

Testimony of:

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On behalf of:

DC Public Power

Submitted to:

District of Columbia Public Service Commission

In re:

FC1119 – The Merger Application of Exelon,
PHI, Pepco, EEDC, LLC and NSPE, LLC

March 23, 2015

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My name is Michael Siegel. I am a resident of the District of Columbia, and am an independent Consultant and subject area expert in the areas of utility finance and tariffs, public and environmental finance, and urban and regional economic and fiscal impact analysis. I have 37 years of experience in my field. Prior to becoming an independent Consultant I was the Assistant Director of the Government Finance Officer's Association. I have presented expert testimony in depositions, State courts, before State Legislative bodies Commissions, and before appointed local Councils and Commissions.

My testimony focuses upon financing, risks, benefits and conflicts, and valuation issues. The issues addressed in my testimony have yet to be identified or fully addressed in other testimony in this Case.

Overview

The Exelon corporation ("Exelon") is seeking approval of the District of Columbia Public Service Commission ("DCPSC") to acquire, through merger, the assets of PHI, Pepco, et.al. ("PHI").

The \$6.8 billion that Exelon is to pay for PHI's assets is well in excess of their book value and of PHI's market cap at the time the merger was announced (the "acquisition premium"). For purposes of this testimony, the acquisition premium is estimated at \$1.8 billion, inclusive of merger-related costs.¹

¹ Trade reports place the acquisition premium at \$1.8 billion (C. Linares, TransmissionHub, January 9, 2015). Testimony before the DCPSC places the premium at 58 percent of the agreed acquisition price based on book value (Hempling Testimony, p. 142 and 144). Exelon places it at 24.7 percent based on PHI closing stock price as of April 25, 2014 and a 28.2 percent premium to the volume-weighted average share price over the 20 trading days prior to announcement of the merger (Exelon Press Release "Exelon to Acquire Pepco Holdings, Inc. ...", April 30, 2014; and, "Exelon Announces Acquisition of Pepco Holdings, Inc.", Exelon corporate briefing, April 30, 2014). At 28.2 percent of volume-weighted share price the acquisition premium amounts to approximately \$1.56 billion. Merger-related costs, however, include about \$0.4 billion in related fees for a total of approximately \$7.2 billion. Merger costs and fees include: capital liquidation and debt issuance costs, underwriter discounts, capitalized interest, legal

Summary

To approve Exelon's application, the DCPSC must determine it to be in the public interest (D.C. Code sec. 34-504). The criteria to be considered in making this determination are:

- (1) whether the transaction balances the interests of shareholders and investors with ratepayers and the community;
- (2) whether the benefits to the shareholders do or do not come at the expense of the ratepayers; and
- (3) whether the proposed merger produces a direct and tangible benefit to ratepayers (see PSC Order No. 17597, page 41 and 42).

Exelon's application to the DCPSC creates a number of risks, costs and conflicts arising primarily from the acquisition premium and the Community Investment Fund ("CIF"). Notably, the CIF also causes the DCPSC to have a potential interest in the outcome of its deliberations.

While PHI shareholders and upper-level Exelon executives and management are virtually certain to be substantial net beneficiaries of Exelon's application, benefits to ratepayers are subject to sizable uncertainty and risks that have yet to be fully identified or addressed, while adherence to cost-of-service principles would obtain an equitable and balanced distribution of benefits to and among ratepayers.

Accordingly, Exelon's application does not reasonably balance the interest of shareholders and investors with that of ratepayers and the community, does not reasonably assure benefits to shareholders are not at the expense of ratepayers, nor that it will produce direct and tangible net benefits to ratepayers.

Finally, Exelon's acquisition premium is found to have no tangible market or economic value. The lack thereof creates inherent conflict and instability that contributes to added uncertainty and risk for ratepayers, the community and shareholders.

I. Exelon's Application Creates Multiple Conflicts

Exelon's application creates multiple inherent and on-going conflicts between and among PHI, Exelon management, Exelon shareholders, Exelon's new Pepco subsidiary, DCPSC, and ratepayers and the community. The allocation of benefits among these interests is not balanced. Nor is it possible to determine them to be

and advisory fees. At 28.2 percent about \$113 million of costs and fees are attributable to the acquisition premium for a total of \$1.7 billion ($\$1.56 + \$0.113 = \1.673, rounded up to \$1.7). This figure accords well with the \$1.8 billion premium cited by trade reports.

with a reasonable degree of confidence since attendant conflicts, benefits, risks and costs are yet to be fully identified, quantified or assessed.

Conflicts and attendant risks include those: a) between the interests of Exelon, and those of its Pepco subsidiary as a result of Pepco's responsibility to its ratepayers as a regulated public utility; b) between Exelon corporate and Exelon shareholders, the latter having been promised substantial earnings accretion from the proposed merger c) between Exelon, and ratepayers and the community (jointly), d) between PHI's current shareholders – who are to receive a windfall from the acquisition premium - and Exelon shareholders and ratepayers and the community; e) between Exelon shareholders, and ratepayers and the community (jointly); f) between Exelon/Pepco and the DCPSC; g) between Exelon and the DCPSC; and, h) between the DCPSC, and ratepayers and the community (jointly).

II. The Community Investment Fund Causes the DCPSC to Have a Potential Interest in the Outcome of its Deliberations

The CIF is to be funded from the District's pro-rata share of the expected \$100 million of cost saving synergies from PHI's regulated enterprises. The \$100 million proffered is virtually identical to the \$102 million of net synergies Exelon expects from PHI's regulated utilities (C. Kazoumi, Joint Applicants, Attachment E, (F)-2, Revised).

The funding for the CIF requires DCPSC to exempt Pepco from regulatory cost-of-service principles by allowing Exelon to continue to charge District ratepayers \$27 million (their approximate pro-rata share of Pepco's post-merger synergies) for costs Pepco will not incur. Funds diverted from ratepayers are to find their way to the CIF where they will be subject to the purview of the DCPSC and for disposition at its discretion:

“Joint Applicants will provide a direct and traceable financial benefit to Pepco distribution customers through the Customer Investment Fund. (See Application at ¶¶ 2, 36. The ***disposition of that fund is left to the Commission's discretion***, but even if the Commission decides to use it for a customer credit, that ***would not affect the base rates that customers pay***” (Brief of Joint Applicants Concerning Classification of Formal Case No. 1119 as an “Other Investigation” Under D.C. Code Section 34-912, p. 5, Footnote 20, bold and italics added).

This arrangement embodies and institutionalizes an elaborate shell game: a) it violates cost-of-service principles; b) it diverts funds from ratepayers pockets without their consent; c) it involves DCPSC as an interested party by imbuing it with exclusive authority over the disposition of the CIF; d) DCPSC is unrestricted in how it is to dispose of diverted funds; ratepayers have no recourse or oversight over how their diverted funds are disposed of; e) diverted funds can be used for DCPSC's administrative expenses in disposing of diverted funds, or for any purpose as DCPSC may allow in its sole discretion; and, f) no provision is made for the expiration of existing rates after the DCPSC has diverted \$27 million to the CIF – after which Pepco would retain ratepayer funds going forward that were previously diverted to

the CIF, or ratepayer funds could continue to be diverted to the CIF until such time as Pepco files its first Rate Case.

Providing the DCPSC with discretionary authority over the disposition of funds diverted from ratepayers causes DCPSC to have a potential interest in the outcome of its deliberations to the detriment of its role as an objective and disinterested fact-finder.

III. The Community Investment Fund Creates Negative and Disparate Distribution of Benefits To and Among Ratepayers

The CIF violates regulatory cost-of-service principles. Exelon considers as “public benefits” amounts that would accrue to a select few ratepayers via the proposed CIF. Absent the CIF, and by Order of the DCPSC as may be required until such time as Pepco submits its first post-merger Rate Case, public benefits would be better and more efficiently transmitted to ratepayers by application of cost-of-service principles.

To the extent the CIF may dispose of diverted funds by providing rate credits, assistance and/or energy efficiency programs all ratepayers not endowed or assisted by the CIF are assured to pay more than they would in its absence, as may some who do receive such assistance. It can be reasonably presumed that only a small number of ratepayers will seek, qualify for, and be awarded CIF funded “credits” and “assistance” from CIF “programs”. Accordingly, the distribution of benefits among ratepayers is neither balanced nor is it consistent with regulatory cost-of-service principles.²

Although rate credits, assistance and/or energy efficiency programs are of benefit to some ratepayers, consistent with cost-of-service principles, these programs would need to be funded by Exelon by a non-regulated source – rather than from the pockets of all ratepayers as Exelon’s application provides.

To the extent that DCPSC or a designated organization or agency incurs administrative or other costs for the disposition and/or administration of the CIF - as can be expected – benefits to all ratepayers are reduced accordingly.

IV. Exelon’s Application Creates Rate Risk to District Ratepayers and the Community

Rate-risk arises from the size of the acquisition premium, the lack of sufficient non-regulated synergies to pay for the acquisition premium and/or to generate a return to Exelon and its shareholders, and the lack of an enforcement mechanism or

² Neither Exelon nor the DCPSC can know how many ratepayers will benefit from the CIF. Were such benefits to accrue to (say) 1,000 or 2,000 of the approximately 265,000 Pepco customers in the District, it is difficult to construe this as producing “...a direct and tangible benefit to ratepayers” if “ratepayers” refers to all, a majority, a plurality, or fewer.

penalties for Exelon's or DCPSC's breach of Exelon's promise to hold ratepayers harmless from costs associated with the acquisition premium.

V. Exelon's Application Creates Service Quality and Reliability Risk for DC Ratepayers and the Community

Going forward, Exelon will be in a position to affect service quality and reliability through future investment. Exelon will have the ability and opportunity to exercise leverage to extract concessions from DCPSC. Should DCPSC relent, service quality and reliability risk become realized rate risk.

VI. Exelon's Promise to Hold Ratepayers Harmless is Non-Binding and Unenforceable Upon Exelon and the DCPSC

There is no mechanism to enforce Exelon's sworn testimony to forego a rate of return from its acquisition premium or to impose costs related thereto on ratepayers (Exelon, Final Full Application and Direct Testimony, Exhibit 5). Exelon's testimony in this regard is, effectively, an unsecured promise. No bond or penalty is provided for its breach. Nor is a future DCPSC bound by it. No mechanism is established by which a breach is to be determined. Exelon's promise is not an operant forward constraint for purposes of making a determination of public benefit.

VII. Net Synergies from Regulated Utilities May Not be Used to Pay for or Support the Acquisition Premium

Consistent with cost-of-service principles that require net synergies from regulated enterprises to be directed to ratepayers (Joint Applicants, Attachment E, p. 26) net synergies from Exelon's regulated utilities are unavailable to repay debt, to provide a return to cash, or as accretion to Exelon's shareholders.

Without violating cost-of-service principles or its promise to hold ratepayers harmless, synergies available to repay debt and to provide a return to cash and accretion to Exelon shareholders for the acquisition premium will obtain from Exelon's non-regulated enterprises. To the extent synergies from non-regulated enterprises are insufficient, the balance will come from earnings or dilution to Exelon shareholders, and/or from ratepayers.

VIII. Expected Net Synergies from Non-Regulated Enterprises Will Not Contribute to Expected Accretion or Yield a Return to Cash

Exelon intends to pay for its acquisition of PHI through a combination of debt (50 percent) and equity (50 percent) - the latter including \$1 billion of cash plus additional shareholder equity. Exelon has made forward-looking statements that its acquisition will be "accretive" to earnings. Exelon's post-announcement briefing anticipates accretion of \$0.15 to \$0.20 per share, amounting to \$129 to \$172 million

annually based on approximately 859 million shares currently outstanding (“Exelon Announces Acquisition of Pepco Holdings, Inc.”, Exelon corporate briefing, dated April 30, 2014).

At either \$129 or \$172 million **annual** accretion exceeds **5-year cumulative** net synergies of \$121 million that Exelon expects from its non-regulated enterprises (C. Kazoumi, Joint Applicants, Attachment E, (F)-2, Revised).

IX. Expected Net Synergies from Non-Regulated Enterprises are Not Likely to be Sufficient to Pay Estimated Interest Costs Associated with the Acquisition Premium

Since repayment of debt takes priority, net synergies from non-regulated enterprises must first be directed towards repayment of debt associated with acquisition costs.

Were Exelon’s interest on debt associated with acquisition of PHI’s assets to reflect Exelon’s lowest long-term debt yield to maturity of 4.17 percent (Morningstar.com, March 2015 for outstanding debt, coupon and yield to maturity) the annual first-year interest expense for the acquisition premium’s ratable share of debt would be \$38 million (at an acquisition premium of \$1.8 billion). Over the first 5-years, this represents a cumulative interest expense of approximately \$190 million.³

Were Exelon’s borrowing cost to reflect its highest long-term debt yield of 5.45 percent, it would incur an annual first-year interest expense for its acquisition premium of approximately \$49 million. Over the first 5-years, this represents a cumulative interest expense of \$245 million (op. cit., Morningstar; see foregoing footnote).

Exelon’s testimony shows expected 5-year net synergies from its non-regulated enterprises amounting to \$121 million (Joint Applicants, op. cit., p. 8).

At the lower interest rate (4.17 percent) and an acquisition premium of \$1.8 billion, 5-year interest cost attributable to the acquisition premium exceeds expected 5-year net synergies of non-regulated enterprises by \$69 million ($\$190 - \$121 = \69).

At the higher interest rate (5.45 percent) the 5-year interest cost attributable to the acquisition premium exceeds expected 5-year net synergies of non-regulated enterprises by \$124 million ($\$245 - \$121 = \124).

The acquisition premium’s ratable share of interest costs will exceed net synergies of non-regulated enterprises until such time as its ratable share falls below net synergies of non-regulated enterprises. Until then, ratepayers remain at risk.

³ Note: longer-term bond coupons typically carry a higher rate in the earlier years so the initial year figure is applied as a reasonable - if not on the low side - proxy of the first 5-year interest cost. The actual amount of interest will not be known until debt associated with the issuance is priced.

X. The Acquisition Premium Creates Sizable Stranded Costs and Incentive for Exelon to Escape its Promise to Hold Ratepayers Harmless

Net synergies from non-regulated enterprises will be consumed by the estimated interest expense associated with the acquisition premium. Accordingly, the acquisition premium can be expected to yield zero or negative returns on investment and equity and zero to negative accretion to shareholders. Lacking a return, the acquisition premium can be considered to have little to no tangible market or economic value.

Having over-paid for PHI's assets, and with no synergies available for accretion to Exelon shareholders, honoring its promise to hold ratepayers harmless for costs related to the acquisition premium will saddle Exelon with sizable stranded costs approaching or equal to the cost of the acquisition premium.⁴

At an acquisition premium of \$1.8 billion, stranded costs represent 6.5 percent of Exelon's recent (mid-March 2015) market cap. At this level, Exelon's future enterprise value, earnings, and/or its credit rating could be diminished below what they would be otherwise and will provide an incentive for Exelon to escape its promise to hold ratepayers harmless.

Having consumed expected synergies from regulated enterprises and depleted synergies from non-regulated enterprises for interest payments on debt associated with the acquisition premium, enhancement of proffered public benefits – as recently reported – can only come from earnings, shareholder dilution, and/or from ratepayers. Even were enhancements to be internalized initially they increase Exelon's incentive to escape its promise to hold ratepayers harmless.

XI. Exelon Will Be in a Position to Exert Leverage over DCPSC Going Forward to the Detriment of DCPSC's Statutory and Regulatory Responsibilities

Exelon's application would provide it with leverage over DCPSC to escape its promise to hold ratepayers harmless. By way of example: Exelon might slow-walk certain investments in Pepco's assets, thereby negatively affecting system reliability and quality of service. Exelon might utilize its leverage to obtain a higher rate of return for legacy or new assets than it might otherwise receive. It might seek a waiver to include some of its acquisition premium into Pepco's rate base. Or, it might seek to impose excessive general corporate service charges on its Pepco subsidiary that would be passed on to ratepayers.

⁴ "Stranded costs" are investments or capital assets that yield or can be expected to yield little to no financial or economic return.

Exelon's leverage will weaken DCPSC's ability to exercise its statutory and regulatory obligations and authority. Exelon will be in control of service quality and reliability going forward, unconstrained by any penalty or enforcement mechanism to bind it to its promise to hold ratepayers harmless. As established earlier, Exelon proposes to fund the CIF out of the pockets of ratepayers. Accordingly, it is not reasonable to presume that Exelon will forego an opportunity to off-load additional costs or to seek a return on its stranded assets from ratepayers.

XII. Risks to Ratepayers Are Persistent and Substantial

An estimate of the probable upward bound of realized rate risk to District ratepayers is the District's ratable share of the acquisition premium, for which a reasonable proxy is its share of PHI's rate base or its share of PHI customers. Based on the number of PHI customers in the District (265,000, or 13 percent of 1.98 million) the District's share of the \$1.8 billion acquisition premium is estimated at about \$234 million.

The upward bound of the cost of realized risk associated with slow-walking or withholding investment is not quantifiable, although it could exceed that of rate risk. Diminished service quality and reliability could result in direct and indirect losses to residents, businesses and institutions, and to property values. Diminished quality and reliability could cause or contribute to businesses, residents, jobs, income and investment to locate or re-locate outside of the District.

XIII. Recommendations

Based on the foregoing, it is recommended that DCPSC disapprove Exelon's application as not being in the public interest. Were DCPCS to approve Exelon's application it is recommended that DCPSC:

- require all synergy cost savings originating from regulated enterprises prior to Exelon's first Rate Case to be utilized for general rate reduction to all ratepayers in the form of a cash refund or credit to ratepayers bills in an amount equivalent to what they would receive consistent with cost-of-service principles,
- require that all public benefits to ratepayers originate from non-regulated synergies and sources,
- assure Exelon identifies a legitimate and verifiable non-ratepayer source of funds sufficient to pay associated debt and other costs related to the acquisition,
- require Exelon to post a non-revocable bond or LOC to be held by an independent third party that would be forfeit upon a downgrade in Exelon's or its PHI subsidiary's credit rating below their corresponding pre-announcement rating; and,

- require Exelon to post a non-revocable bond or LOC to be held by an independent party that would be forfeit were Exelon to seek or be provided relief from its promise to hold ratepayers harmless or fail to pay for public benefits to selected groups of ratepayers from non-regulated sources.
- affirm that Exelon's acquisition premium is not supported by a tangible market or economic value.