

OREGON

Public Utility Commission

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Mergers and Ring Fencing Issues: An Oregon Perspective

Oregon Public Utility Commission
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Summary

FERC should not adopt mandatory ring fencing rules regarding cross-subsidies, affiliate transactions and access to information. Instead, FERC should adopt default rules to be applied to mergers and acquisitions in states which do not have adequate authority to protect their utility customers.

- Many states, like Oregon and Arizona, have adequate state authority to require ring fencing, to protect against cross-subsidies, to prevent abuse of affiliate transactions and to ensure access to information. These states can protect their utility customers.
- States should adopt their own rules. In the event they do not, Federal rules should apply.
 - This will encourage States to adopt, update or strengthen laws to protect their utility's customers.
 - Mergers are unique to each state and will require a different mix of protections.
 - If states do not act then their utility customers will have some minimal level of protection.
- FERC rules should mirror the rules adopted by states such as Oregon and Arizona.
- FERC rules should be minimum, default standards. States should be allowed and encouraged to provide additional protections to address the unique characteristics of each merger/acquisition and its impact on utility customers of the state.

Outline

- **Ring Fencing**
 - Rating Agency's view
 - Affiliate Transactions

- **Oregon's Laws**

- **Reflections on PUHCA**

- **Oregon's Merger Experience**

- **Conclusions**

What is Ring Fencing?

- **Purpose** – To **isolate** the utility from negative financial impacts created by affiliates:
 - To ensure the utility maintains a strong credit rating and is able to attract capital.
 - To prevent the utility from cross-subsidizing non-regulated utilities.
 - To ensure regulators' access to timely, accurate information

Rating Agency's View Ring Fencing

Standard & Poor's

Any action that state regulators take that provides support (whether legal, regulatory, financial or operational) to the utility and/or isolates the utility (most importantly financial obligations) from its parent company will be positive for credit.

- Parent company's non-regulated businesses matter.
- Parent company risk can be mitigated by:
 - Restricting parent's access to utility dividends;
 - Restricting utility loans to affiliates; and
 - Standards for pricing of transactions with affiliates.

Oregon Statutes

Oregon Revised Statutes protect customers from potential abuses in utility/affiliate transactions.

- Define affiliated interest.
- Require approval before an utility may guarantee another's (long-term) indebtedness.
- Require approval of stock and bond issuance.

Ring fencing(757.511)

Affiliated Interest Statutes (757.015, 757.490, 757.495)

Financing Statutes (757.480)

Acquisition Statutes (757.511)

Oregon Statutes and Rules (continued)

- **Require approval for the purchase of property or stocks of one utility by another.**
- **Require approval for utilities to contract with affiliated interests, when the utility is the buyer of goods, services and assets.**

Oregon Statutes and Rules (continued)

- **OAR 860-027-0100** requires annual reporting of affiliate transactions.
- **Oregon Transfer Pricing Policy (Rule):**
 - Services provided by affiliate to utility
 - Priced at lower of cost and market.
 - Services provided by utility to affiliate
 - Priced at higher of cost or market.

Transfer Pricing is in place to prevent cross-subsidies between utility and affiliate. More protective than the SEC's "cost" standard.

Oregon Statutes and Rules (continued)

- **Require approval for mergers and acquisitions of Oregon energy utilities.**

Any acquisition or merger requires:

- Net Benefit for Utility customers.
- No harm to Oregon citizens on a whole.

PUHCA and Oregon

➤ Oregon's general perspective on PUHCA

- Due to our strong state law regarding mergers and acquisitions, PUHCA provided little additional protection.

Under Oregon law, any purchaser who has the ability to obtain the power to exercise substantial influence and has more than 5% interest in a Oregon regulated utility must receive Commission approval under ORS 757.511.

PUHCA and Oregon

- The SEC is the wrong federal agency to protect utility ratepayers. The SEC is charged with protecting the interest of shareholders.
- Oregon statutes adequately protect customers. Other states, who do not have merger authority, may need to rely on FERC to protect their utility customers.

PUHCA and Oregon

With the repeal of PUHCA, utilities and holding companies still have to comply with:

- OPUC statutes and rules;
- OPUC conditions imposed on merger transactions and other OPUC orders affecting utilities;
- New FERC authority resulting from the EPOA 2005 (FERC still maintains its primary means of protecting customers – FPA and NGA);
- Generally accepted accounting principles (GAAP);
- SEC reporting requirements such as Forms 10-K, 10-Q, and 8-K's;
- Annual FERC Form 1 Reports;
- Additional federal laws such as the Sarbanes-Oxley Act; and
- Findings of external auditors.

PUHCA and Oregon - Auditing

- **OPUC statutes/rules include extensive investigatory powers over utilities books and records related to financial and affiliate transactions.**
- **OPUC imposed conditions in mergers and acquisitions allow this same access to the holding company's and other affiliates books and records.**
- **OPUC Staff performs audits of annual affiliate interest reports and semi-annual operational audits of energy utilities.**

Oregon Merger Experience - PGE

- **PGE is Oregon's largest utility and serves 767,000 customers.**
- **Since 1997, Commission has reviewed five applications to acquire PGE:**
 - UM 814 – Enron Merger (Approved)
 - UM 967 – Sierra Pacific Acquisition (Approved; Never completed due to SEC requirements)
 - UM 1045 – NW Natural Acquisition (Withdrawn due to Enron's bankruptcy filing)
 - UM 1121 – TPG Acquisition (Denied)
 - UM 1206 – PGE Stock Distribution (Approved)

Oregon Merger Experience - PGE

- **Oregon's statutes and administrative rules enable effective ring fencing provisions.**
 - Portland General Electric was able to maintain investment grade ratings even after Enron filed bankruptcy.
 - The Commission imposed 10 ring fencing conditions in its approval of Enron's purchase of PGE.
 - PacifiCorp has similar ring fencing provisions in place based on MidAmerican Energy Holding Company's (MEHC) acquisition.
 - The Commission imposed 40 ring fencing conditions in its approval of MEHC's purchase of PacifiCorp.

Oregon Merger Experience – PGE

Portland General Electric - Enron

➤ Ring fencing conditions included:

1. Full access to information requirements and review of inter-corporate transactions involving PGE.
2. Maintain separate long-term debt and preferred stock ratings.
3. Maintain common equity portion of at least 48%.
4. PGE must notify the Commission of certain dividends and distributions to Enron

Oregon Merger Experience – PGE

Portland General Electric – Enron

5. Prohibition on allocations or direct charges from Enron to PGE without Commission authorization.
6. Restrictions on Enron's access to PGE's power, natural gas assets, or excess pipeline capacity.
7. Not allowed to seek a higher cost of capital than it would have been authorized absent the merger.

Oregon Merger Experience – PGE

Additional Ring Fencing Approved

➤ The Golden Share

- Commission approved the issuance of a \$1.00 Par Junior Preferred Stock.
- Created an “independent director.”
- Prevented Enron from forcing PGE to file for bankruptcy.
- Avoided future downgrades of PGE's bond ratings due to Enron's bankruptcy.

Oregon Merger Experience – PGE

Texas Pacific Group's (TPG) proposed acquisition of PGE

- **Application was denied by the Commission. Concerns included potential harms resulting from:**
 - Harms related to excessive consolidated debt (TPG's long-term debt)
 - Risks related to short-term ownership business plan

Oregon Merger Experience – PGE

Portland General Electric – Stock Distribution

- **Enabled PGE to again be a publicly traded utility.**
 - PGE approved to issue 62,500,000 shares of new PGE common stock and cancel existing stock owned by Enron.
- **Ring fencing provisions included mirrored those already in place for PGE, except where no longer applicable.**
 - Notice of dividends concurrent with public announcement.
 - Minimum equity requirements are reduced as the percentage of equity held by the “Reserve” is reduced.

Oregon Ring Fencing - PacifiCorp

PacifiCorp

- Second largest Oregon utility and serves approximately 527,000 customers.
- Recent mergers/acquisitions involving PacifiCorp:
 - UM 918 – Scottish Power
 - UM 1209 – Mid-America Energy Holding Company

Oregon Ring Fencing – PacifiCorp

PacifiCorp – Scottish Power

➤ Ring fencing conditions adopted:

1. Maintain separate accounting system.
2. Keep all financial books and records at its Portland, Oregon headquarters.
3. Access to records of ScottishPower pertaining to transactions to PacifiCorp and all its affiliated interest.
4. Authority to audit accounting records of ScottishPower and its unregulated subsidiaries that are bases for charges to PacifiCorp.

Oregon Ring Fencing – PacifiCorp

PacifiCorp – Scottish Power

5. Maintain a minimum common equity ratio of 35% (ramping up to 40%)
6. Maintain separate long-term debt and preferred stock ratings and provide notice of certain distributions from PacifiCorp to Scottish Power.
7. PacifiCorp not allowed to seek a higher cost of capital than it would have been authorized absent the merger.

A pre-merger order placed a \$200,000,000 (aggregated) ceiling on loans that PacifiCorp could make to affiliates.

Oregon Ring Fencing – PacifiCorp

PacifiCorp – MEHC

- Ring fencing adopted in UM 1209 enhanced the ring fencing from the ScottishPower merger.
 - Minimum Equity Percentage increased to 48.25%
 - Gives 50% weighting to existing preferred stock.
 - Independent director – Analogous to Golden Share
 - Alternative minimum equity percentage of 35% which includes short-term debt and capital lease obligations
 - Non-utility business will not be held by PacifiCorp or its subsidiaries
 - Dividend restriction should PacifiCorp's unsecured debt rating is BBB- or lower by two or more ratings agencies.

Affiliated Interest Conclusions

- **Should FERC adopt rules regarding cross-subsidies and affiliated interest transactions?**
 - From Oregon's perspective this is unnecessary. Oregon Statutes provide adequate authority to protect customers.
 - For other states that do not have such authority FERC needs to adopt default rules to provide some level of protection for customers.
- **What additional information Should FPA section 203 applicants file with FERC and/or states?**
 - From Oregon's perspective no additional information is required. Oregon's statutes and conditions imposed by the Commission in ORS 757.511 proceedings ensure adequate information to protect customers.
 - FERC rules should provide access to the same information required under state laws and merger proceedings in Oregon and Arizona in order to access the necessary information to act in behalf of customers in states who do not have such authority.

Ring Fencing Conclusions

- Oregon's experience demonstrates that states are capable of providing effective customer protections from holding company financial risks through:
 - Ring fencing(757.511)
 - Affiliated Interest Statutes (757.015, 757.490, 757.495)
 - Financing Statutes (757.480)
 - Acquisition Statutes (757.511)
- FERC should not adopt mandatory generic ring fencing.
 - FERC rules could impede State's implementation of protections
- FERC should adopt default ring fencing rules that apply when a state does not have adequate authority.
- FERC should clarify that its requirements are minimum, default requirements. Rules should encourage states to go farther in protecting utility customers.

Rating Agency View

Ring-Fencing Is Not a Cure for All

In general, ring-fencing will only create a marginal rating differential between subsidiary and its parent entity. In many cases, a distressed parent, or its creditors, will perceive that significant economic incentives exist to file a solvent subsidiary into bankruptcy. Those incentives may well give rise to strategies that can trump the legal structures that may be in place. Surprise outcomes are not unheard of in the bankruptcy context. Despite the economic and legal arguments that support rating levels of the ring fenced entities well above those of Edison International and PG&E Corp., Standard & Poor's cautions that each ring-fencing exercise must be viewed on its own merits.

Source: Standard & Poor's Project & Infrastructure Finance (October, 2001)