

**UNITED STATES OF AMERICA  
BEFORE THE  
FEDERAL ENERGY REGULATORY COMMISSION**

**Exelon Corporation**

**Public Service Enterprise Group Incorporated**

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**Docket No. EC05-43-000**

**SUPPLEMENTAL PROTEST AND REQUEST FOR HEARING  
OF THE PPL COMPANIES**

**May 27, 2005**

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OF THE PPL COMPANIES**

Pursuant to Rule 211 of the Rules of Practice and Procedure of the Federal Energy Regulatory Commission (“Commission”), 18 C.F.R. § 385.211, and the Commission’s Notice of Amendment to Filing issued on May 13, 2005, PPL Electric Utilities Corporation; PPL EnergyPlus, LLC; PPL Brunner Island, LLC; PPL Holtwood, LLC; PPL Martins Creek, LLC; PPL Montour, LLC; PPL Susquehanna, LLC; PPL University Park, LLC and Lower Mount Bethel Energy, LLC (collectively the “PPL Companies”) protest the answer and supplemental application for authorization of disposition of jurisdictional facilities submitted by Exelon Corporation (“Exelon”) and Public Service Enterprise Group Incorporated (“PSEG”) (collectively, the “Merging Parties” or the “Applicants”) in the above-captioned proceeding (the “Answer”).<sup>1</sup> The PPL Companies also request that this matter be set for hearing to address the myriad of concerns raised by the PPL Companies and other intervenors regarding the proposed merger of Exelon and PSEG.

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<sup>1</sup> Answer of Exelon Corporation and Public Service Enterprise Group Incorporated, Docket No. EC05-43-000 (filed May 9, 2005).

## **I. EXECUTIVE SUMMARY.**

Exelon and PSEG are proposing that the Commission approve a merger unlike any other the Commission has considered since it began giving weight to competitive concerns. Never have public utilities subject to the Commission's jurisdiction proposed a merger that was so anticompetitive on its face that the Applicants themselves proposed to divest over 5000 megawatts of capacity. Despite this highly extraordinary and potentially anticompetitive transaction, the Applicants are asking the Commission to approve it summarily without the benefit of hearings. Granting this request would mean foregoing careful examination of the market power mitigation measures proposed by the Applicants. This is not a case in which the Commission can summarily approve a merger under Section 203 without a hearing. Rather, as discussed below, the factual issues surrounding this merger and the proposed mitigation are material, hotly disputed and critical to the Commission's determination of whether the merger is "consistent with the public interest."<sup>2</sup>

Applicants continue to press the Commission to accept contracts for the sale of energy for as short as three years as "virtual divestiture." However, such contracts are not divestiture. They are nothing more than sales contracts that Applicants would normally make for excess capacity. Applicants' Answer fails to address the policy reasons why the antitrust enforcement agencies disfavor sales contracts and prefer real divestiture. The Applicants also have no answer for the fact that their retained ownership of the "virtually divested" generation leaves them with the incentive and ability to exercise market power. For example, as most of the "virtually divested" assets will be

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<sup>2</sup> 16 U.S.C. §824b(a) (2000).

sold in annual auctions of three year contracts, any exercise of market power by the merged entity can affect the price for such contracts. The issue of real versus virtual divestiture cries out for full hearings by the Commission.

Applicants said that using FTRs to assign shares of transmission imports across the Eastern interface could not be done. However, PPL's expert, Dr. Kalt did it, and his study is included in this Supplemental Protest. As the PPL Companies suspected, when FTRs are used to provide a rational and fact-based assignment of transmission import shares, the Applicants' mitigation proposal fails the merger screens. In the face of this evidence, the Commission is not obligated to accept the "squeeze down" method of assigning shares of transmission imports.

Applicants continue to ignore two critical geographic markets: Northern New Jersey and PJM Classic. Applicants hid the analysis of the Northern New Jersey market in their work papers. They provide a nonsensical explanation for the declining to evaluate the PJM Classic market. Both markets must be analyzed if the Commission is to fully understand the impact of the merger on competition. Moreover, Applicants continue to refuse to apply logical or realistic energy prices to their relevant product markets.

Applicants continue to seek an inordinate amount of time to complete their divestiture. Applicants' proposal is contrary to the sound policies of both the Department of Justice and the Federal Trade Commission ("FTC"). The policy of these agencies is quick restructuring of markets once a decision has been reached requiring divestiture. Rather than sparring with the Applicants regarding how much time is necessary to

complete the divestiture, the Commission should condition the merger closing on approval of the units to be divested and the entities to whom they will be sold.

Finally, a hearing is clearly warranted for at least two additional reasons. First, the PJM Market Monitoring Unit has confirmed that the proposed merger could lead to increased cost capping in PJM East. Second, Applicants' new offer to build new transmission raises serious questions under the PJM Open Access Transmission Tariff and the PJM Operating Agreement.

Applicants have threatened to withdraw their revised mitigation proposal unless the Commission bows to their will and declines to hold a hearing. Thus, the Commission must also analyze the merger, as originally proposed, including the limitations on purchasers of divested assets. These limitations are anticompetitive and discriminatory. They will have the affect of solidifying Applicants' market position and denying to other market participants the efficiencies that the Applicants claim for themselves.

In sum, this merger raises serious policy and factual issues never before considered by the Commission. Nor can they be considered fairly by the Commission without full discovery and a full hearing. That hearing must consider the impact of the proposed merger on competition and both the original and revised mitigation proposed by the Applicants. While the Commission has done much in recent years to expedite review of proposed mergers, no one can fault the Commission for taking the extra time necessary to get this decision right.

**II. NEITHER APPLICANTS’ REVISED PROPOSAL NOR THEIR RESPONSE TO PROTESTORS JUSTIFY APPROVAL OF THE APPLICATION WITHOUT A FULL EVIDENTIARY HEARING.**

**A. The Commission Should Not Bow To Applicants’ Threat To Withdraw Their Additional Mitigation Proposals.**

The proposed merger of Exelon and PSEG creates serious competitive problems which prevent it from being approved by the Commission absent significant mitigation. The Applicants initially proposed a mitigation package that included the divestiture of 2900 megawatts of capacity, long-term contracts for 2600 megawatts of base load nuclear capacity, and other commitments that came with various restrictions and limitations. The PPL Companies protested and demonstrated that Applicants’ mitigation proposal barely passed muster under the Commission’s merger screens and did so only by using overly favorable and often unrealistic assumptions. For example:

- Applicants’ proposal to count 2600 megawatts of long-term contracts as “virtual divestiture” did not mitigate the market power Applicants will acquire as a result of the merger. Moreover, “virtual divestiture” is contrary to well established antitrust remedies policy.
- Applicants’ proposal to exclude companies that would be effective competitors from acquiring their divested assets is anticompetitive and exclusionary. These restrictions are unnecessary and would likely preserve Applicants’ dominant market position.
- Applicants failed to analyze the impact of the merger in both the PJM Classic market and the Northern New Jersey market.
- Applicants’ proposal to reduce their mitigation obligation when they retire units is not the equivalent of divestiture. In fact, it is more like withholding of capacity than divestiture of capacity.
- The proposed merger could cause an increase in cost capping under the PJM three-pivotal supplier rule leading to greater regulatory interference in competitive markets.

In response to the obvious problems with their proposed mitigation plan, Applicants propose to “sweeten the pot.” Their proposal, however, comes at a

considerable price: the Commission must put aside the significant concerns that still remain with Applicants' mitigation package and approve the merger *without any further scrutiny*. The Commission must cut off the rights of protestors, ignore the public interest, and prevent a full and complete evaluation of the effects of this merger. Even if the Commission could, consistent with the public interest, accept such a "bargain," the Applicants are offering very little in return.

As discussed more fully below, Applicants cling to their virtual divestiture proposal for baseload capacity without addressing the serious shortcomings of using sales contracts to mitigate an anticompetitive merger. Applicants have corrected minor errors in their merger screen analysis. However, they continue to refuse to correct the major error of ignoring the impact of FTRs on assigning shares of transmission imports. Applicants offer an additional 1100 megawatts of mitigation. But they ignore the impact of the merger on the Northern New Jersey and PJM Classic markets. Applicants have proposed to drop their anticompetitive restrictions as to who can purchase divested assets. But they continue to seek an inordinate amount of time in which to complete any divestitures ordered by the Commission. Applicants have proposed to construct transmission. But they ignore the fact that they might have been required to construct this transmission anyway even absent the proposed merger, and they ignore the fact that the construction may interfere with the recently implemented PJM economic expansion process.

Each of these additional mitigation proposals, as well as Applicants' justification for refusing to address numerous other concerns will be discussed in the succeeding sections. However, nothing of what Applicants propose justifies ending all further

inquiry into the serious anticompetitive consequences of this proposed transaction. For example, although Applicants claim that the merger will barely change the HHIs in the relevant product and geographic markets once their mitigation proposals are adopted, the margin of error by which they may be wrong is extreme. If the PPL Companies are correct in only two of their criticisms of Applicants' revised mitigation proposals, Applicants will fail the Commission's merger screens in each relevant product and geographic market, not by a little, but by an enormous margin. The following table presents revised post-merger concentration for PJM East assuming that (i) virtual divestiture is of only limited value in mitigating market power<sup>3</sup> and (ii) FTRs should be used to assign shares of Eastern Interface transmission import capacity. This table gives the Applicants the benefit of their additional 1100 MW mitigation offer, despite the fact that Applicants have threatened to withdraw it if the Commission orders a hearing.

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<sup>3</sup> Thus, the following table, based on Exhibit PPL-14, assumes that the Applicants' virtual divestiture is not considered merger mitigation. It also assumes that the four largest owners of installed capacity in PJM East: FirstEnergy, Pepco, PPL and Reliant, each acquire 25% of divested assets in each time period.

<b>Period</b>	<b>Pre-Merger HHI</b>	<b>EEG Post-Mitigation Market Share</b>	<b>Post-Merger Post-Mitigation HHI</b>	<b>Change in HHI</b>
S_SP1	1491	40%	1991	499
S_SP2	1437	41%	2032	594
S_P	1705	45%	2268	563
S_OP	2083	60%	3679	1596
W_SP	1455	42%	2069	615
W_P	1643	44%	2187	545
W_OP	1930	54%	3129	1199
SH_SP	1439	41%	1981	543
SH_P	1705	51%	2746	1041
SH_OP	2039	58%	3504	1465

Each of the Post-Merger, Post-Mitigation PJM East product markets would be “highly concentrated” and the resulting changes in HHIs would substantially violate the Commission’s merger screens. Unless the Commission is rock-solid certain that virtual divestiture is as good as real divestiture and that FTRs should be ignored in assigning shares of imports into PJM East, the Commission must hold a hearing.

In addition, the determination this Commission must make here involves seriously disputed issues of material fact. These disputed facts range from the appropriate energy prices to use under the Commission’s merger screen analysis to the appropriate market definition to the viability of Applicants’ virtual divestiture proposal to mitigate competitive harm. None of these issues are the type of issues that can be decided on summary

disposition. Market definition issues alone are intensely factual and typically are not resolved by antitrust courts without extensive discovery and trial type proceedings.<sup>4</sup>

The recently released report of the PJM Market Monitoring Unit on impact of the merger on competition in PJM underscores the need for a full hearing before the Commission can approve this merger.<sup>5</sup> This report, requested by the New Jersey Board of Public Utilities, finds numerous, serious merger screen failures in the PJM energy, capacity, and regulation markets, including the PJM East energy market.<sup>6</sup> As discussed below, the PJM MMU Report also confirms violations of the PJM Three-Pivotal Supplier rule in PJM East and elsewhere. These screen failures and violations raised by the PJM MMU must be investigated further in the hearing process.

The PJM MMU Report also discusses potential mitigation, including divestiture. Regarding mitigation, the PJM MMU concludes that before it can determine whether a divestiture plan will truly restore a structurally competitive market, the PJM MMU must

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<sup>4</sup> Although market definition can be an appropriate issue for summary judgment where the relevant facts are not in dispute or where the party with the burden of proof provides only conclusory statements in support of its alleged relevant market, summary judgment is generally inappropriate because the pertinent economic facts are often disputed. *See, e.g., Forsyth v. Humana, Inc.*, 114 F.3d 1467, 1477 (9th Cir. 1997) (plaintiff's evidence presented jury issue regarding the existence of relevant submarkets), *aff'd on other grounds*, 525 U.S. 299 (1999); *Thompson v. Metro. Multi-List, Inc.*, 934 F.2d 1566, 1573-74 (11th Cir. 1991) (reversing summary judgment because of disputed issues of material fact related to defining relevant geographic market), *cert. denied*, 506 U.S. 903 (1992); *Yeager's Fuel Inc. v. Pa. Power & Light Co.*, 953 F. Supp. 617, 645 (E.D. Pa. 1997) ("definition of a relevant market may be decided on summary judgment if the moving party satisfies Rule 56 requirements and 'shows its market theory describes the actual market behavior so accurately that the nonmoving party's assertion of the moving party's market power, if not implausible, is at least unreasonable. The Supreme Court has defined this burden as substantial.'") (citations omitted).

<sup>5</sup> Exelon/PSEG Merger Analysis, PJM Market Monitoring Unit (May 24, 2005) ("PJM MMU Report"). The report is available at <http://www.pjm.com/markets/market-monitor/downloads/mmu-reports/20050524-mmu-merger-report-njbpu-color.pdf>.

<sup>6</sup> *See* PJM MMU Report at 18, 20, 24, 25-26.

know which specific units will be divested and who will purchase those specific units.<sup>7</sup> As the Applicants continue to refuse to say which units will be divested and to whom they will be sold, the Commission must also consider the PJM MMU's concerns about appropriate mitigation in the hearing process.

The impacts of the merger are permanent. They will not be re-examined after three years, as in the case of a grant of market-based rate authority. Accordingly, close scrutiny must be paid to the issues now and thorough analyses must be performed. The Commission need not, of course, hold a hearing in every merger proceeding; some mergers raise only minimal competitive concerns. But this merger — by Applicants' own admission — raises significant competitive concerns. Given the size of the amount of divestiture required to pass the Commission's merger screens, it is simply not "consistent with the public interest"<sup>8</sup> for the Commission to decide this proceeding without the benefit of a full and fair hearing with adequate discovery, and a detailed initial decision by an administrative law judge.

The Commission is not here engaged in a private bilateral negotiation with the Merging Parties. It is not free to "compromise" the public interest. Rather, Applicants' merger proposal, either as initially proposed or as modified, must be consistent with the public interest to be approved. Even if the Applicants' supplemental relief proposal may address some of the competitive concerns raised by the merger, the Commission should order hearings into whether that supplemental proposal does in fact resolve those concerns. As demonstrated below, Applicants' modified proposal leaves many serious

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<sup>7</sup> *Id.* at 18-19, 21, 26.

<sup>8</sup> 16 U.S.C. § 824b(a).

questions and concerns unanswered regarding the impact of the merger on competition in the relevant markets.

**B. Applicants Have Failed To Demonstrate That The Virtual Divestiture Proposal Adequately Mitigates The Market Power Created By Their Merger Or Their Incentive And Ability To Exercise Market Power.**

As the PPL Companies pointed out in their response to the Applicants' initial proposal, virtual divestiture is not divestiture at all.<sup>9</sup> Instead, virtual divestiture is the Applicants' attempt to equate firm contracts for sale of energy with the divestiture of assets. Applicants have not addressed concerns that virtual divestiture will leave them with the incentive and ability to exercise market power and manipulate prices to the Applicants' advantage.<sup>10</sup>

The Applicants' Answer ignores the important public policy concerns raised by the PPL Companies. Since the Applicants have conceded in their revised proposal that divestiture of additional generation, including baseload generation, is feasible, the Commission should be reluctant to rely on a virtual divestiture mechanism that is rife with uncertainty. Structural relief provides certainty of result and will eliminate the need for continued regulatory monitoring and intervention by the Commission. As the Department of Justice has recognized: "Structural remedies are preferred to conduct remedies in merger cases because they are relatively clean and certain, and generally avoid government entanglement."<sup>11</sup> In contrast, a conduct remedy "typically is more

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<sup>9</sup> Protest of the PPL Companies, Docket No. EC05-43-000 at 25 (filed Apr. 11, 2005) ("PPL Protest").

<sup>10</sup> Prepared Supplemental Direct Testimony of Joseph P. Kalt, Ph.D. at 13, 15-16, attached to this Supplemental Protest as Exhibit PPL-6 ("Kalt Supplemental Testimony").

<sup>11</sup> U.S. Dep't of Justice, *Antitrust Division Policy Guide to Merger Remedies* at 8 (Oct. 2004) ("*DOJ Merger Remedies Guide*").

difficult to craft, more cumbersome and costly to administer, and easier than a structural remedy to circumvent.”<sup>12</sup> True divestiture of baseload assets (nuclear or fossil) will not require further Commission involvement in this case years after its decision is issued.<sup>13</sup>

**1. Virtual Divestiture Will Leave Applicants With The Incentive And Ability To Exercise Market Power.**

At the outset, it is important to clarify that unlike the impression given by Applicants, their virtual divestiture proposal will not lock up all 2600 MW under 15-year contracts. In fact, Dr. Kalt expects that the 15-year contracts will be a small fraction of the virtually divested MW.<sup>14</sup> Rather most of the virtually divested capacity will be sold annually in rolling three-year contracts. Thus, Applicants will regularly be in the market selling energy. This annual turnover provides Applicants with the opportunity and the incentive to exercise market power to raise the price of these contracts.

In addressing the concerns voiced in various protests regarding virtual divestiture, the Applicants rely heavily on the fact that they would be liable for liquidated damages if they withheld energy. Specifically, the Applicants claim:

Since the liquidated damages are based on the cost of “covering” (*i.e.* the cost of purchasing replacement energy), if the Applicants were to attempt to withhold energy subject to the virtual divestiture from the market in order to raise prices, they would have to pay as damages the cost of the withheld energy at the increased price — a strong disincentive to such a withholding strategy.<sup>15</sup>

This sleight of hand argument focuses on the Applicants’ ability to withhold energy under the three-year contracts, in an attempt to divert attention from their ability

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<sup>12</sup> *Id.*

<sup>13</sup> PPL Protest at 27-28.

<sup>14</sup> Kalt Supplemental Testimony at 14.

<sup>15</sup> Answer at 35-36.

to influence energy prices through their control over generation assets, both nuclear and fossil. Applicants do not need to withhold energy under these contracts, however, by retaining control of the operation of nuclear or fossil baseload facilities under the virtual divestiture proposal, Applicants will have the ability to use this control to influence the price of baseload energy at the annual three-year contract auctions. Referring to Applicants' retention of control over their nuclear facilities under virtual divestiture, Dr. Kalt concluded "I believe that this fact, combined with the expected repeated auctions for three-year forward sales of "virtually divested" capacity, can create incentives for the merged entity to discover means for affecting near-term forward market electricity prices."<sup>16</sup>

Applicants argue that the characteristics of operating nuclear facilities eliminate the ability or incentive to withhold these units from the market on a short-term basis. They claim that the Commission has recognized "this truth" on a number of occasions.<sup>17</sup> Although it may well be true that to strategically dispatch nuclear units over time is difficult, it is not impossible.<sup>18</sup> Key attributes of ownership will leave Applicants with considerable ability to affect energy prices. These include perfect knowledge of the

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<sup>16</sup> Kalt Supplemental Testimony at 15.

<sup>17</sup> Answer at 37 (citing *USGen New England, Inc., et al.*, 109 FERC ¶ 61,361, at P 23 (2004); *Ohio Edison Co.*, 94 FERC ¶ 61,291, at 62,044 (2001); *Commonwealth Edison Co.*, 91 FERC ¶ 61,036, at p. 61,134 n.42 (2001)). In the orders cited by the Applicants, the Commission finds that nuclear facilities are "difficult to ramp up or down so as to withhold output during the most profitable time period." *Commonwealth Edison Co.*, 91 FERC at p. 61,133 n.42. With virtual divestiture, the Applicants have eliminated the difficulty in coordinating nuclear facility operation with profitable times in the market. Under the virtual divestiture plan, the Applicants need only to coordinate the ramping down of the facility with the timing of the annual three-year contract auction, the timing of which the Applicants will be aware of well in advance. See Kalt Supplemental Testimony at 15-16.

<sup>18</sup> Kalt Supplemental Testimony at 15-16.

condition and operation of each of its nuclear units and the ability to control maintenance schedules of each virtually divested unit.

For example, because the Applicants will retain control over the operation of the nuclear facilities in question, the Applicants will retain sole “discretion” over when to schedule annual refueling and prolonged maintenance events. The Applicants will also be able to increase or decrease the time that the units are down. If the Applicants schedule the refueling of a nuclear baseload facility to coincide with the three-year auction, the removal of that facility from the market may affect the market price of energy that is sold under the three-year auction contracts. As Dr. Kalt explains, because near-term electricity prices can be affected by present supply/demand conditions that are expected to persist into the future, the incentive exists for the Applicants to try to influence the prices that will result from the annual auction of divested capacity.<sup>19</sup>

Because generation “outages” and maintenance decisions are discretionary, it will be difficult for the Commission and other market participants to evaluate the merits of such decisions and to ensure that the Applicants are not using these outages to drive up market prices. Moreover, any decision justified or based on safety or maintenance concerns to take or keep a nuclear unit offline is unlikely to be challenged.

Given nuclear units are rarely on the margin (*i.e.* set the market price in PJM), even if Applicants are limited in the amount of control they can exercise over nuclear contracts, they can achieve the same effect by controlling non-nuclear generation. For example, if the Applicants can withhold any generation at the time the three-year contracts are being auctioned, they may be able to affect the price at those auctions. The

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<sup>19</sup> *See id.*

withholding need not come all from one unit or in large increments. In short, it can be almost undetectable either by the Commission or the PJM Market Monitor. However, the market will anticipate that it will be required to pay a market power premium.<sup>20</sup>

The market's anticipation of higher three-year contract prices will particularly affect the New Jersey BGS auctions. One of the standard contracts for serving residential and small commercial load in New Jersey closely coincides with the three-year virtual divestiture contracts proposed by Applicants. The potential that Applicants' virtual divestiture proposal will leave them with the incentive and ability to exercise market power in New Jersey should be of great concern to the Commission. Surely the risk that virtual divestiture may undermine New Jersey's efforts to introduce retail competition warrants, at a minimum, taking a close look at the proposal through a full evidentiary hearing.

**2. Applicants' Defense Of Their Proposal To Reduce Mitigation If They Retire Capacity Ignores The Fact That Applicants, Not Independent Third Party Purchasers Of Divested Assets, Will Control Retirements.**

The Applicants have not retreated from their proposal to reduce the amount of virtual divestiture of baseload nuclear capacity megawatt-for-megawatt for reduced, derated or decommissioned nuclear capacity. In their answer to the concerns expressed by the PPL Companies and others,<sup>21</sup> Applicants respond that: (1) such practice is consistent with physical divestiture; (2) once the assets are retired, the assets will no

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<sup>20</sup> See *id.* at 16 (“[W]ithholding mid-merit supplies in conjunction with, or as opposed to, nuclear plants as the next round of nuclear power contracting comes due might credibly be used to signal prospects of higher going-forward prices, . . .”).

<sup>21</sup> See, e.g., PPL Protest at 13-14, 23; Exhibit PPL-1, Prepared Direct Testimony of Joseph P. Kalt, Ph.D. at 35 (“Kalt Testimony”).

longer be able to produce power; and (3) it is extremely difficult and impractical to exercise a withholding strategy with nuclear facilities.<sup>22</sup>

This response, however, fails to address the fact that under virtual divestiture, the Applicants retain control over their nuclear facilities. It is Applicants, not third parties, that decide if and when each unit will actually be retired.<sup>23</sup> If Applicants were required to divest these facilities, their competitors — who do not have market power — make those decisions, and might well decide differently. This is reason enough to reject their megawatt-for-megawatt reduction condition.

**3. The Commission Should Also Consider Post-Merger HHIs Calculated As If The Virtually Divested Capacity Were Retained By Applicants.**

Given the shortcomings and uncertainty that surround the virtual divestiture mechanism, the Commission should consider the effect of the proposed merger on competition as if the virtually divested assets as retained by the Applicants. In order to fully appreciate the potential for the proposed merger to eliminate competition if virtual divestiture fails to mitigate the Applicants' market power, the Commission must review a scenario that retains the virtually divested assets in the Applicants' pool of retained generation. Because the virtually divested proposal is so novel and substantial – and subject to significant criticisms – the Commission should at least consider such an alternate calculation.

In Exhibit PPL-8, the PPL Companies have provided such an analysis. Virtual divestiture is treated as if the megawatts of virtually divested capacity are retained by the

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<sup>22</sup> Answer at 50-51.

<sup>23</sup> *Id.* at 52.

Applicants, *i.e.* not divested. As shown in the Exhibit PPL-8, once the Applicants' virtual divestiture proposal is discounted, the proposed merger looks radically different. There are substantial increases in post-merger HHIs in each relevant product and geographic energy market with almost all markets failing the Commission's merger screens. This is how the post-merger world would look if virtual divestiture does not work. Because of the dramatic increase in concentration that would occur if virtual divestiture is properly discounted, the Commission needs to be very certain that virtual divestiture will work as advertised before approving it. That certainly can not be achieved unless the Commission supplements the record with a full evidentiary hearing in which the Applicants' virtual divestiture proposal can be full explored and tested.

**4. Applicants' Proposal To Address The Failings Of Virtual Divestiture Will Increase Reliance On Inefficient Regulation.**

The Applicants drew criticism from several intervenors, including the PPL Companies, that the virtual divestiture proposal requires reliance on continued Commission regulation.<sup>24</sup> But the Applicants chose not to address these arguments by developing a structural mitigation solution that reduces reliance on future regulation. Instead, the Applicants' revised proposal solidifies the need for such regulation. Specifically, the Applicants propose to institute a public website that would chronicle the Applicants' efforts to comply with their mitigation requirements including their virtual divestiture requirements.<sup>25</sup>

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<sup>24</sup> PPL Protest at 25-27, 31-33.

<sup>25</sup> Answer at 43.

The Applicants claim that this additional measure will “make it easier for the Commission to monitor the Applicants’ compliance.”<sup>26</sup> But the Applicants fail to fully comprehend that this requirement only serves to solidify the need for Commission involvement in overseeing compliance with their mitigation proposals. By its very nature, Applicants’ proposal requires constant supervision by either the Commission or interested parties to be effective. If the Commission, after constantly monitoring the Applicants’ website, determines that the Applicants are not in compliance with their virtual divestiture requirements, the Commission would still need to act on this non-compliance through a formal Commission proceeding.

Given the fact the Commission’s resources are not limitless, constantly monitoring the Applicants’ compliance will impose upon it continuing costs from the merger. Such actions do not reduce regulation, but only ensure that regulation will continue indefinitely. The only viable solution to this problem is for the Applicants to physically divest rather than virtually divest an additional 2600 MW of baseload generation. To date, the Applicants have been unwilling to offer the necessary physical divestiture.

**C. When The Impact Of FTRs On Energy Imports Is Considered, The Proposed Merger, Even As Mitigated, Fails The Commission’s Merger Screens.**

In the PPL Companies’ Protest, the PPL Companies pointed out that witness Hieronymus’ use of the so-called “squeeze down” method rather than the economic method for assigning shares of transmission imports could make a significant difference in evaluating market concentration, particularly in the Northern New Jersey and PJM

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<sup>26</sup> *Id.* at 42.

East markets. In addition, the PPL Companies noted that the Applicants had failed to consider the impact of FTRs on transmission imports in determining market share and hence whether the proposed merger passes the Commission's merger screens. While the Commission has accepted the squeeze down method of assigning shares of imports to competitors in the past,<sup>27</sup> it nonetheless requires that whatever method is used be adequately supported.<sup>28</sup> Applicants failed to support their method.

FTRs provide significant benefits for financial hedging in the event of congestion in the relevant PJM markets. FTRs will permit the Applicants to have a greater competitive presence in constrained markets than unhedged competitors. This greater competitive presence should be reflected in a larger share of imports being assigned to them for purposes of measuring market share.<sup>29</sup> By failing to take into account these FTRs in assigning import capacity, the Applicants have understated significantly the degree of concentration caused by their merger.<sup>30</sup>

Applicants dismissed the PPL Companies' arguments without any factual analysis. First, they rely on the fact that the Commission has in the past approved the use of the same squeeze down method that they use here.<sup>31</sup> Second, witness Hieronymus claims that:

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<sup>27</sup> *Ohio Edison Co.*, 94 FERC ¶ 61,291, at p. 62,044 (2001).

<sup>28</sup> *Revised Filing Requirements Under Part 33 of the Commission's Regulations*, Order No. 642, 65 Fed. Reg. 70,983, at 70,998 (Nov. 28, 2000), FERC Stats. & Regs., Regulations Preambles (Jul. 1996 – Dec. 2000) ¶ 31,111 (2000), *order on reh'g*, Order No. 642-A, 66 Fed. Reg. 16,121 (Mar. 23, 2001), 94 FERC ¶ 61,289 (2001).

<sup>29</sup> Kalt Testimony at 32-33.

<sup>30</sup> PPL Protest at 44-46.

<sup>31</sup> Answer at 19-20 & n.8.

It is not possible to perform a useful analysis of FTRs in PJM, however. There is no single way that FTRs are allocated that can be used to model ownership of FTRs in PJM. Instead, FTRs – which do not have a duration of more than one year – are sold at auction, are potentially convertible from auction revenue rights (“ARRs”) and are actively traded on the secondary market.<sup>32</sup>

Witness Hieronymus is wrong. The PPL Companies have been able to assign import shares based on FTRs. As explained in the supplemental testimony of the PPL Companies’ witness Kalt, there is adequate information from publicly available sources in PJM to determine the ownership of FTRs at any particular time.<sup>33</sup> While it is true that FTR ownership could vary slightly from time to time, FTR ownership is basically stable and does not vary significantly from year to year. Indeed, the definition of FTRs — the linkage of a generation source and a load sink — means that absent significant changes in ownership of generation or significant shifts in load serving responsibility, FTR ownership should remain relatively stable every time.<sup>34</sup> The fact that FTRs can be sold on secondary markets means nothing. Selling FTRs on the secondary market is no different than selling generation by contract on secondary markets.

When imports are assigned based on FTRs, as presented by Witness Kalt, a different picture of the proposed merger, even as mitigated, emerges. Set forth below is a table based on Exhibit PPL-13, showing revised market concentration calculations assigning transmission import capability across the Eastern interface consistent with FTR ownership.

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<sup>32</sup> *Id.*, Exhibit J-17, Supplemental Testimony of William H. Hieronymus at 18 (“Hieronymus Supplemental Testimony”).

<sup>33</sup> Kalt Supplemental Testimony at 19.

<sup>34</sup> Kalt Supplemental Testimony at 20-21.

Period	Pre-Merger HHI	EEG Post-Mitigation Market Share	Post-Merger Post-Mitigation HHI	Increase in HHI	Merger Screen Failure
S_SP1	1491	37%	1774	282	Yes
S_SP2	1437	36%	1734	297	Yes
S_P	1705	38%	<b>1807</b>	102	Yes
S_OP	2083	45%	<b>2300</b>	217	Yes
W_SP	1455	37%	1757	302	Yes
W_P	1643	37%	1741	99	No
W_OP	1930	43%	<b>2150</b>	220	Yes
SH_SP	1439	35%	1661	223	Yes
SH_P	1705	41%	<b>1987</b>	282	Yes
SH_OP	2039	45%	<b>2263</b>	224	Yes

This analysis shows that there would be merger screen failures in all but one of the post-merger markets. Also, five of the post-merger markets would be considered “highly concentrated” (highlighted in bold in the table). At a minimum, this alternative calculation of scarce transmission import capacity requires further consideration and a hearing by the Commission. Serious questions of fact have been raised that cannot be resolved based upon the pleadings before the Commission.<sup>35</sup>

Nor is it appropriate for the Commission to cite its past use of the squeeze down method as Applicants argue.<sup>36</sup> Much of the past use of the squeeze down method has

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<sup>35</sup> Kalt Supplemental Testimony at 22-23.

<sup>36</sup> *Williams v. Wash. Metro. Area Transit Comm’n*, 415 F.2d 922, 960 (D.C. Cir. 1968) (remanding to the agency because of a failure to consider the “individual and perhaps unique characteristics” of the particular situation). *See also Ass’n of Oil Pipe Lines v. FERC*, 83 F.3d 1424, 1431 (D.C. Cir. 1996) (indicating that the court will conduct “a searching and careful inquiry in order to assure that the Commission has examined the relevant data and articulated a rational connection between the facts found and the choice made.”) (internal citations omitted).

been by witness Hieronymus himself, and is linked to the way his program analyzes transmission import capacity. Of course, in many contexts, there is no information regarding an ability to assign transmission according to economic factors such as FTRs. However, because of the unique presence of FTRs in PJM and the stable rules for allocating those FTRs, PJM is different from the rest of the country. Since this transaction will result in a permanent change in the structure of PJM markets, particularly PJM East, the Commission cannot simply rely on past practices to assign import market share when a more accurate means of assigning imports is available.

**D. Applicants' Market Definition And Concentration Analysis Is Still Flawed, Even As Corrected.**

In response to protests identifying several factual errors in their initial application, the Applicants made several factual corrections in their Answer.<sup>37</sup> The Applicants have also responded to the concerns that the proposed mitigation is not sufficient and that the limitations on the proposed divestitures discriminate against large competitors in PJM. Applicants now propose to divest additional generation assets and to drop restrictions on potential purchasers — but, only if the Commission does not set the matter for hearing.<sup>38</sup> The Applicants refuse, however, to address the concerns raised by several protestors, including those presented by the PPL Companies and Dr. Kalt, that the proposed merger may have an adverse impact on the constrained PJM Classic market.<sup>39</sup> Similarly Dr.

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<sup>37</sup> Answer at 7-9.

<sup>38</sup> *Id.* at 31-34.

<sup>39</sup> Kalt Testimony at 28. *See also* Motion to Intervene and Protest of Ameren Services Company, Docket No. EC05-43-000, Exhibit A, Affidavit of Peter Fox-Penner and Johannes P. Pfeifenberger at paras. 54-57 (filed Apr. 11, 2005).

Hieronymus refuses to revise his analysis of the Northern New Jersey market to address Dr. Kalt's concerns that the analysis is inadequate.<sup>40</sup>

As the PPL Companies' Witness Kalt explained in his testimony, although the PJM Classic market was expanded in 2002 with the addition of Allegheny's service territory, the constraints along the interface between PJM Classic and Allegheny still isolate the PJM Classic region from the combined PJM Classic and Allegheny region during times of constraint.<sup>41</sup> As a result, given the ownership of generation assets in the PJM Classic market, the Applicants' pre- and post- merger presence in the PJM Classic generation market may be significantly larger without the presence of Allegheny's generation assets.

The Applicants argue that with the integration of Allegheny into PJM, there is no longer a constraint separating the Allegheny system from the PJM Classic market.<sup>42</sup> They claim that "[t]oday, PJM operates the system so that when constraints threaten to limit the Western interface, certain generation units in PJM automatically are re-dispatched, preserving the flows from west to east."<sup>43</sup> Applicants assert that because a constraint no longer creates two separate markets, there is no reason to analyze the impact on the PJM Classic market separate from the PJM East market.

The Applicants' response, however, fails to explain the persistent price differentials that exist on either side of the western interface as shown by Dr. Kalt in

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<sup>40</sup> Kalt Supplemental Testimony at 10-12.

<sup>41</sup> Kalt Testimony at 28-30.

<sup>42</sup> Answer at 11-12.

<sup>43</sup> *Id.* at 11.

Exhibit PPL-7.<sup>44</sup> Instead, the Applicants’ response proves the opposite. The very fact that higher cost generation is dispatched out of merit order to compensate for constraints along the Western interface demonstrates that the Commission must consider the PJM Classic market as a separate market. Redispatch does not mean more power gets through. Redispatch means higher cost generation must be run to meet demand. This fact goes to the heart of the “hypothetical monopolist” test for defining separate antitrust markets upon which the Commission’s Merger Policy and Appendix A analysis are based.<sup>45</sup>

As Dr. Kalt explains, an examination of the PJM Market Monitoring Unit’s 2004 State of the Market Report, the very document upon which the Applicants rely, demonstrates the flaw in the Applicants’ logic. Referring to the definition of “congestion” in the 2004 PJM State of the Market Report, Dr. Kalt explains:

Congestion occurs when available, low-cost energy cannot be delivered to all loads because of limited transmission capabilities. When the least cost available energy cannot be delivered to load in a transmission-constrained area, higher cost units must be dispatched in this constrained area to meet the load (footnote excluded). The result is that the price of energy in the constrained area is higher than elsewhere because of transmission limitations.<sup>46</sup>

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<sup>44</sup> Kalt Supplemental Testimony at 6-7; Exhibit PPL-7.

<sup>45</sup> The “hypothetical monopolist” test assumes that the magnitude of potential competitive harm from a merger is greater if a hypothetical monopolist post-merger would raise price within the relevant market by substantially more than a “small but significant and non-transitory” amount. This may occur when the supply substitutes outside the relevant market, as a group, are not close substitutes in price (or other characteristics) for the products within the relevant market. The test involves determining if a hypothetical monopolist would raise price by at least five percent. U.S. Dep’t of Justice and Fed. Trade Comm’n, *Horizontal Merger Guidelines* at § 1.21 (April 1992).

<sup>46</sup> Kalt Supplemental Testimony at 8 (quoting PJM Interconnection, L.L.C., Market Monitoring Unit, 2004 State of the Market Report at 201 (Mar. 8, 2005) (“PJM 2004 State of the Market Report”), available at <http://www.pjm.com/markets/market-monitor/som.html>).

Therefore, as Dr. Kalt concludes, the price differentials identified in Exhibit PPL-7 are a result of congestion. Moreover, although the PJM 2004 State of the Market Report does report fewer absolute interface constraints, there continue to be transmission facilities associated with particular interfaces that experience considerable congestion. For example, a review of the 2004 State of the Market Report reveals that the Bedington—Black-Oaks line, which is on a pathway to Doubs-Brighton and forms part of the Western interface was the single-most constrained facility in all of PJM during 2004.<sup>47</sup> Thus, Dr. Kalt concludes that it is these transfer limitations on upstream facilities that limit flow into PJM Classic.<sup>48</sup> This explains the price differentials shown in Exhibit PPL-7 and demonstrates a need for consideration of PJM Classic as a relevant market in the Applicants’ market analysis.

It is puzzling why the Applicants refuse to present a market analysis of the merger’s impact on the PJM Classic market, even when they are willing to offer additional mitigation to eliminate market concentration concerns.<sup>49</sup> Inexplicably, Applicants are quite willing to rerun and present the market analyses to account for four errors that had a “de minimis” impact on Dr. Hieronymus’ analysis, but not to present a PJM Classic market analysis.<sup>50</sup> This is a strong indication that the analysis would reveal additional merger screen violations.

Similarly, Dr. Hieronymus refuses to revise his analysis of the Northern New Jersey market. As Dr. Kalt explained in his initial testimony, Dr. Hieronymus’ analysis

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<sup>47</sup> *Id.* at 9 (quoting PJM 2004 State of the Market Report at 214).

<sup>48</sup> *Id.*

<sup>49</sup> Answer at 6, 45-46.

<sup>50</sup> *Id.* at 7-8.

of the Northern New Jersey market is unconventional when compared to the analysis of other markets conducted by the Applicants. Specifically, Dr. Hieronymus' analysis of the Northern New Jersey market does not report starting and ending market concentrations.<sup>51</sup> In responding to protests, the Applicants do not address these concerns, but instead they rely upon Dr. Hieronymus' erroneous conclusion that the Northern New Jersey market is not relevant because Exelon owns no generation there.<sup>52</sup>

Exelon's lack of generation in the Northern New Jersey market has no bearing on this issue. Dr. Hieronymus ignores Exelon's access to FTRs and past activity as a wholesale supplier in the New Jersey basic generation services auctions.<sup>53</sup> As Dr. Kalt explains, under PJM's system of allocating FTRs, parties that lack generation in a constrained region are able to enter that region as importers of power.<sup>54</sup> Therefore, Dr. Kalt concludes that "Going forward in the absence of the proposed merger, Exelon would continue to represent a ready entrant and, hence, actual competitor of PSE&G."<sup>55</sup> By merging with Exelon, PSEG will in effect be not only eliminating a competitor, but also gaining Exelon's future rights to import power in the Northern New Jersey market. This will leave a post-merger EEG with an enhanced ability and incentive to exercise market power in that market, the most congested area of PJM.<sup>56</sup>

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<sup>51</sup> Kalt Supplemental Testimony at 4. Dr. Kalt demonstrates that Northern New Jersey is appropriately considered a separate market due to persistent elevated prices relative to the neighboring portions of PJM. *Id.* at 11; Exhibit PPL-9.

<sup>52</sup> Answer at 10.

<sup>53</sup> Kalt Supplemental Testimony at 10-12.

<sup>54</sup> *Id.* at 12.

<sup>55</sup> *Id.*

<sup>56</sup> *Id.* at 11-12; Exhibit PPL-9.

At a minimum, these unanswered questions about the impact of the proposed merger on both the Northern New Jersey and the PJM Classic markets should be addressed through discovery and a full hearing on the merits.

**E. Dr. Hieronymus Has Yet To Analyze The Relevant Markets Using Realistic Expected Energy Prices.**

As the PPL Companies explained in their Protest, the validity of the prices used to analyze the relevant markets by Dr. Hieronymus are of paramount importance because the accuracy of the delivered price test turns on the price levels chosen to run the test.<sup>57</sup> For this reason, the PPL Companies raised significant concerns regarding the pricing levels chosen by Dr. Hieronymus for use in his delivered price test.

Dr. Hieronymus did not address these concerns in his supplemental testimony. Instead, Dr. Hieronymus contends that “choosing market prices to analyze for purposes of the [delivered price test] *is as much an art as it is a science.*”<sup>58</sup> He goes on to claim that by analyzing a range of price levels, he was able to gather a full range of results.<sup>59</sup> However, Dr. Hieronymus fails to show that his chosen prices are consistent with observed market prices. Nor does Dr. Hieronymus explain why the same price range is accurate for two different product markets.

As Dr. Kalt demonstrates, Dr. Hieronymus chose to analyze off-peak price levels that are consistently lower than prices typically observed in the market. Given that different generation units are marginal at different times throughout the year, the market price levels chosen must accurately assess likely seasonal generation dispatch. Therefore

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<sup>57</sup> See PPL Protest at 40 (citing Kalt Testimony at 31-32).

<sup>58</sup> Hieronymus Supplemental Testimony at 18 (emphasis added).

<sup>59</sup> *Id.*

to claim that across seasons all prices levels are captured does not account for the unique supply mixture that is available during each particular season.<sup>60</sup> Unless Dr. Hieronymus is able to explain an analytical connection between the energy prices chosen and fuel prices, the Commission must conclude that he has only “art” to support his selected price levels, but no hard facts.<sup>61</sup>

In addition, the PPL Companies pointed out in their Protest that Dr. Hieronymus uses the same price levels for each of the markets analyzed. The PPL Companies explained that, because PJM East is a separate product market from PJM Pre-2004, the Applicants should have used separate price levels for each market.<sup>62</sup> If a certain price level was determined to be an accurate reflection of price levels in PJM Pre-2004 for a given load level, such as the \$80 used by Dr. Hieronymus to represent S\_SP2, then the corresponding price level in PJM East would need to be increased by approximately \$5 to account for observed price differences between the two markets.<sup>63</sup> Instead, Dr. Hieronymus relies upon the same price levels in all of the markets analyzed.

Regardless of Dr. Hieronymus’ claims, the fact remains that his response fails to address the concerns raised by the PPL Companies that the price levels he chose are not consistent with observable market prices. Nor does he explain how his use of the same price level for all of the markets in PJM analyzed is a realistic assumption. As such, the Commission should order a hearing to allow interested parties, such as the PPL

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<sup>60</sup> Kalt Supplemental Testimony at 25.

<sup>61</sup> *Id.* at 24-25.

<sup>62</sup> PPL Protest at 42.

<sup>63</sup> *Id.* at 41.

Companies, to further explore these concerns and ensure that Dr. Hieronymus' analysis accurately reflects realistic assumptions about the PJM market.

**F. A Year Is Still Too Long For Divestiture.**

In their divestiture proposal, the Applicants proposed that they would have 18 months to complete divestiture. The PPL Companies pointed out in their protest that this intended divestiture period provided the Applicants with an incentive to withhold capacity and drag their feet in complying with the needed divestiture. In response to these and similar complaints by others, the Applicants propose to shorten the period permitted to divest assets to one year. Applicants' proposal effectively rejects the concerns raised by protestors. It is still completely inconsistent with the policies of the Department of Justice, which has much more experience than the Commission in supervising the divestiture of assets in connection with merger transactions. Under Applicants' proposal, they still have an incentive to delay the divestiture, while the markets' only defense would be greater interference with competitive market forces through increased regulation. Instead, the Commission should reject Applicants' proposal and make the closing of the merger transaction contingent upon the Commission's approval of the sale of specific assets to specific purchasers.

The Department of Justice has an established policy of requiring divestiture to be completed within 60 to 90 days after a decree is filed and in some instances more rapid divestiture.<sup>64</sup> There are numerous obvious reasons why prompt divestiture is appropriate. These reasons include the fact that until the assets are divested, the market power the divestitures were intended to mitigate remains with the merging parties. Also, once

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<sup>64</sup> See PPL Protest at 32 n.78 (citing *DOJ Merger Remedies Guide* at 29-30).

assets have been identified for divestiture, the merged entity has little incentive to continue to spend money to keep the divested assets competitive or to retain key employees. For these reasons, the Department of Justice and FTC normally insist that the merging parties adhere to strict requirements to maintain the competitive viability of the assets to be divested, and to keep them separate from the rest of the merging parties' operations. Sometimes the agencies require the appointment of an independent monitor or trustee to supervise the assets.<sup>65</sup> The Department of Justice also often requires that if divestiture is not accomplished within the time period allowed, an independent third-party trustee be appointed to supervise the divestiture process to make sure it gets done.<sup>66</sup> Thus, under typical Justice Department guidelines, even a failed divestiture effort could be completed in far less time than the one year that Applicants are proposing here. Moreover, the Commission has not always been successful in requiring merger applicants to meet their merger conditions promptly.<sup>67</sup> So even the one year proposed by Applicants may understate how long it will take to complete the divestitures required by the Commission.

The Commission has two logical choices to address the legitimate concerns raised by the PPL Companies and others with respect to the timing of divestitures. The Commission could require that the divestiture package be completed before the Applicants are permitted to close their transaction. This would give the Applicants a very strong incentive to complete their divestitures expeditiously. It also would give the

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<sup>65</sup> *DOJ Merger Remedies Guide* at 29.

<sup>66</sup> *See United States v. Waste Mgmt., Inc.*, 2004-2 Trade Cases ¶ 74,480 (2003).

<sup>67</sup> *See PPL Protest* at 31-32 & n.77 (citing *Am. Elec. Power Co. & C. & S.W. Corp.*, 90 FERC ¶ 61,242, at p. 61,788 (2000)).

Commission an opportunity to look at the entire merger package, including the divestitures, prior to the Applicants completing their transaction. Thus, if the Commission is unsatisfied with either the quality or nature of the assets divested or the identity of the entities purchasing those assets, the Commission can prevent the transaction from closing until a satisfactory package is submitted.<sup>68</sup> The need to identify the specific assets being divested in order to assess the efficiency of a proposed plan was emphasized by the PJM Market Monitor in his recent analysis of the impact of the proposed merger on locational energy markets:

It is not possible to determine whether divestiture will in fact mitigate the issue without knowing the exact units and their distribution factor impacts on the identified constraints.<sup>69</sup>

The Commission could also require a reasonably expeditious period of 60 to 90 days for divestiture. If the Applicants failed to complete the divestitures within that deadline, the Commission can intervene to require further steps to expedite the process. The Commission may also choose to employ a trusteeship provision similar to that employed by the Department of Justice, which could become effective if the 90-day period expires without the divestitures being completed.

In sum, it is not enough for applicants simply to say they will cut six months off their divestiture plan and assume that they have satisfied the grave concerns with the

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<sup>68</sup> Under this proposal, it would not be necessary for Applicants to delay the closing until all sales of divested assets are also ready to close. Rather, the Applicants could close once a divestiture package had been submitted to the Commission and received approval. Once this has occurred, the parties purchasing the divested assets will have an incentive to close their transactions expeditiously. This approach will also eliminate the need for any post-approval pre-divestiture mitigation measures and enhanced scrutiny to prevent the exercise of market power.

<sup>69</sup> Exelon/PSEG Merger Analysis, PJM Market Monitoring Unit (May 24, 2005) at 4 (“PJM MMU Report”). *See id.* at 15, 18-19, 20-21, 25, 26. *See also* Kalt Supplemental Testimony at 27.

interim exercise of market power. The Commission must impose much stricter terms upon Applicants' divestitures, or at a minimum set the issue for hearing.

**G. The Applicants' One-Year Relief Proposal And The Pre-Divestiture Mitigation Plan Also Create Issues Of Fact That Can Only Be Determined After An Evidentiary Hearing.**

The Applicants propose to retain the discretion to decide which units they will offer in order to achieve the 2900 megawatts of interim "virtual unit transfer" contracts. But there is no guarantee that the units selected will in fact address the potential for exercise of market power in the relevant markets determined by the Commission. Indeed, before the interim relief can be determined to be adequate, all of the issues regarding the appropriate definition of relevant markets and the degree of concentration in those relevant markets would need to be determined. Once those factual determinations are made, then the precise units to be divested during the interim period would need to be identified. The Commission could then determine if those units in fact appropriately mitigated Applicants' market power during the interim period.

The Commission also needs to determine whether the proposals to bid the non-nuclear units into the PJM market at variable cost plus 10% or to bid the nuclear units in at zero might have a distorting effect on PJM markets during the interim period. Competitive market bids reflect a variety of considerations and are much more complex than simply bidding at marginal cost. For example, PJM is rapidly expanding its demand response programs. The combination of bids, load and demand response set the appropriate price in each hour within PJM. Simply bidding in at marginal cost or bidding in the nuclear units at zero could be inefficient and distort proper market price signals. Such bidding might result in too much generation being dispatched and not enough

demand response. These issues also must be addressed by the Commission in determining whether the interim relief is appropriate.

**H. Applicants Did Not Address The Impact Of The Proposed Merger On PJM's Application Of The Three-Pivotal Supplier Rule.**

In their Protest, the PPL Companies pointed out that the proposed merger would reduce the number of parties likely to be pivotal suppliers from five to four within PJM East. This fact raises the prospect that the PJM Three-Pivotal Supplier rule would be triggered if one of the suppliers was not present in an area in which a transmission constraint arose. Under PJM's Three-Pivotal Supplier rule, PJM is required to cap price levels of any generation dispatched out of economic order to control a transmission constraint where market power can be exercised.<sup>70</sup> PJM imposes offer caps where there are fewer than four suppliers.<sup>71</sup> The PPL Companies pointed out that because this rule could be invoked more frequently as a result of the proposed merger, regulatory intervention into the market could be increased. Such regulatory intervention, in turn, could discourage investment that could help in limiting the potential of the merged entity to exercise market power in the future. New generators will be more reluctant to enter a market in which prices are frequently determined administratively, rather than by market forces.

The PJM Market Monitoring Unit Report has now confirmed that this concern is very real. The recently released report on the merger found that PJM East passed the

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<sup>70</sup> Amended and Restated Operating Agreement of PJM Interconnection, L.L.C. ("PJM Operating Agreement"), Schedule 1, Section 6.4.1(a), Substitute First Revised Sheet No. 131.

<sup>71</sup> *Id.*, Section 6.4.1(e), Substitute First Revised Sheet No. 131.

Three-Pivotal supplier test pre-merger, but failed it post merger.<sup>72</sup> The prohibition on offer capping of all of PJM East is reviewed from year to year by the PJM Market Monitor by order of the Commission.<sup>73</sup> This PJM Market Monitoring Unit finding could call into question the future of the PJM Eastern Interface general exemption.

Applicants' Answer completely ignores this issue. Nonetheless, the issue of the increased offer capping in PJM East must be considered in a hearing. Increased offer capping and reliance on administered prices is the antithesis of competition and contrary to the Commission's policies of encouraging competitive markets. A thorough inquiry into this issue is required.

**I. Applicants' Transmission Proposals Do Not Offset The Injury To Competition Caused By The Proposed Merger.**

As part of their new mitigation commitments, Applicants are proposing to take credit for building transmission that Applicants are already required to build. In addition, Applicants are promising to build at least two economic transmission projects even before the PJM economic transmission expansion process concludes that additional transmission construction is warranted. In sum, Applicants' additional transmission commitments offer either no additional value or potentially interfere with the orderly PJM Planning process for determining when economic transmission should be constructed.

Under the PJM Operating Agreement, the PJM Transmission Owners Agreement and the PJM West Transmission Owners Agreements, transmission owners are required to construct transmission projects needed for reliability that are approved as part of the

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<sup>72</sup> PJM MMU Report at 17.

<sup>73</sup> *PJM Interconnection, L.L.C.*, 108 FERC ¶ 61,187 (2004).

regional transmission expansion plan pursuant to Schedule 6 of the PJM Operating Agreement, except in certain specified circumstances.<sup>74</sup> Such circumstances include the inability to obtain necessary state or local citing approvals or rights of way or the inability to obtain financing. Thus, all of the \$580 million the Applicants commit to spend on reliability transmission upgrades referenced by Applicants in their Answer<sup>75</sup> would have been spent whether or not Applicants merge.

The PPL Companies strongly support appropriate incentives for the construction of new transmission, even transmission required to be constructed under RTO arrangements, such as PJM's Regional Transmission Expansion Planning Protocol ("RTEPP"). But those incentives should be delineated by the Commission as part of its transmission expansion policy or in response to either a general or a specific rate case filed by a transmission owner under Section 205 of the Federal Power Act.<sup>76</sup> Applicants should not be rewarded by this Commission approving a potentially anticompetitive merger just because they promise to build transmission that they are already required to build.<sup>77</sup>

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<sup>74</sup> PJM Operating Agreement, Schedule 6, Section 1.7, Third Revised Sheet No. 187; PJM Transmission Owners Agreement, Section 7.1, Original Sheet No. 16A; West Transmission Owners Agreement among PJM Interconnection, L.L.C. and Certain Owners of Electric Transmission Facilities ("West Transmission Owners Agreement"), Section 7.2, First Revised Sheet No. 15.

<sup>75</sup> Answer at 56.

<sup>76</sup> 16 U.S.C. § 824d.

<sup>77</sup> It is also worth noting that the Applicants cite to two transmissions projects in the ComEd service territory which has little to do with the markets threatened by Applicants anticompetitive merger.

The Applicants have also committed to construct two projects that are part of the PJM economic transmission expansion process.<sup>78</sup> Both of these projects will stand or fall based upon the RTEPP process and have little or no relevance to this proceeding. Applicants' commitment to spend \$5 million per year for five years on economic transmission expansion is also a rather insignificant sum compared to the cost of the exercise of market power as a result of the Commission approving a merger that has not been properly mitigated.

The Applicants should, of course, commit funds to transmission expansion, including economic transmission expansion when found by PJM to merit the expenditures of such transmission expansion funds. But the economic transmission expansion process has nothing to do with this merger. If the economic transmission expansion projects have merit and can be constructed at a reasonable cost in a reasonable period of time, transmission owners should engage in such construction. If, under the RTEPP, PJM finds that an economic transmission expansion project does not have merit, then the commitment of dollars to construct that project simply makes no sense from either an economic or transmission planning prospective.

Finally, it should be noted that none of the proposed transmission expansion dollars referenced by Applicants affect Applicants' stockholders. Rather, all of these projects will be paid for by ratepayers once the costs of the projects are included in the Applicants' transmission cost of service and a new transmission rate is filed.

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<sup>78</sup> PJM Operating Agreement, Schedule 6, Sections 1.5.6 (d), 1.5.7.

In sum, the Commission should discount the Applicants' transmission expansion arguments and proposals as a basis for approving what otherwise could be an anticompetitive merger.

**III. IF THE COMMISSION PERMITS THE APPLICANTS' REVISED PROPOSAL TO BE WITHDRAWN, THE COMMISSION SHOULD REJECT THE BUYER RESTRICTIONS ON DIVESTED ASSETS AND ORDER A HEARING ON THE ORIGINAL MERGER PROPOSAL.**

The Applicants' original proposal recognized the need for substantial divestiture to mitigate the competitive problems that would arise in post-merger PJM absent such mitigation. But the Applicants' original proposal severely restricted the pool of eligible entities to participate in the divestiture. Specifically, the Applicants restricted eligible buyers such that: (1) no more than half of total capacity will be sold to a single purchaser; (2) no capacity will be sold to a market participant that the Merging Parties believe has a greater than 5% share of installed capacity in either PJM East or the entire PJM footprint; and (3) no more than 25% of the capacity will be sold *in the aggregate* to market participants that the Merging Parties believe possess 3%-5% of the total installed capacity in either PJM East or the entire PJM footprint.<sup>79</sup>

In response to these discriminatory and unprecedented restrictions, several protestors including the PPL Companies strongly opposed these restrictions because they handicapped the ability of other PJM market participants to effectively operate in a post-merger PJM market. The obvious purpose of the restrictions is to reduce to the absolute

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<sup>79</sup> Exelon Corporation, Public Service Enterprise Group Incorporated, Application for Authorization of Disposition of Jurisdictional Assets, Docket No. EC05-43-000, Testimony of Frank Cassidy at 3-4 (filed Feb. 4, 2005). As a result of the 3% to 5% restriction, if one entity that owns between 3% and 5% of the installed capacity market share buys 25% of divested assets, then none of the other entities that own between 3% and 5% of the installed capacity in the market can buy any of the divested capacity. Kalt Testimony at 9.

minimum the amount of divestiture required to pass the Commission's merger screens. However, in doing so, the restrictions will create a post-merger PJM in which the merged entity will hold a large share of the market and its competitors will be held as small as possible. Such limitations run counter to sound economic policy, which dictates that the mitigation should encourage competition not restrict it.<sup>80</sup>

As Dr. Kalt explained, the Applicants should design their mitigation proposal not to prevent Merger Screen failures, but instead, to preserve competition in the post-merger PJM markets.<sup>81</sup> Purchasers who are best suited to restore competition to the post-merger market should be allowed to bid for assets even if they result in minor screen failures. However, as Dr. Kalt demonstrated, with additional divestiture, these discriminatory restrictions were unnecessary and could be lifted with minimal effects on the Commission's market screens.<sup>82</sup>

The Applicants have not addressed any of these concerns raised by Dr. Kalt and the PPL Companies. Nor have they demonstrated how, in light of the evidence presented

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<sup>80</sup> Kalt Testimony at 14-16.

<sup>81</sup> *Id.* at 16-19.

<sup>82</sup> *Id.* at 16-19, 23. The PJM MMU Report examined the impacts of divesting all of the divested generation (both actual divestitures and virtually divested generation) to a single buyer in PJM East. The PJM MMU studied two alternate scenarios, a purchase of all of the divested generation by a single buyer with a pre-divestiture market share of 35% and one with a pre-divestiture market share of 5%. The PJM MMU found that in either case the post-merger HHI would increase compared to the divestiture scenario proposed by Applicants. PJM MMU Report at 19. In his Prepared Direct Testimony, Dr. Kalt concluded that it was unlikely that a single buyer would purchase all of the divested generation, since the buyer would understand that it also would have to obtain Commission approval for the purchase. Kalt Testimony at 18. Instead, Dr. Kalt tested several, more realistic scenarios in which generation is divested to the four largest PJM East market participants other than the merging parties, in varying shares. In each case, modest increases in the amount of divested generation, similar to that subsequently, offered by Applicants in their revised proposal, kept the HHI changes within the Commission's merger screens. Kalt Testimony at 20-22; Exhibit PPL-2a - 2c.

by Dr. Kalt, it is in the public interest to restrict the pool of eligible buyers when with only a slight increase in the amount of divested assets, these restrictions could be lifted. Instead, the Applicants offer to remove most of these restrictions and add additional mitigation – *but only if the matter does not go to hearing*.<sup>83</sup> Since, as the PPL Companies argued above, it would be contrary to the Commission’s obligation to protect the public interest for it to approve the proposed merger without a full hearing, it should be assumed that Applicants will continue to press for the restriction on ownership of divested assets. The Commission should reject the restriction. As Dr. Kalt observed, “the Applicants’ desire to restrict asset sales to only small buyers continues to constitute an inappropriate substitution of the Merging Parties’ wishes for both the power of the marketplace to allocate assets efficiently and the power of the Commission to review whether any particular acquisitions pose threats to competition.”<sup>84</sup>

As the PPL Companies have demonstrated throughout this supplemental protest, even with these additional divestitures and revised restrictions, significant concerns regarding the Applicants’ merger proposal remain. The Commission must order a hearing that considers both Applicants’ original proposal as well as the revised proposal. The Commission should not allow the Applicants’ veiled threat to withdraw this additional mitigation and revised restrictions to prevent the Commission from fully addressing each of the myriad of problems that permeate both of Applicants’ proposals.

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<sup>83</sup> Answer at 32.

<sup>84</sup> Kalt Supplemental Testimony at 26, 29 (“Moreover, because the revised proposal is contingent upon no evidentiary hearing, and the original buyer restrictions are still intact if a hearing is called for by the Commission, the Applicants continue to request that the Commission apply poor public policy by accepting the Merging Parties’ judgments as opposed to the Commission’s own reasoned review.”).

All interested parties should be given the opportunity for full discovery and the benefit of a proper hearing to address their concerns and to ensure that competition will prevail in the PJM marketplace.

#### **IV. CONCLUSION.**

For the above stated reasons, the PPL Companies request that the Commission grant a full hearing on the proposed merger, including both the Applicants' original and revised mitigation proposals, before an Administrative Law Judge.

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**CERTIFICATE OF SERVICE**

I hereby certify that a copy of the foregoing was served this 27th day of May 2005 upon each person designated on the official service list compiled by the Secretary in this proceeding.

*/s/ Donald A. Kaplan*

Donald A. Kaplan

Dated at Washington, D.C., this 27th day of May, 2005.