
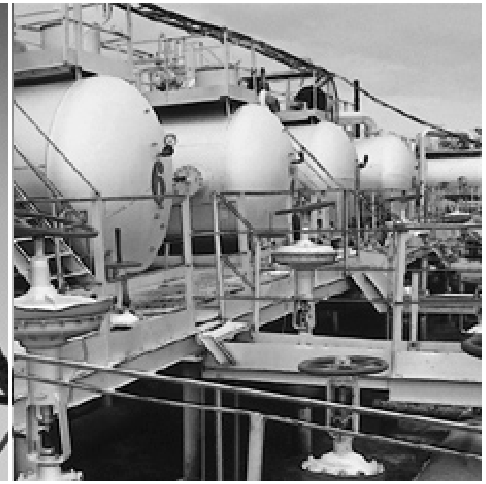


Utility Mergers: New Jersey
The Exelon-PSEG Merger

Center for Research in Regulated Industries

January 19, 2007

Collin Cain, M.Sc.

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Agenda

- Rationale for the merger
- Timeline of key events
- Merger-specific problems
- General lessons

Rationale for Merger

Increased scale and scope, reduced costs, stable earnings growth

- Balanced portfolio of generation and demand
  - Large combined generation portfolio, mostly in PJM
  - Large nuclear fleet, optimize PSEG nuclear performance
- Three distribution utilities, providing half of the combined company's revenue and earnings
- Better asset optimization through combined power marketing
  - Lower generation and marketing costs
- Benefits customers, "by enhancing operations and strengthening reliability"

Rationale for Merger (cont.)

- Claimed synergies of $400m-$500m per year
  - Improved operating efficiencies, primarily PSEG nuclear (15% of total synergies)
  - Cost reduction, elimination of duplicative activities
    - Marketing and trading
    - Transmission and distribution, corporate and business services
  - Supply chain benefits from improved sourcing
  - 70% of the synergies from the unregulated businesses, 30% from the regulated utilities
- Expertise in competitive markets
  - New Jersey, Pennsylvania and Illinois

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Timeline of the merger

- Dec 2004 – Merger agreement announced
- Feb 2005 – FERC application, state filings
- Mar 2005 – DOJ second request for information
- May 2005 – Supplemental FERC filing
- June 2005 – FERC approval
- Sep 2005 – PECO settlement
- Nov 2005 – NJ BPU standard of review: positive benefit standard
- Jan 2006 – Pennsylvania PUC approval
- Feb 2006 – NJ hearings extended for further market power analyses
- Jun 2006 – DOJ settlement
- Jul 2006 – PJM MMU report on DOJ settlement

  Exelon bid cap offer
- Sep 2006 – Exelon notice of termination

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Bates White Analyses

- Bates White synergy analysis
  - Synergy claims by merging companies did not meet DOJ/FTC definitions of cognizable synergies
    - Claims were vague, speculative and not verifiable by reasonable means
  - Claims did not meet FASB or SEC standards for accounting estimates
    - Estimates did not meet criteria for relevance, reliability, objectivity or reproducibility
  - Event analysis of aggregate stock value changes showed considerably lower synergy value of combined companies
- To be considered cognizable, synergies must be:
  - Merger-specific – benefits not realizable in roughly the same time frame but for the merger
  - Verifiable, reproducible
  - Net of costs-to-achieve – excluding sunk costs

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Bates White Analyses (cont.)

- Bates White cost-benefit analysis
  - Annualized benefit to New Jersey
    - High value case = **$66 million**
      - No market power impacts
      - $44 million annual benefit to NJ from increased nuclear output
      - $22 million annual synergy benefits to PSE&G customers
    - Base case = **$10 million**
      - $24 million market power costs
      - $(24) million nuclear benefits
      - $22 million synergies
      - $(12) million other costs (common cost allocation, etc.)
    - Low value case = **$(133) million**
      - $(132) million market power costs
      - No nuclear benefits
      - $22 million synergies
      - $(23) million other costs

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Bates White Analyses (cont.)

- Cost-benefit analysis conclusions
  - Relative to $7 billion retail electricity expenditures in 2002, expected benefit is negligible
  - Horizontal and vertical market power concerns are not fully addressed by merging companies' mitigation plans
  - If market power potential is not completely mitigated with certainty, the ability of the combined company to meet BPU's positive benefit standard is highly unlikely

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Merger-specific problems

Market power hurdles related to increased concentration of generation control

- Vagueness of initial and subsequent divestiture proposals
  - Feb 2005 FERC filing
    - 2900MW of fossil divestiture, unspecified units, within 18 months of closing
  - May 2005 supplemental FERC filing
    - 4000MW, list of eligible units, within 12 months of closing
  - DOJ settlement 5600MW fossil divestiture, specific units, DOJ approval of buyers, within 150 days of closing
- Novelty of "virtual" divestiture combined with emphasis on synergies from improved nuclear performance

Vertical market power

- Incentive and ability to use combined gas transportation capacity to increase price and price volatility to benefit of generation and trading
  - Interruptible transportation capacity poor substitute for firm capacity

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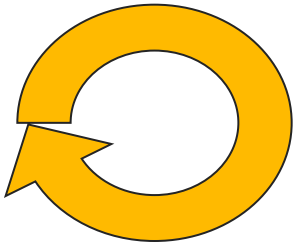
Merger-specific problems (cont.)

Corporate stance on market power

- Vertical market power doesn't exist
- Horizontal market power is not a real problem, because of PJM rules and oversight
- It can't be accounted for in cost-benefit analysis, because the merger would not be approved if market power remained



Claimed synergies and customer benefits

- Claim of significant synergies
  - Not reliable, verifiable
  - Nuclear benefit not demonstrated as requiring merger
- Generalized benefits claimed for customers
  - Not translated into rate offer

Merger-specific problems (cont.)

Regulatory jurisdiction

- BPU control, oversight and influence over PSE&G would be radically different under merger
- Positive benefit standard?
  - Significant as a signal
  - Not a deal breaker

Bottom line: small benefits – large potential costs

- Merger is terminated because the BPU wanted more mitigation, significant rate concessions for customers

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General Lessons

- Combining major players in one market
  - Synergies from coordination
  - Potential for market power
  - Mitigation may undermine rationale for merger
- Utilities provide demand hedge and stable revenue, but….
  - A merger that irrevocably alters a regulator’s control over a major utility will receive aggressive scrutiny
  - Key standard is not “positive benefit” or “no harm”, but a high degree of certainty if regulator has little recourse in the future
- Challenge of multi-state mergers
  - Challenge for companies; maybe more of a challenge for regulators
  - One hurdle too many? Illinois, FERC, Pennsylvania, DOJ, New Jersey

Tension between utility as key piece of merger, and utility as Achilles heal

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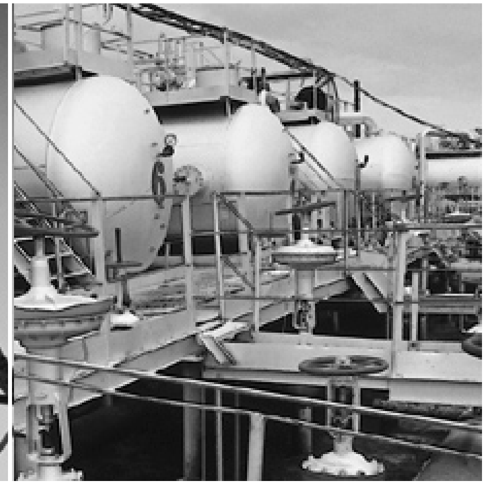


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Collin Cain, M.Sc., is a Manager with Bates White, LLC. Mr. Cain has more than 10 years experience in electricity and environmental economics. He assists clients in developing investment, divestiture and risk management strategies. Mr. Cain's expertise includes power plant valuation, forensic analysis in litigation support, and prudence evaluation. Mr. Cain also assists clients in developing regulatory strategies, and has provided expert testimony in both regulatory and private legal proceedings.