. Together with other city-owned utilities, many join municipal power supply agencies to jointly obtain power and other services, thereby achieving economies of scale, cost savings, and professional management. In addition to municipal ownership, many communities receive electric service through cooperative forms of ownership.

The American Public Power Association reports that there are over 2,000 municipally-owned electric utilities in the United States, serving more than 48 million people, or about 14 percent of all electricity consumers.” These include very large cities, such as Los Angeles, San Antonio, Seattle, Orlando and Cleveland; they also include very small cities as well.

Municipally-owned utilities often sell electricity less expensively than privately-owned utilities. In the most recently available year for which data are available (2010), residential customers of investor owned utilities paid rates on average that were 13 percent above those of public power utilities systems. Commercial customers were 5 percent higher. Industrial public power customer rates were very slightly higher than those of privately owned companies. www.publicpower.org American Public Power Association • 2015-2016 *Annual Directory & Statistical Report* at 55.

There are a number of reasons for this this public power rate advantage. Public power is municipally-owned. It is established not-for-profit. If rates become excessive, the electorate has access to means to seek correction whereas privately-owned utilities, shareholder-owners, and their management benefit from high rates and profits. Additionally, utility rates are generally driven by the costs of capital. Cities generally debt finance. Private company equity costs are often more than twice the cost of municipal debt. Further, public power systems generally do not pay federal income taxes, which are a large component of

⁴ The D.C. PSC found that the merger carried a “\$1.6 billion stock premium that is being paid to shareholders” (Merger Case Order at P 109), an amount that Exelon undoubtedly anticipated recovering as a result of the merger..

electricity rates. Nor do public power systems have the high executive salaries and similar management costs of private companies.

In addition to rates, municipally-owned electric systems often have better service than privately owned ones. One reason is that public power is local with managers and employees living at or near points of service. Public power officials and managers are generally readily accessible, unlike utilities that may be headquartered in distant locations. Publicly owned utilities are locally controlled and are designed to support their communities.

Although an examination of District of Columbia electric options would be expensive, the cost of not examining them would be more expensive, potentially tens and hundreds of millions of dollars. Moreover, if a revised Exelon takeover of Pepco is disapproved, additional Pepco sell-out proposals are likely: if DC has a public power option, this will provide a means of evaluating and negotiating any subsequent Pepco merger proposals. It should be noted that among the public power options that might be considered, one approach would be to start small, for example with test projects, such as serving public buildings or particular groupings of customers, and expanding from there.

There are few cities that have public power that would want to give it up. The same cannot be said in reverse. Under public power there is local control and there tends to be lower rates, better service and revenues stay more at home. For these reasons, the DC City Council should exercise its leadership and provide guidance and the means to develop a public approach to the distribution of electricity in DC.