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THE EXELON-PEPCO MERGER

A GOOD OPPORTUNITY FOR CHANGE IN MARYLAND

BY NICOLAS LORIS

CHICAGO-BASED EXELON proposed to acquire Washington, D.C.-based Pepco Holdings on April 30, 2014. The $6.8 billion merger, already approved by the Federal Energy Regulatory Commission (FERC), Pepco stockholders, and several affected states, awaits approval from Maryland's Public Service Commission (PSC). Approving the merger would bode well for Maryland's energy consumers as well as the state's economy, and be a welcome shift from bad business and bad energy policy in Maryland.

Special interests and unfounded concerns have hijacked the proposed merger discussion in what should be a routine business decision that undergoes the appropriate regulatory review. Maryland's PSC should recognize the broad economic benefits and strengthening of Maryland's electricity network the acquisition would generate, and approve the merger.

THE MERGER AND OTHER STATE APPROVALS

After filing an application to merge with FERC last May, Exelon and Pepco filed applications with utility commissions in Delaware, Maryland, New Jersey, and Washington, D.C. in subsequent months. The Virginia State Corporation Commission also had to approve the merger because Pepco owns transmission infrastructure in the state.

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FERC authorized the merger last November, concluding that the acquisition is consistent with the public interest and dismissing concerns that ratepayers would be harmed as speculative and unfounded.[1] FERC made this determination after analyzing the merger's effect on three major components: the effect on competition, the effect on rates, and the effect on regulation. In each analysis of three areas, the agency determined the acquisition is consistent with the public interest.[2]

Broadly, the proposed merger will produce substantial gains to the affected states, creating more than 10,000 jobs and generating more than $1 billion in economic benefits.[3] Understanding the advantages the merger would create, Delaware, New Jersey, and Virginia moved efficiently in negotiating its settlements. Exelon's settlement with New Jersey is intended to protect jobs, and promises additional job creation and $62 million in rate credits for the state's energy customers.[4] Similarly, Delaware reached an agreement with job protection and rate credits. Delaware's ratepayers will receive $49 million in direct credits and see additional savings, and Delmarva, whose parent company is Pepco and also operates in Maryland, estimates "another $61.5 million in merger savings that would be reflected in rates."[5]

Regarding gains to the other states, the merger would boost Maryland's economy and benefit the state's ratepayers.

Virginia, having less stake in the merger with only a small amount of transmission infrastructure affected, approved as well.[6] With both Republican and Democratic governors in these states, the approval indicates that the merger is not a partisan issue.

Maryland should not be the outlier. As Johns Hopkins Professor Benjamin F. Hobbs said, "It's the [Public Service] Commission's job to make sure financial troubles on one side don't splash over. In theory, there shouldn't be any problem, and, if the state commission does its job, it shouldn't matter in the least bit."[7]

Maryland counties are moving in the right direction in recognizing that evidence suggests the merger would be good for the state. On March 17, Montgomery and Prince George's counties reached an agreement with Exelon and Pepco, which represent "all of Pepco's Maryland customers and nearly three-fourths of Pepco Holdings total customers in Maryland."[8] Both county executives praised the benefits of the merger. Prince George's County Executive Rushern L. Baker III said, "This agreement not only deals with the importance of reliable electric service, but also addresses some of my highest priorities: promoting jobs in Prince George's County, creating pathways out of poverty, and ensuring that our residents will enjoy the provision of energy service under stronger and more stringent reliability standards."[9]

BENEFITS TO MARYLAND'S RESIDENTS, COMMUNITIES AND ECONOMY

Maryland's Public Service Commission must determine if the merger is in the public interest. The economic benefits generated as a result of the merger clearly indicate this is the case. Exelon is one of the country's largest energy providers, already delivering electricity to more than 1.2 million residents in Maryland and employing more than 7,000.[10]

Regarding gains to the other states, the merger would boost Maryland's economy and benefit the state's ratepayers. In the most recent proposal, Exelon is offering $94.4 million—$128 a customer—for its customer investment fund, in which Maryland's Public Service Commission would dictate how the funds are spent, such as rate credits or low-income assistance. In back-and-forth negotiations like those between Exelon and the states of New Jersey and Delaware, the $94.4 million is up from the original offer of $40 million; however, Maryland is the only state of these three yet to approve.[11]

The customer investment fund is just a part of the gains Maryland residents would see as a result of the merger. Exelon and Pepco have committed to provide Maryland with more reliable power, promising to cut power outages by 40 percent and restore power 43 percent faster compared to the 2011–2013 period.[12] The company agreed to pay substantial fines should Exelon fail to meet those commitments.

Opponents may scoff at these commitments, but if past is prologue for Exelon's acquisition history in Maryland, the state's residents can expect such benefits in the near future. In fact, Baltimore Gas & Electric (BGE) has achieved its best-ever reliability and customer satisfaction after becoming part of Exelon in 2012, moving toward first quartile performance to match its sister utilities, ComEd and PECO. Wayne R. Fraizer Sr., president of the Maryland–Washington Minority Contractors Association, emphasized that business opportunities improved after Exelon acquired BGE and expects the Pepco merger to provide even more opportunities.[13]

Additionally, during major storm events, BGE can now restore customers' electricity faster, thanks to the help of its sister utilities. Similarly, the Exelon–Pepco merger would increase the capabilities to share resources to recover quicker and more efficiently after major storms. The merger's increased propensity to more efficiently restore power and manage reliability issues won the support of the American Red Cross.

In total, the merger would lead to the creation of an estimated 6,300–7,000 indirect jobs and up to $623 million in economic impact for Maryland within six years of the

merger closing.[14] On the surface, not very much will change from the state. Similar to other states, Exelon promises job protection for at least two years after the merger, and the Pepco and Delmarva brands will remain the same. Furthermore, 2013 contributions in Maryland of $623,000 will be matched for a decade.[15]

The economic benefits are abundant, which would clearly serve the public interest of the state. Since the only relevant test of a merger is whether it serves the public interest, Maryland's PSC should also consider how the future might look for Pepco in the absence of a merger. One could argue that Pepco would be significantly weaker because the company has continued to make significant infrastructure investments and would not have filed for recovery of these investments while the merger was being considered by the PSC.

Rate increases will likely occur in either case, but would be inevitable without the merger and come without the improvements. Moreover, in all likelihood, for several years after a failed merger, Pepco's emphasis would be on spending reductions to strengthen the company's financial position, instead of building a more efficient and responsive power system.

DISPELLING CONCERNS ABOUT RENEWABLE ENERGY

Several coalitions and officials have criticized the potential merger, most commonly saying that Exelon is pro-nuclear and anti-renewable, that Exelon's market power would be too big, and that the merger presents a risk to Maryland's ratepayers. But the benefits to the state of Maryland are overwhelmingly positive, and many of the concerns voiced by groups opposed to the merger are unfounded, misguided, or serve to protect special interests—not Maryland ratepayers.

Exelon is Maryland's largest producer of carbon-free energy, largely from nuclear but also from wind and solar.[16] However, environmental activists disapprove of the merger, claiming that Exelon is anti-development of renewable energy and citing its investment in nuclear power and opposition to a generous subsidy to wind power and the production tax credit as reasons why. [17] If one believes carbon-free energy is important to combat climate change, it should not matter what source of energy provides that energy. In fact, Maryland residents would be better served as both taxpayers and energy consumers if the government does not pick winners and losers by subsidizing expensive energy technologies that cannot compete in the marketplace without the federal government's crutch.

The wind production tax credit (PTC) is a prime example of how taxpayer-funded handouts distort markets and hurt ratepayers. Producers compete against one another to sell electricity to the grid. When selling electricity to grid operators, wind companies can underbid other electricity producers in times of excess supply, pay utilities to take their power, and still collect the money generated from the tax credit.

Although wind companies selling their power more cheaply to the grid sound attractive to electricity consumers, these sales have short- and long-term adverse implications on the electricity market. Integrating an intermittent source of energy such as wind into the power grid makes life difficult for grid operators who are constantly trying to balance supply and demand.[18]

To compensate for the irregularity and uncertainty of wind-powered electricity, wholesale operators must increase the amount of readily available backup power from conventional sources such as natural gas. The operational costs are then spread among the ratepayers. Net metering policies can similarly benefit special interests and spread costs to the rest of ratepayers.[19]

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Federal and state energy policy should remove preferential treatment for all energy sources, including conventional and nuclear sources, which come in a variety of forms including direct grants, targeted tax credits, government-backed loans and loan guarantees, mandates and more. Furthermore, energy policy should open access to markets and remove burdensome regulations that drive up energy prices for families and business and lack meaningful environmental benefits. Nonetheless, any Maryland policy issues should be debated in Annapolis, not in merger proceedings.

DISPELLING CONCERNS ABOUT MARKET POWER

Opponents have also raised concerns over Exelon's concentration of market power arguing that consolidated market power will result in less competition and unregulated power. But utilities are heavily regulated and their share of the market is irrelevant. Utilities are regulated monopolies, which mean Exelon is still only able to do what the Maryland PSC approves. As FERC notes, the merger would not have impact the competition of electricity capacity markets.[20]

In the approval of the merger, FERC shows that the applicants conducted a simplified Herfindahl–Hirschman Index (HHI) calculation, a common and widely-accepted measurement for market concentration. HHI is calculated by squaring the market share of the firms in the market place and adding those numbers. For instance a firm with 100 percent of the market place would have a score of

10,000 (100 squared). FERC states, "In a horizontal merger, an increase of more than 50 HHI points in a highly concentrated market or an increase of 1000 HHI points in a moderately concentrated market fails the relevant screen and warrants further review."[21]

The simplified HHI calculation for the Exelon-Pepco merger changed HHI less than one point in each market. Thus, FERC concludes that the proposed merger would not adversely affect horizontal competition of generation. Similarly, FERC found that the merger would not adversely impact vertical competition from the combination of generation and upstream natural gas inputs, nor will it adversely impact vertical competition from the combination of generation and distribution assets.[22]

That is not to say, however, that de-monopolization is impossible or would not produce economic benefits. The idea that electric utilities serve consumers best as natural monopolies by producing energy at the lowest possible cost is untrue and borne of companies and politicians lobbying for special protection from competition.[23] However, the merger will have no effect on wholesale reform of the regulatory structure of electric utilities and, again, de-monopolizing the electric utility industries is a policy decision to be deliberated by federal and state governments.

Not only would the merger approval help promote a better business climate, but so can the promise of a more efficient and reliable grid that is more responsive to outages.

OPPORTUNITY TO CHANGE A BAD BUSINESS CLIMATE

Approving the Exelon–Pepco merger presents an opportunity for Maryland to treat a normal business transaction approved by three other states with logic and rationality. Importantly, Maryland has an opportunity take a step to reverse its anti-business climate that has adversely affected the state. The state has long suffered from bad energy and economic policies.

For instance, Maryland's renewable electricity mandate forces pricier electricity onto families and businesses[24] and its participation in the Regional Greenhouse Gas Initiative (RGGI), a multi-state cap-and-trade program, adds an additional price to conventional fuels.[25] These higher energy prices as a result of Maryland's anti-market energy policies will squeeze both production and consumption. Since energy is a critical input for most goods and services, residents will be hit repeatedly with higher prices as businesses pass higher costs onto consumers. However, if a company had to absorb the costs, high energy costs would shrink profit margins and prevent businesses from investing and expanding. The cutbacks result in less output, fewer new jobs, and less income with no climate benefit to show for it. The adverse economic effects paired with no meaningful change in global temperatures are a large reason for why New Jersey chose to cease its participation in RGGI.[26]

Former Maryland Governor Martin O'Malley's leadership has been anything but friendly to businesses and inflicted a great deal of harm to Maryland's economy. An onslaught of tax increases and regulations drove more than 6,000 small businesses out of the state and caused venture capital investment to plummet.[27] According to the Tax Foundation's 2015 State Business Climate Tax Index, Maryland ranks 40thin the United States.[28]

Furthermore, denying the merger, especially when Delaware, New Jersey, and Virginia have all approved, will perpetuate the problem of the state's anti-business climate, making Maryland worse off economically. Granted, one merger approval will not fully reverse the economic damage imposed by years of bad policy, but it can help shift the business climate. Not only would the merger approval help promote a better business climate, but so can the promise of a more efficient and reliable grid that is more responsive to outages. Businesses stand to lose a lot of money during power outages; thus having a more robust electricity system is an enticing asset for business location.

Maryland's PSC has until April 8th to make a decision on the merger. Evidence suggests that approving Exelon's acquisition will create new opportunities, and businesses and communities in Maryland's will benefit from a stronger, more resilient power supply. The PSC should follow the lead of FERC as well as Delaware, New Jersey, and Virginia, and approve the merger. Doing so would be a welcome shift away from anti-business policies and decisions that have left Maryland's economy weaker and less prosperous.

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