The American Antitrust Institute

February 25, 2015

William J. Baer
Assistant Attorney General
U.S. Department of Justice
Antitrust Division
950 Pennsylvania Avenue NW
Washington, D.C. 20530

RE: PROPOSED MERGER OF EXELON AND PEPCO HOLDINGS – ANTITRUST REMEDIES

Dear Assistant Attorney General Baer:

The American Antitrust Institute (AAI) frequently comments on proposed mergers, allegations of anticompetitive conduct, and competition policy involving electricity markets in the U.S.[1] The complementary relationship between antitrust and regulation in promoting competition in electricity markets has been a major theme in the AAI's analysis and advocacy. We write today to reiterate this important message and to encourage the U.S. Department of Justice (DOJ) to seek antitrust merger remedies in the proposed merger of Exelon Corporation and Pepco Holdings Inc. (Exelon-Pepco). If a remedy that fully restores competition lost by the merger is not available, then we urge the DOJ to sue to enjoin the transaction.

I. Overview of the Proposed Merger

On April 30, 2014, Exelon and Pepco proposed to merge in a transaction worth over $6 billion.[2] The deal falls into line with a series of deals that make up the current merger wave. Like other proposed transactions in key infrastructure industries (e.g., Comcast-Time Warner Cable (TWC)), Exelon-Pepco could fundamentally reshape competition in an important market. This transformation could well reverse some of the achievements of wholesale market restructuring and competition to date, including entry of innovative market participants.

[1] The AAI is an independent non-profit education, research, and advocacy organization. AAI's mission is to advance the role of competition in the economy, protect consumers, and sustain the vitality of the antitrust laws. For more information, see www.antitrustinstitute.org. AAI's involvement in competition issues involving electricity spans a wide range of advocacy, including pleadings in Federal Energy Regulatory Commission (FERC) rulemakings, letters and white papers to both FERC and the U.S. Department of Justice (DOJ), and an annual energy roundtable.

[2] *Combining to Create the Leading Mid-Atlantic Electric and Gas Utility Company*, PEPCOHOLDINGS.COM, available http://www.pepcoholdings.com/about-us/exelon-acquisition/.

The proposed merger combines two vertically-integrated utilities that operate in the PJM Interconnection, one of the largest Regional Transmission Organizations (RTOs) and centralized wholesale electricity markets in the U.S. PJM operates the transmission system and markets for energy, capacity, and ancillary services in parts or all of Delaware, Maryland, New Jersey, Pennsylvania, Virginia, the District of Columbia, and eight other mid-western and southern states. These activities affect numerous wholesale market participants and millions of retail consumers.[3]

Exelon is a vertically integrated utility that owns high voltage transmission and distribution, as well as a large fleet of fossil fuel and nuclear generation. It operates three regulated affiliates: Commonwealth Edison, Baltimore Gas & Electric, and PECO. Pepco is also a vertically integrated utility that owns and operates high voltage transmission and distribution under three regulated affiliates: Pepco, Atlantic City Electric, and Delmarva Power. While Pepco does not own generation, it has an important portfolio of demand-side resources.

The merger will combine Exelon's roughly 17 percent share of total transmission service credits in PJM with Pepco's share of about 7 percent, for a total share of over 23 percent.[4] While the merger does not substantially increase ownership of generation, demand-side, and energy efficiency resources, Exelon-Pepco will hold about 14 percent of total capacity in PJM.[5] This market share is much higher in geographic sub-markets that are smaller and more concentrated at times when transmission is constrained.[6]

II. The Proposed Merger Raises Both Horizontal and Vertical Competitive Issues

The proposed merger combines the high voltage transmission and distribution systems of Exelon and Pepco, greatly expanding the umbrella of "wires" controlled by the merged company. This larger set of wires would extend over the sizeable Exelon generation fleet and Pepco's demand-side resources. Post-merger, Exelon-Pepco will have a larger vote in the PJM stakeholder process that is commensurate with its expanded ownership of wires. The combination thus poses both horizontal and vertical competitive issues.

For example, the merger will eliminate Pepco in the PJM stakeholder voting structure – a vote that many argue has often been cast in the interests of the demand-side (i.e.,

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[3] *Who We Are*, PJM Interconnection, PJM.COM, available http://www.pjm.com/about-pjm/who-we-are.aspx.

[4] Exelon Corporation and Pepco Holdings, Inc., Comments of the Independent Market Monitor for PJM ("IMM"), Federal Energy Regulatory Commission, Docket No. EC14-96 (July 21, 2014), at p. 7 (henceforth "Exelon-Pepco"). *See also* Exelon-Pepco, Answer and Leave for Motion for Leave to Answer of the Independent Market Monitor for PJM (September 4, 2014), at pp. 2-4.

[5] Applicants' FERC filing states that Pepco holds about .5 percent of total capacity in PJM, while Exelon holds about 14.1 percent. *See* Exelon-Pepco, Joint Application for Authorization of Disposition of Jurisdictional Assets and Merger Under Sections 23(A)(1) and 203(A)(2) of the Federal Power Act, Affidavit of Julie Solomon (Exhibit J-1) (May 30, 2014), at p. 6.

[6] *See* Exelon-Pepco, Joint Application for Authorization of Disposition of Jurisdictional Assets and Merger Under Sections 203(A)(1) and 203(A)(2) of the Federal Power Act (May 30, 2014), at p. 18; and Solomon Exhibit J-1, *supra* note 5, at p. 6.

consumers), as opposed to the supply-side (i.e., generators).[7] The importance of this loss of rivalry should not be minimized, since demand-side resources play an increasingly important role in PJM's market portfolio as the region attempts to increase energy efficiency. The merger also eliminates competition for transmission expansion projects in PJM by concentrating ownership in the hands of a larger Exelon-Pepco.

By combining the Exelon and Pepco transmission systems, the proposed merger also enhances the ability of the merged company to vertically foreclose rivals seeking to expand or build new projects in PJM. By virtue of Exelon's substantial generation ownership in PJM, the merged company would possess a powerful incentive to frustrate rivals' access to customers that it could serve with its own resources. As such, the merged utility poses a formidable barrier to entry to incumbents and new market participants that require interconnection in order to participate in wholesale electricity markets.

The proposed merger is unlikely to generate any merger-specific, cognizable efficiencies that would ameliorate concerns over its likely anticompetitive effects. For example, Exelon-Pepco make no compelling (if any) case for enhanced economies of scale or scope relating to combining generation and demand-side resources. And any scale economies associated with combining transmission have likely been exhausted and would, in any event, be exploited by PJM's operation of the integrated transmission system.

As discussed next, the merger-related enhancement of Exelon-Pepco's ability to exercise market power – coupled with a powerful, pre-existing incentive to exercise market power – is not adequately addressed by any existing federal or state regulatory regime. This situation highlights the importance of antitrust merger remedies and the complementarity between antitrust and regulation.

III. The Proposed Merger Tests the Limits of Regulatory Access Remedies

On November 20, 2014, the Federal Energy Regulatory Commission (FERC) issued an order approving the proposed Exelon-Pepco merger.[8] Among the many issues raised by intervenors is the size of the merged transmission system and the enhanced ability for Exelon-Pepco to potentially foreclose rivals and block entry. PJM's Independent Market Monitor (IMM), notably, filed comments highlighting this concern.[9]

FERC's order dispenses with the PJM IMM's and other intevenor arguments by noting that the Commission's RTO policy (Order No. 1000) and transmission open access policy (Order No. 888) provide a regulatory framework for addressing vertical competitive concerns.[10] The

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[7] Exelon-Pepco, Protest of the Delaware Public Service Commission (July 21, 2014), at pp. 8 and 11. See also Exelon-Pepco, Comments of the Office of the People's Counsel for the District of Columbia (July 21, 2014), at pp. 3-4.

[8] Exelon-Pepco, Order Authorizing Proposed Merger (November 20, 2014), at PP. 79, available http://www.ferc.gov/whats-new/comm-meet/2014/112014/E-1.pdf.

[9] Comments, of the PJM IMM, *supra* note 4.

[10] FERC, *supra* note 8, at PP. 79.

Commission explains that intervenors did not support their competitive concerns with merger-related "evidence."[11] The Commission's order also notes that should the merged entity engage in anticompetitive conduct, it would be detected as a deviation under the terms of the merged firm's open access (OATT) tariff.

It is no surprise that FERC's order dismisses intervenors' competitive concerns. *Not* to do so would serve as a powerful indictment of the Commission's own policies. The requirement that utility members of an RTO relinquish control of transmission is part of FERC's ongoing initiative to reduce the ability of vertically integrated utilities to discriminate against their rivals. This step-wise initiative has occupied the time of FERC and the courts for years. Multiple rulemakings have encompassed the terms and conditions of nondiscriminatory access, generator interconnection standards, codes of conduct, network planning and expansion, and the creation of independent (transmission) system operators.[12]

Transmission open access and RTOs have likely delivered some benefits. However, this regulatory solution to market access problems suffers from a number of well-known imperfections that are particularly noticeable in markets, such as electricity, that are conducive to the exercise of market power. This includes the inability of a sector regulator to write perfect rules or fully anticipate market or technological developments that will affect the efficacy of the remedy. While conduct-based access remedies prohibit certain actions by a firm with market power, they do not negate the incentive to pursue profit, nor the firm's interest in circumventing the prohibition. For this reason, the prohibited conduct often goes "underground," or the merged firm develops workarounds to exploit loopholes in the access remedy. Moreover, the ongoing oversight, monitoring, and compliance enforcement on the part of the government and a parallel compliance organization within the merged company involve non-trivial costs, that are likely to be passed on to consumers in the form of higher prices.[13]

The PJM IMM highlights transmission planning and operation as one area in which the existing regulatory process is particularly inadequate to deal with the merged firm's increased market power. The IMM notes that the span of the RTO's control over transmission does not extend to every aspect of transmission planning and operation. This allows vertically integrated transmission owners to retain an important measure of control. For example, as a large wires owner in PJM, Exelon-Pepco would have significant influence in the process of evaluating proposals from rivals, including control over interconnection studies and the furnishing of transmission capacity data to the RTO.[14]

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[11] *Id.,* at PP. 80.

[12] *See, e.g.*, Federal Energy Regulatory Commission, Major Orders and Regulation: Electric, http://www.ferc.gov/legal/maj-ord-reg.asp?new=sc3.

[13] *See, e.g.,* John E. Kwoka and Diana L. Moss, *Behavioral merger remedies: evaluation and implications for antitrust enforcement,* 57 THE ANTITRUST BULLETIN 979 (2012). Behavioral remedies suffer from a variety of problems, including: information asymmetries, implementation costs, inability to fully specify remedies in consent orders, countervailing incentives, noncompliance and arbitration problems, and inability to specific the term of the remedy in light of market dynamics.

[14] Comments of the IMM, *supra* note 4, at p. 7.

The foregoing limitation of an RTO "as conduct remedy" is not ameliorated by merger settlements reached by the New Jersey Board of Public Utilities and the Delaware Public Service Commission.[15] For example, both settlements include an "electric generation interconnection study" provision that is ostensibly designed to reduce the merged company's ability to influence the assumptions or outcomes of interconnection studies. The settlements require that the merged firm identify independent third party engineering consulting firms qualified to conduct facilities studies, share the list with the parties to the settlements, and consider alternative engineering firms proposed by the parties. As inclusive as this sounds, however, Exelon-Pepco appears to retain the authority to make the final decision on the firms that ultimately "make" the list. These provisions arguably do not effectively disable the merged company – which has significant incentive to foreclose rivals – from using the interconnection study process as a tool to foreclose rivals or block entry.

In light of the competitive issues raised by the proposed merger, Exelon-Pepco is perhaps the biggest "test" to date of the limitations on FERC's regulation of wholesale power markets. A similar debate is ongoing in the context of the Comcast-TWC, where the proposed merger of the nation's two largest cable broadband providers will exacerbate incentives to foreclose rival online video distributors. As the AAI has noted, however, the current network neutrality (i.e., access) regime will not provide adequate protections from the competitive and consumer harm that would likely result from the merger.[16]

IV. Regulatory Remedies are Compatible with Antitrust Remedies

The presence of FERC regulation presents no impediment to antitrust remedies.[17] There are a number of cases in which the DOJ has pursued not only a different remedy than FERC, but also imposed a remedy when the Commission decided not to. In the merger of San Diego Gas & Electric and Southern California Gas, for example, the Commission developed an open access pipeline capacity reporting system to address vertical foreclosure issues. The DOJ's consent decree, in contrast, required divestiture of generation facilities.[18] In the failed

[15] In the Matter of the Application of Delmarva Power & Light Company, Exelon Corporation, and Pepco Holdings, Inc., Settlement Agreement, Public Service Commission of the State of Delaware, PSC Docket No. 14-193 (February 13, 2015). *See also* In the Matter of the Merger of Exelon Corporation and Pepco Holdings, Inc. Stipulation of Settlement, State of New Jersey Board of Public Utilities, BPU Docket No. EM14060581.

[16] *See* In the Matter of Applications of Comcast Corp. and Time Warner Cable Inc. for Consent to Transfer of Licenses and Authorizations, MB Docket No. 14-57, Reply Comments, American Antitrust Institute (December 2, 2014), available In the Matter of Applications of Comcast Corp. and Time Warner Cable Inc. for Consent to Transfer of Licenses and Authorizations, MB Docket No. 14-57. *See also* Letter to Assistant Attorney General William Baer, Proposed Comcast-Time Warner Cable Merger – Exclusionary Gatekeeping and the Emergent Access Problem, American Antitrust Institute (September 16, 2014), available http://antitrustinstitute.org/sites/default/files/Comcast-TWC_DOJ%20Letter%20re%20Gatekeeping%20and%20Access_9-16.pdf.

[17] *See generally California v. Federal Power Comm'n*, 369 U.S. 482 (1962); *Otter Tail Power Co. v. United States*, 410 U.S. 366 (1973).

[18] U.S. v. Enova Corporation, Complaint, Civil Action No. 1:98CV00583 (March 9, 1998), available http://www.justice.gov/atr/cases/f1700/1790.htm.

merger of Exelon and Public Service Electric & Gas, FERC approved the merger without conditions, while the DOJ again required divestitures of generation facilities.[19]

The limitations of regulatory conduct remedies that underlie FERC's RTO and open access policies – coupled with the DOJ's history of requiring structural remedies in electricity mergers that violate Section 7 of the Clayton Act – suggest a strong and necessary complementarity between antitrust and regulation. Moreover, divestitures are specifically targeted at reducing the incentive and/or ability of the merged firm to exercise market power. In short, antitrust merger remedies are an essential complement to FERC regulation for preserving and promoting competition in wholesale electricity markets.

V. Conclusion

A merged Exelon-Pepco would possess an enhanced ability and pre-existing, powerful incentive to engage in vertical foreclosure and block entry by rivals. If unaddressed through antitrust remedies, the proposed merger stands not only to harm competition and consumers but also to reverse some of the gains from restructuring. In electricity, broader but imperfect access policies that fail to address the specific competitive harms posed by a merger should provide no obstacle to antitrust enforcement. Merger enforcement thus plays a vital and complementary role in circumstances where regulatory conduct remedies are insufficient to protect and promote competition.

The AAI encourages the DOJ to consider these important issues, and to seek merger remedies, if available, to fully restore competition lost by the proposed merger of Exelon-Pepco. If such remedies are not available, then we encourage the DOJ to sue to enjoin the transaction.

Sincerely,

Diana L. Moss

President
American Antitrust Institute

cc:

Cheryl LaFleur, Chairwoman, Federal Energy Regulatory Commission
William H. Stallings, Chief, Transportation, Energy, and Agriculture Section, U.S. Department of Justice, Antitrust Division

[19] U.S. v. Exelon Corporation and Public Service Enterprise Group, Inc. Complaint, Case No.: 1:06CV01138 (June, 22, 2006), available http://www.justice.gov/atr/cases/f216700/216785.htm.