DOCKET NO. 34077

JOINT REPORT AND APPLICATION	§	
OF ONCOR ELECTRIC DELIVERY	§	PUBLIC UTILITY COMMISSION
AND TEXAS ENERGY FUTURE	§	OF TEXAS
HOLDINGS LIMITED PARTNERSHIP	§	
PURSUANT TO PURA § 14.101	§	

DIRECT TESTIMONY OF
CRAIG R. ROACH, Ph.D.

ON BEHALF OF
THE STAFF OF THE PUBLIC UTILITY COMMISSION OF TEXAS

September 21, 2007

BOSTON PACIFIC COMPANY, INC.

Table of Contents

I. QUALIFICATIONS 1

II. PURPOSE AND SUMMARY OF THE TESTIMONY 4

A. Evaluation Standards 6

B. Possible Harm Absent Mitigation 8

C. Mitigating Possible Harm 10

D. Possible Benefits 15

E. Recommendations to the Commission 17

III. CHOOSING A PUBLIC INTEREST STANDARD TO EVALUATE THE PROPOSED ACQUISITION 19

A. A Texas Commission Case Concerning the Acquisition of TNP Enterprises, Inc. 22

B. A Texas Commission Case Concerning the Merger of AEP and CSW 29

C. An Oregon Commission Case Concerning the Acquisition of PGE by TPG 36

D. An Oregon Commission Case Concerning the Merger of PGE and Enron 41

E. An Arizona Commission Case Concerning the Acquisition of Unisource By KKR 47

IV. NATURE AND IMPACT OF THE ACQUISITION 56

A. Overview of the Acquisition 56

B. The Bond Rating Agencies' Views 62

C. Ten Possible Harms to Oncor from the Proposed Transaction 69

V. MITIGATING THE TEN POSSIBLE HARMS 71

1. Additional debt may be imposed on Oncor to finance the acquisition or Oncor's assets may be pledged to guarantee new debt 71

2. To service debt incurred by TXU, cash may be extracted from Oncor through excessive dividends, management and shared services fees and/or inter-company loans 72

3. To generate more cash, Oncor may have to cut jobs 80

4. To generate more cash, Oncor may have to defer or eliminate operation and maintenance (O&M) expenditures 82

5. To generate more cash, Oncor may have to defer or eliminate capital expenditures (CapEx) 83

6. Cuts in jobs, O&M expenditures and CapEx can result in a decline in the reliability of the system 86

7. Cuts in jobs, O&M expenditures and CapEx can result in higher risk to the health and safety of customers and/or employees 90

8. Decline in the reliability of the system and higher risks to the health and safety of customers and/or employees may force the Commission to have to increase rates so that these harms can be mitigated 91

9. Oncor might lose its investment grade rating which would result in higher borrowing cost, and thereby, Oncor's customers may pay higher rates 93

10. Oncor faces the risk of being drawn into a TXU bankruptcy proceeding 96

VI. ASSESSING THE POTENTIAL BENEFITS OF THE PROPOSED TRANSACTION 102

VII. ADDRESSING THE THIRTEEN ISSUES SET FOR THE HEARING 108

A. Statutory Issues In Accordance With PURA § 14.101(b) 108

B. Additional Issues Under the Public Interest Determination 115

VIII. RECOMMENDATIONS TO THE COMMISSION 120

1 **I. QUALIFICATIONS**

2

3 Q. Please state your name, position, and business address.

4 A. My name is Craig R. Roach. I am the President of Boston Pacific Company, Inc.

5 (Boston Pacific). My business address is 1100 New York Avenue, NW, Suite 490

6 East, Washington, DC 20005.

7

8 Q. On whose behalf are you testifying?

9 A. I am testifying on behalf of the staff of the Public Utility Commission of Texas

10 (hereafter the "Commission" or the "PUCT").

11

12 Q. Please summarize your educational background.

13 A. I earned my Ph.D. in Economics from the University of Wisconsin in 1983 and

14 my Bachelor of Science Degree in Economics, *cum laude*, from John Carroll

15 University in 1972.

16

17 Q. Please summarize your relevant professional background.

18 A. I have 32 years of experience working on investments in, policies for, and

19 litigation concerning the electricity and natural gas businesses and other energy

20 businesses. From 1975 to 1979, I was an Economist with the U.S. Congressional

21 Budget Office. From 1979 to 1982, I was a Project Manager with ICF

22 Incorporated, an energy and environmental consulting firm. I founded Boston

23 Pacific, and have worked under the Boston Pacific name since 1983, first in San

1 Francisco and since 1987 in Washington, D.C. Boston Pacific is a consulting and
2 investment services firm specializing in the electricity and natural gas businesses.
3 My clients include the full range of stakeholders: public utility commissions,
4 regional transmission organizations, competitive power suppliers, electric utilities,
5 electric gas marketers, gas pipeline companies, trade associations, government
6 agencies, and energy consumers.
7
8 Q. Please summarize your experience as an expert witness.
9 A. I have extensive experience as an expert witness having submitted testimony,
10 affidavits, or comments to the Federal Energy Regulatory Commission (FERC) in
11 more than thirty proceedings, to public utility commissions in eighteen states
12 (some on multiple occasions), in arbitrations, in State Court, in Federal Court, to a
13 City Council, before two Canadian Provincial Boards, and before a Congressional
14 Subcommittee. The topics of my testimony range from antitrust to contract
15 abrogation to finance. A complete list of my testimony is contained in
16 Attachment No. CRR-1.[1] Also shown therein is a list of my speeches and articles
17 on issues in the electricity and natural gas business, and on other energy
18 businesses.
19
20 Q. Did any of your testimony concern utility mergers and acquisitions?
21 A. Yes. I have testified in eight major utility mergers and acquisitions including two
22 that involved Texas companies: AEP with Central and Southwest and Orion with
23 Reliant.

[1] Attachment CRR-1.

1 Q. Please provide examples of your consulting work beyond expert witnessing.

2 A. I will provide two examples of my work beyond expert witnessing. First, Boston
3 Pacific now does substantial work as independent monitors for electricity markets
4 and competitive solicitations. Since 2004, Boston Pacific has served as the
5 Internal Market Monitor/External Market Advisor for the Southwest Power Pool
6 Regional Transmission Organization (SPP RTO). In this engagement, we report
7 to the SPP RTO Board of Directors. I lead the SPP work.
8
9 Boston Pacific has also served since 2004 as independent monitors for
10 competitive solicitations in the District of Columbia, Delaware, Illinois,
11 Maryland, New Jersey, Oregon, and Virginia. In this work, Boston Pacific
12 generally reports to the State Regulatory Commissions.
13
14 Second, Boston Pacific team members have conducted financial evaluations of
15 power project developments and acquisitions throughout North America and in
16 about two dozen countries around the world. Our clients typically were the equity
17 investors. The work challenges in these financial evaluations ranged from
18 forecasting power and fuel prices to determining the level of debt that could be
19 supported.

1 **II. PURPOSE AND SUMMARY OF THE TESTIMONY**

2

3 Q. What is the purpose of your testimony?

4 A. The purpose of my Direct Testimony is to report on Boston Pacific's review of
5 the consequences for Oncor Electric Delivery Company (Oncor) of the acquisition
6 of TXU Corp. (TXU) by Texas Energy Future Holdings Limited Partnership
7 (TEF).[2] The TEF investors are led by two widely publicized private equity firms:
8 Kohlberg Kravis Roberts & Co. L.P. (KKR) and Texas Pacific Group (TPG).[3]
9 With the acquisition, all of the existing, publicly-held stock of TXU – Oncor's
10 parent company – will be purchased by TEF for $69.25 per share in cash; TXU
11 stock will no longer be publicly traded (it will be "delisted" on the New York
12 Stock Exchange and the Chicago Stock Exchange).[4]

13

14 Q. What is the focus of your review of the proposed acquisition?

15 A. My focus is to identify and assess both the possible harm and possible benefit of
16 the proposed acquisition with special attention paid to the effect of the fifteen
17 commitments made by TEF as part of its proposal.

18

19 Q. Did your review of possible harm and benefits cover TXU and all of its
20 subsidiaries?

---

[2] Docket No. 34077, *Joint Report and Application of Oncor Electric Delivery Company and Texas Energy Future Holdings Limited Partnership Pursuant to Public Utility Regulatory Act Section 14.101* (April 25, 2007)(hereafter "Joint Report").
[3] TXU Corp., *Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934* at 12 (July 24, 2007) (hereinafter "Proxy").
[4] Proxy at A1.

1 A. No. While the possible consequences extend to TXU and all of its subsidiaries, staff requested that I focus only on the consequences for Oncor.

3

4 Q. What is the expected total cost of the acquisition and how will it be financed?

5 A. While financing has not been finalized, KKR and TPG estimate that the total cost of the acquisition will be $46.7 billion; this includes the cost of purchasing all TXU stock plus the assumption of existing debt and payment of transaction costs.[5] The acquisition will be financed with $8 billion of equity investment (about 17% of the total).[6] This means the remaining $38.7 billion (about 83%) must be *financed* entirely or mostly with either new or existing debt.

11

12 Q. What is the most important element of the acquisition?

13 A. The most important element of the acquisition is the heavy use of debt to finance the transaction. This will result in an approximate tripling of the amount of debt owed by TXU and its subsidiaries – from about $12.7 billion now to about $38.7 billion when the transaction closes.[7] Concerns arise because TXU would have to service triple the amount of debt – service means pay the interest and pay back the principal – using the same, uncertain level of cash flow from the same sales of electricity and related services provided by TXU and its subsidiaries. This point about having to cover debt service with the *same uncertain level of cash flow* is driven home by the fact that the bulk of this new debt will be used to buy shares

---

[5] Id. at 84.
[6] Id.
[7] TXU Corp., *Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934, For the quarterly period ended June 30, 2007* (hereafter "TXU Corp. 10-Q, June 30, 2007") at 19.

1 of stock at a premium, not for strategic investments that could increase cash
2 flow.[8] Further, this high level of debt may constrain the ability of TXU to borrow
3 additional funds to finance future strategic investments.
4
5 To illustrate this concern, we can use a simple analogy to a home mortgage.
6 Consider a homeowner with $50,000 remaining on the loan he used to buy a
7 home. The homeowner is tempted to seek a second mortgage of $100,000. If he
8 takes the second mortgage, that homeowner would have to service – pay the
9 monthly mortgage payment on – $150,000, or triple the amount of debt. And he
10 would take on that significantly increased financial burden with the same job and
11 the same income he had been using to pay off the much smaller $50,000
12 remaining loan.
13
14 **A. Evaluation Standards**
15
16 Q. What standards apply to the Commission's evaluation of the acquisition?
17 A. Under the Public Utility Regulatory Act (PURA § 14.101), the acquisition must
18 be evaluated under a public interest standard.
19
20 Q. What are the options for the public interest standard?
21 A. The options can be viewed as ranging along a ladder from a *no harm* standard to a
22 *net benefits* standard. The lowest rung of the ladder would set a no harm standard
23 by which the acquisition would be found to be in the public interest if its possible

[8] Proxy at 22.

1 harm to Oncor's customers was substantially mitigated. The highest rung on the
2 ladder would require that, beyond mitigation, substantial benefit must be offered
3 which exceeds the mitigated harm.
4
5 Q. Are there case precedents which give some guidance on choosing a public interest
6 standard?
7 A. Yes. I reviewed five cases to define these options in more detail. Two of the
8 cases were decided by the Texas Commission. In one of the cases – the financial
9 acquisition of TNP by investors – the public interest standard was closer to a no
10 harm standard. In the other case – the strategic merger of CSW and AEP – the
11 chosen public interest standard was closer to a net benefit standard. Both
12 acquisitions were approved by the Texas Commission after a substantial
13 settlement had been achieved among some or all of the parties.
14
15 Of the three other case precedents, two were decided by the Oregon Commission
16 and the third was decided by the Arizona Commission. The first Oregon case and
17 the Arizona case both involved financial acquisitions and adding to their
18 relevance here is the fact that the investors were led, respectively, by TPG and
19 KKR. In both cases, after considerable discussion on the meaning of public
20 interest standards, both acquisitions were rejected under a net benefit standard.
21 The other Oregon case was a strategic merger of PGE and Enron. In this case,
22 Enron's acquisition of PGE was approved under a net benefit standard.
23

1 Q. Are there any other notable elements of these five case precedents?

2 A. Yes. The other notable element is that, in all five cases, extensive, enforceable
3 commitments were offered and considered either to mitigate possible harms or to
4 better define benefits.

5

6 Q. Do any other standards apply to the Commission's evaluation of the acquisition?

7 A. Staff's position is that PURA § 37.154 should also apply to the Commission's
8 evaluation of the acquisition. This provision requires that the acquiring entity be
9 able to provide adequate service.

10

11 **B. Possible Harm Absent Mitigation**

12

13 Q. What is the primary cause of the possible harm?

14 A. The primary cause of the possible harm is the increase in debt cited above.

15

16 Q. Who has raised concerns about increased debt levels?

17 A. Most importantly, all three of the debt rating agencies – Standard & Poor's,
18 Moody's, and Fitch – have raised red flags over the increased debt levels. All
19 three have warned that, because of the increased debt, the bond ratings for TXU
20 could be lowered deep in the non-investment grade area.

21

22 Q. What are the specific harms of concern for Oncor?

1 A. Absent any mitigation measures, such as the fifteen commitments made by the
2 Applicants, the possible string of harmful consequences to Oncor from this
3 increased debt can be summarized with the following ten points:
4
5 First, some portion of the debt incurred to finance the acquisition may be imposed
6 directly on Oncor, which may result in Oncor's customers paying the added debt
7 service, and Oncor's assets may be pledged to guarantee new debt.
8
9 Second, Oncor may be drained of cash to help TXU pay its portion of the debt
10 service. This would be done primarily through excessive dividend payments by
11 Oncor to TXU, but also by payments of excessive management fees and shared
12 services fees as well as through inter-company loans.
13
14 Third, to generate more cash, jobs may be cut at Oncor.
15
16 Fourth, also to generate more cash, operation and maintenance (O&M)
17 expenditures might be deferred or eliminated at Oncor.
18
19 Fifth, also to generate more cash, capital expenditures (CapEx) to expand or
20 upgrade the transmission or distribution systems might be postponed or
21 eliminated at Oncor.
22

1 Sixth, because of the cuts in jobs, O&M expenditures, and CapEx, the reliability
2 of electric delivery might decline at Oncor.
3
4 Seventh, again because of the cuts in jobs, O&M expenditures, and CapEx, the
5 health and safety risks for Oncor's customers and employees might increase.
6
7 Eighth, to address the decline in reliability and increased health and safety risks,
8 the Commission might be left with no choice but to increase rates to finance new
9 jobs, O&M and CapEx at Oncor.
10
11 Ninth, the bond ratings of Oncor's public debt might be lowered so that the cost
12 of borrowing increases and, thereby, Oncor's customers may pay higher rates.
13
14 Tenth, TXU or one of its subsidiaries may declare bankruptcy and, at a minimum,
15 draw Oncor into the control of the Bankruptcy Court, if not into bankruptcy itself.
16
17 **C. Mitigating Possible Harm**
18
19 Q. Did TEF propose commitments either to mitigate possible harms or to define
20 benefits?
21 A. Yes. TEF made fifteen explicit commitments.[9]
22
23 Q. What is your view on these commitments?

[9] Joint Report at 5-7.

1 A. My view is that, as a whole, these commitments are a constructive response to at
2 least some of the ten possible harms listed above. However, these fifteen as
3 proposed are insufficient in the sense that they do not substantially mitigate these
4 ten harms. To meet a no harm standard, significant additional mitigation is
5 needed.
6
7 Q. What specific additional mitigation must be put in place?
8 A. Table One provides an overview. The first column of Table One lists the ten
9 possible harms, the next column lists which of the Applicants' fifteen
10 commitments (if any) addresses the possible harm, and the third column lists the
11 additional mitigation measures that must be put in place in order to better mitigate
12 each of the ten possible harms. The body of my testimony contains more details
13 on all of this and you will see there that, for the most part, the additional
14 mitigation measures I recommend are grounded in commitments made in the case
15 precedents I reviewed.

TABLE ONE: APPLICANTS' COMMITMENTS PLUS ADDITIONAL MITIGATION REQUIRED TO ADDRESS THE TEN POSSIBLE HARMS

Possible Harm	Applicants' Commitments	Additional Mitigation Measures Required
1. Additional debt imposed on Oncor or Oncor's assets pledged to guarantee new debt	1. No Transaction-Related Debt at Oncor commitment	1. Extend the commitment to state that no transaction costs will be recovered through Oncor.
2. Cash extracted from Oncor through:		
2a. Excessive dividends paid to TXU by Oncor	2a. Separate Board, Independent Board, and Debt-to-Equity Ratio commitments	2a. The Oncor Board must (i) have exclusive rights to declare dividends, (ii) commit to maintain Oncor's investment grade ratings, and (iii) in pursuit of (ii) set cash flow metrics that must be met before declaring dividends. The Commission must approve the cash flow metrics. Dividends may not be paid by Oncor if (a) Oncor does not maintain its investment grade debt rating, (b) cash flow metrics are not met, (c) reliability and safety standards are not met, or (d) if TXU or any subsidiary is in bankruptcy. Oncor's Board cannot be overruled by the Board of TXU or any subsidiary on major actions which include, but are not limited to, dividend policy, debt issuance, capital expenditure, management and service

		fees, and appointment of Board members. The term 'independent' when applied to Oncor Board Members must include independence from any party to this acquisition. If a minority shareholder is brought in, it must also be independent. Calculations for the Debt-to-Equity Ratio commitment may not allow the "goodwill" from the acquisition to justify increased debt.
2b. Excessive management and shared services fees paid to TXU by Oncor	2b. Arm's-Length Relationship commitment	2b. The requirement under existing affiliate rules for contemporaneous written records and the right to audit must be extended to corporate support services.
2c. Inappropriate inter-company loans	2c. Same as 2b	2c. Oncor may not make loans to, or take loans from, any affiliate or share credit facilities with such affiliates.
3. Unjustified job cuts to generate cash	3. None	3. Reliability Standards must be defined for this transaction and approved by the Commission.
4. Unjustified O&M cuts to generate cash	4. None	4. Same as 3 above
5. Unjustified CapEx cuts to generate cash	5. Capital Expenditure and Continued Ownership commitments	5. Same as 3 above.
6. Harms 3, 4, and 5 result in a decline in system reliability	6. None, although TEF indicated a willingness to negotiate under its Service and Safety	6. Same as 3 above.

	commitment	
7. Harms 3, 4, and 5 result in a decline in health and safety	7. Same as 6 above	7. Safety Standards based on Oncor's historical performance must be defined for this transaction and approved by the Commission.
8. Increased rates to remedy Harms 6 and 7	8. Rate Case commitment	8. To prevent large rate increases in the near term, an additional mitigation measure should link annual rate increases to a level keyed to an adder plus inflation for a specified period of time. The "goodwill" allocated to Oncor will not be reflected in rates in any manner
9. Oncor's bond ratings are lowered and rates must be increased to cover the higher cost of debt	9. Part 2 of Debt-to-Equity Ratio commitment	9. For a specified period of time going forward, the cost of capital for rate purposes will reflect investment grade ratings regardless of actual ratings. TXU will compensate Oncor for additional debt expense (due to lower bond ratings) that is not reflected in rates.
10. Oncor drawn into bankruptcy proceeding by TXU	10. Holding Company and Separate Books and Records commitments	10. Add "separateness covenants" to debt agreements as well as to organizational documents. Oncor will not seek rate recovery for losses due to a bankruptcy of an affiliate.

1 Q. Please give an example of the additional mitigation you would require.

2 A. One possible harm (number 2a in Table One) is that TXU could extract cash from
3 Oncor through excessive dividend payments from Oncor to TXU. As I see it, the
4 Applicants' commitments address this possible harm with corporate governance;
5 that is, with the commitments to have a *separate* Board of Directors for Oncor
6 with a majority of *Independent* Board Members.
7
8 As additional mitigation, I would add explicit standards that must be met before
9 dividends could be paid by Oncor. I would strengthen corporate governance by
10 requiring that the Oncor Board must (i) have exclusive rights to declare dividends,
11 (ii) commit to maintain Oncor's investment grade ratings, and (iii) in pursuit of
12 (ii) set cash flow metrics that must be met before declaring dividends.
13
14 As to standards for paying dividends, I would require that dividends cannot be
15 paid if (a) Oncor does not maintain an investment grade debt rating, (b) cash flow
16 metrics related to debt service are not met, and (c) reliability and safety standards
17 are not met or (d) if TXU or any subsidiary is in bankruptcy. Note that the
18 Commission must approve the cash flow metrics and the reliability and safety
19 standards.
20
21 **D. Possible Benefits**
22

1 Q. You mentioned that you also assessed possible benefits. What are your views on
2 possible benefits?
3 A. The benefits cited by the Applicants are very limited. The Applicants readily
4 admit that there are no "merger savings" at Oncor because this is not a strategic
5 merger – that is, it is not the merger of companies that are or hold electric
6 utilities.[10] The Applicants do claim, however, that there are benefits to the
7 acquisition. All but one of the items listed as benefits are better characterized as
8 mitigation of possible harm. Among those listed, the only one sufficiently
9 defined to quantify as a possible tangible benefit is the DSM/Energy Efficiency
10 Commitment – a commitment to spend $200 million on demand side management
11 (DSM) and energy efficiency over the next five years over and above what Oncor
12 already reflects in rates and not to seek rate recovery for the extra $200 million.[11]
13
14 However, TEF says the $200 million could be spent by any TXU subsidiary.[12] If
15 any of the $200 million were spent by any subsidiary other than Oncor, it would
16 not have been included in Oncor rates in any event. Furthermore, because TEF
17 can elect to have Oncor spend none of the money, it cannot be considered a
18 benefit to Oncor's customers. Instead, TEF may elect to have TXU's retail
19 electric provider, TXU Energy Retail, spend all of the money for DSM and
20 energy efficiency. In that case, although the money may be used to reduce energy
21 consumption, its expenditure will not be subject to the Commission standards, and

[10] Docket No. 34077, Direct Testimony of Robert Shapard at 24, line 17 to page 25, line 8.
[11] Id. at 25, lines 9 to 21.
[12] Id. at 13, lines 31 to 34.

could be used primarily as a marketing tool by TXU Energy Retail to advance its interests in competition with other retail electric providers.

E. Recommendations to the Commission

Q. What are your recommendations to the Commission?

A. Not surprisingly, as a threshold matter, the Commission's choice of an evaluation standard can make a substantial difference in how it rules in this proceeding. My recommendations take this into account and can be summarized with the following three points.

First, the acquisition *as proposed* does not meet any of the public interest standards along the ladder from no harm to net benefit and would not adequately ensure that Oncor can provide adequate service.

Second, if the Commission chooses the no harm standard for this proceeding, and limits its boundary for harm to Oncor alone, that standard may be met with a combination of the Applicants' fifteen commitments plus additional mitigation measures summarized in Table One. This standard would ensure that Oncor could provide adequate service. The relevant commitments and additional mitigation measures should be incorporated as conditions of any Commission order that concludes that the transaction is in the public interest. Absent such an order that incorporates the commitments and additional mitigation measures, the

1 Commission should conclude that the transaction is not in the public interest, and
2 that Oncor could not provide adequate service.
3
4 Third, if the Commission chooses a net benefit public interest standard, that
5 standard may only be met with (a) a combination of the Applicants' fifteen
6 commitments and the additional mitigation measures summarized in Table One
7 plus (b) a requirement that the Applicants be required to provide substantial
8 benefits that exceed the mitigated harm.
9
10 Q. Are you making any other recommendations?
11 A. Yes. If the Commission finds the acquisition to be in the public interest, a full
12 review should be conducted of the *Limited Liability Company Agreement of*
13 *Oncor Electric Delivery Company LLC*;[13] the purpose of that review would be to
14 remove any inconsistencies with testimony and statements made here.

[13] Docket No. 34077 response to RFI Staff 4 CR-6-01 (TEF) HSC (August 4, 2007 Draft).

1 **III. CHOOSING A PUBLIC INTEREST STANDARD TO EVALUATE THE**
2 **PROPOSED ACQUISITION**
3

4 Q. What is the topic of this section of your testimony?

5 A. In this section, I discuss the range of possible public interest standards from which
6 the Commission might choose. The discussion is based on the relevant Texas
7 statute and a review of cases from the Texas Commission and other State
8 Commissions.
9

10 Q. Does Texas have a statute requiring a public interest standard be used here?

11 A. Yes. PURA § 14.101 states the basics of the public interest standard to be used
12 by the Commission to evaluate mergers and acquisitions. It states in part:

13 (b) A public utility shall report to the commission within a reasonable time
14 each transaction that involves the sale of at least 50 percent of the stock of
15 the utility. On the filing of a report with the commission, the commission
16 shall investigate the transaction, with or without a public hearing, to
17 determine whether the action is consistent with the public interest. In
18 reaching its determination, the commission shall consider:
19

20 (1) the reasonable value of the property, facilities, or securities to be
21 acquired, disposed of, merged, transferred, or consolidated;
22 (2) whether the transaction will:
23 (A) adversely affect the health or safety of customers or
24 employees;
25 (B) result in the transfer of jobs of citizens of this state to
26 workers domiciled outside this state; or
27 (C) result in the decline of service;
28 (3) whether the public utility will receive consideration equal to the
29 reasonable value of the assets when it sells, leases, or transfers
30 assets; and
31 (4) whether the transaction is consistent with the public interest.[14]
32

[14] P.U.C. PUBLIC UTILITY REGULATORY ACT §14.101.

1 Q. What do the prior cases add?

2 A. Prior Commission cases show us how this language was interpreted and applied in
3 practice and, in this way, flesh out the public interest standard.

4

5 Q. What did you look for in the prior cases?

6 A. In reviewing these case precedents, I looked for two things in particular. First, as
7 a threshold matter, I wanted to know whether the Commission used a *net benefit*
8 standard or a *no harm* standard when judging what was in the public interest. A
9 no harm standard means the acquisition would be in the public interest if any
10 possible harm were adequately addressed. A net benefit standard means any
11 possible harm must be mitigated, but also, substantial benefit must be offered
12 which exceeds the mitigated harm.

13

14 If a *net benefit* standard was used, I also wanted to answer three subsidiary
15 questions: (a) to whom must the benefits accrue? (b) what is the nature of the
16 benefits (rate cuts, funding increases, non-monetary benefits, etc.)?, and (c) do the
17 benefits have to be a result of the proposed transaction – do they count if they
18 could be achieved absent the proposed transaction?

19

20 If a *no harm* standard was used, I also wanted to know if it was (a) a *hold*
21 *harmless* standard in which compensation for harm was required or (b) a
22 *mitigation standard* – all harms must be substantially mitigated.

23

1 Second, I wanted to know the nature and extent of commitments or conditions set
2 to assure the transaction was in the public interest. Moreover, I wanted to know if
3 these commitments were enforceable in the sense that (a) the commitment was
4 stated in terms of a quantifiable measure or metric and (b) there were penalties for
5 failing to meet the commitment.
6
7 Q. What cases did you review?
8 A. I reviewed five cases in total including two cases decided by the Texas
9 Commission. The first Texas case involved the acquisition of TNP Enterprises.[15]
10 The second Texas case involved the merger of American Electric Power
11 Company, Inc. (AEP) and Central and South West Corporation (CSW).[16]
12
13 I also reviewed two cases from other State Commissions which involved
14 proposed private equity transactions. One of these cases was in Oregon and the
15 other in Arizona. The Oregon Commission case concerned the proposed
16 acquisition of Portland General Electric Company (PGE) by investment funds
17 managed by TPG, one of the private equity firms involved in this proceeding.[17]
18 The Arizona Commission case concerned the proposed acquisition of Unisource

[15] Docket No. 21112, *Application of Texas-New Mexico Power Company and TNP Enterprises, Inc. Regarding Merger of TNP Enterprises, Inc. and ST Acquisition Corp.* (Feb. 22, 2000).
[16] Docket No. 19265, *Application of Central and South West Corporation and American Electric Power Company, Inc. Regarding Proposed Business Combination*. (Nov. 18, 1999).
[17] Oregon Public Utility Commission (hereafter "OPUC") Docket No. UM 1121, *In the Matter of Oregon Electric Utility Company, LLC, et al, Application for Authorization to Acquire Portland General Electric Company*. (March 10, 2005).

1 Energy Corporation by investment funds managed by KKR, also one of the
2 private equity firms involved in this proceeding.[18]
3
4 Finally, I reviewed another Oregon case in which Enron merged with PGE.[19]
5 Here I was most interested in conditions set on the merger which, in reality,
6 appear to have shielded PGE from the effects of Enron's bankruptcy.
7

8 **A. A Texas Commission Case Concerning the Acquisition of TNP**
9 **Enterprises, Inc.**
10

11 Q. Please briefly describe the first Texas case.
12 A. In July 1999, a transaction was proposed in which all of the outstanding stock of
13 TNP Enterprises, Inc. (TNP) would be acquired by an entity formed for this
14 purpose and named SW Acquisition, L.P. TNP was a holding company and the
15 parent of Texas-New Mexico Power Company (TNMP), a public utility serving
16 about 175,000 customers in 43 counties in Texas.[20]
17
18 This appears to have been a purely financial transaction – the acquiring entity was
19 not otherwise in the electricity business – and, in this sense, the TNP case is
20 similar to the proposed acquisition of TXU.[21]
21

[18] Arizona Corporation Commission, Docket No. E-04230A-03-0933, *In the Matter of the Reorganization of Unisource Energy Corporation*. (Jan. 4, 2005).
[19] OPUC Docket No. UM 814, *In the Matter of the Application of ENRON CORP for an Order Authorizing the Exercise of Influence Over Portland General Electric Company*. (June 4, 1997).
[20] Docket No. 21112, *Application of Texas-New Mexico Power Company and TNP Enterprises, Inc. Regarding Merger of TNP Enterprises, Inc. and ST Acquisition Corp.,* Final Order at 1, 6 (Feb. 22, 2000).
[21] Id. at 6.

1 Q. How did the Commission rule?

2 A. The Commission found that the proposed transaction was in the public interest as
3 required under PURA § 14.101 and, for that finding, it relied substantially on a
4 Joint Stipulation and Agreement (a Settlement) filed by the parties in the case.
5 That Settlement, in turn, relied upon a long list of detailed commitments by TNP
6 and TNMP.

7

8 Q. What issues were set for hearing by the Commission?

9 A. Seventeen issues were set for hearing, although there was no restriction on raising
10 additional issues.[22] In summary, of the seventeen issues, (a) seven were deemed
11 by the parties in the settlement to be "not applicable," (b) the resolution of eight
12 were tied explicitly to commitments made by TNP and TNMP, and (c) the
13 remaining two were resolved with facts independent of the commitments.

14

15 Q. Which issues were deemed not applicable?

16 A. The seven that were deemed to be not applicable by the parties to the Settlement
17 included four that generally concerned possible benefits. Issue No. 13 explicitly
18 asks about "tangible benefits" – "Whether the merger results in tangible benefits
19 to Texas customers on a timely basis." While the Applicants had presented
20 testimony on benefits, the Settlement reflects an agreement that "this issue is not
21 applicable to a transaction of this type."[23] Similarly, Issues Nos. 7, 8, and 16,
22 referred to "cost savings," "improvement in service," and minimum "share of

[22] Docket No. 21112. Preliminary Order at 7 (Aug. 30, 1999).
[23] Docket No. 21112. *Joint Stipulation and Agreement at 7* (Nov. 9, 1999).

1 merger savings," respectively.[24] Again, these three additional issues were
2 deemed to be not applicable.
3
4 Of the other three issues deemed to be not applicable, two, Issues Nos. 11 and 12,
5 concerned the impact on competition. The last of the seven issues was one of
6 those, Issue No. 5, related to PURA § 14.101 – "Will the public utility receive
7 consideration equal to the reasonable value of the assets when it sells, leases or
8 transfers assets?"[25] This was deemed to be not applicable because there was no
9 sale, lease, or transfer of assets in the proposed transaction.[26]
10
11 Q. Which issues had resolutions tied to explicit commitments made by the
12 Applicants?
13 A. Of the eight issues that were tied to explicit commitments, it is useful to start with
14 the broadest, Issue No. 6, which asks directly "Is this transaction consistent with
15 the public interest?"[27] Agreement that the transaction was in the public interest
16 was explicitly tied to all of the commitments made.
17
18 Several of the other issues tied to commitments reflect detailed thought on making
19 the commitments enforceable and effective. Issues Nos. 2, 4, and 14, respectively
20 deal with adverse effects on "health or safety of customers or employees,"

[24] Id. at 6, 8.
[25] Id. at 5.
[26] Id.
[27] Id.

1 "decline in service," and guarantees on "service quality and customer relations."[28]
2 Each gave rise to commitments that were laid out in an attachment. In this regard,
3 TNP and TNMP make commitments concerning: (a) maintaining customer
4 service staffing levels, (b) the response time for service turn on and upgrades, (c)
5 the time to respond to customer calls, and (d) commitments to reliability
6 standards. In each instance, there are explicit, quantifiable standards so one can
7 tell if the commitment is met, and if it is not met, there are dollar penalties
8 defined.
9
10 Commitment #8 also deserves separate mention. It states that "TNMP commits
11 that no transaction costs related to the merger will be borne by TNMP or its
12 customers..."[29] And, further "TNMP will not seek to recover the premium paid
13 for TNP's common stock in this transaction."[30]
14
15 Q. Were there commitments in the Settlement that are not linked explicitly to one of
16 the seventeen issues?
17 A. Yes. There were five other commitments that were detailed and appear to be
18 central to the Settlement's conclusion that the transaction was in the public
19 interest, but were not tied to one of the seventeen issues by the authors of the
20 Settlement. All five of these address the possible financial consequences of the
21 transaction. These five are commitments #4, #5, #6, #7, and #9.

---

[28] Id. at 4, 5, and 7.
[29] Docket No. 21112. *Joint Stipulation and Agreement*, Exhibit A at 3 (Nov. 9, 1999) ("Agreed Commitments and Terms").
[30] Id.

Commitment #4 states that “TMNP will strive to maintain investment grade bond ratings on its senior debt obligations.”[31] Commitment #7 puts some teeth in this by requiring that any projected financing for the 2002 Test Year “will be assumed to be done at investment grade rates.”[32]

Commitment #5 requires TNMP, for a specific period of time, to hold debt to 65% of its capitalization – this is “total debt outstanding including current maturities divided by total debt plus equity.”[33] This is later set at 70% for an additional period of time.[34] If either of these “maximum leverage ratios” is exceeded, TNMP agrees to limit dividends to 65% of net income.[35]

Commitment #6 sets limits on the dividends paid to TNP by TNMP. In sum, it limits dividends to cumulative cash flow from operations less cash flow from investing. If the dividend commitment were violated, TNMP would pay a penalty of $5,000 per day. Under this same commitment, TMNP commits “to expend funds to maintain its transmission and distribution system in an amount of at least $8 million annually in maintenance expense and $23 million annually in capital expenditures.”[36]

---

[31] Id. at 1.
[32] Id. at 2.
[33] Id. at 1.
[34] Id.
[35] Id. at 2.
[36] Id.

Commitment #9 provides protection against bankruptcy and insolvency of TNP. The commitment warrants a statement in full:

> TNP debt will include separateness covenants, which will remain effective as long as the rated indebtedness at TNMP remains outstanding, or until January 1, 2004, which will state that: (a) TNP and TNMP are being operated as separate corporate and legal entities and that the Lenders, in agreeing to make the loans, are relying solely on the creditworthiness of TNP based on the assets owned by it and the repayment of the loan will be made solely from the assets of TNP and not from any assets of TNMP and that they will not take any steps for the purpose of procuring the appointment of an administrative receiver or the making of an administrative order for instituting any bankruptcy, reorganization, insolvency, wind up or liquidation or any like proceeding under applicable law in respect of TNMP or any of its liabilities; and (b) TNP agrees that any future material indebtedness will comply with the foregoing restrictions.[37]

Q. Which two issues were settled without a direct link to commitments?

A. The first of the two issues settled with facts independent of the commitments was Issue No. 1, which concerned the "reasonable value of property, facilities or securities to be acquired."[38] The Settlement seemed to rely heavily on the 'fairness opinion' from the investment firm Warburg Dillion Reed; the Settlement also stated that the price is "not harmful to ratepayers."[39]

The second of these two issues was Issue No. 17, concerning protection against "cost shifting, cross subsidies, and/or discriminatory behavior occur[ing] among

[37] Id. at 3.
[38] Docket No. 21112. *Joint Stipulation and Agreement* at 4 (Nov. 9, 1999).
[39] Id.

1 affiliates."[40] The Settlement stated that the adoption of affiliate rules and a code

2 of conduct adequately addressed this concern.[41]

3

4 Q. How would you characterize the public interest standard used in this case

5 precedent?

6 A. The TNMP case involved a settlement agreement approved by the Commission.

7 While the Final Order explicitly stated that its entry "[did] not indicate the

8 Commission's endorsement or approval of any principle or methodology that may

9 underlie the agreement,"[42] the settlement approved reflects a public interest

10 standard closer to no harm than to net benefit.[43] The no harm standard reflects

11 efforts to both compensate for, and to mitigate harm. In addition, the TNMP case

12 precedent had a significant number of detailed commitments set to assure the

13 transaction was in the public interest. Moreover, many of these commitments

14 were enforceable in the sense that (a) the commitment was stated in terms of a

15 quantifiable measure or metric and (b) there were explicit penalties for failing to

16 meet the commitment.

17

[40] Id. at 8.
[41] Id.
[42] Docket No. 21112, Final Order at 13 (Feb. 22, 2000).
[43] *See* Docket No. 21112, Final Order at 12-13 (Feb. 22, 2000). In approving the stipulation, the Commission specifically stated that "[a]s recognized by the Stipulation, consideration of the following issues identified in the Preliminary Order is not necessary to a public interest determination given the type of transaction involved in this docket, which does not involve the sale of the utility's assets or a merger of operating utilities . . ." *Id.* at 12. Those issues included: whether the merger did more than promise cost savings, whether the merger resulted in improvements of service, whether the merger resulted in tangible benefits to customers on a timely basis, and whether customer's share of merger savings was subject to a guaranteed minimum amount. *Id.* at 12-13.

1 **B. A Texas Commission Case Concerning the Merger of AEP and CSW**

2

3 Q. Please briefly describe the second Texas case.

4 A. In April 1998, American Electric Power, Inc. (AEP) and Central and South West
5 Corporation (CSW) submitted an application for a public interest finding for their
6 merger.[44] AEP was a utility holding company headquartered in Columbus, Ohio.
7 AEP controlled seven domestic electric utility operating companies in that area of
8 the country which served almost three million customers. CSW was a utility
9 holding company based in Dallas, Texas. CSW controlled domestic utility
10 operating companies which served about 1.7 million customers in Texas,
11 Oklahoma, Louisiana, and Arkansas.[45]

12

13 Q. Was this case also settled?

14 A. Yes. As in the TNP case, a Settlement – termed the Integrated Stipulation and
15 Agreement (ISA) – was central to the Commission's findings that the AEP/CSW
16 merger was consistent with the public interest.[46]

17

18 Q. What issues were set for hearing?

19 A. In its Preliminary Order, the Commission set the issues to be addressed in
20 hearing. It started with the six issues listed in PURA § 14.101(b) and added six

[44] Docket No. 19265, *Application of Central and South West Corporation and American Electric Power, Inc. Regarding Proposed Business Combination*, Final Order at 5 (Nov. 18, 1999).
[45] Id. at 4.
[46] Id. at 1, 21.

1 others from a previous commission case precedent.[47] All twelve of these were
2 included in the case discussed above concerning the acquisition of TNP.[48]
3
4 In addition, the Commission listed another twelve issues bringing the total to 24.[49]
5 Some of these were specific to AEP and CSW – for example, three related to
6 consistency with other proceedings involving CSW companies.[50]
7
8 Five of these added twelve issues were also addressed in the TNP case discussed
9 above. Among the more notable are three that concern benefits. For example,
10 Issue No. 5 in the AEP/CSW case is the same as Issue No. 13 in the TNP case –
11 "Whether the merger results in tangible benefits to Texas customers in a timely
12 basis."[51]
13
14 Q. Did the Preliminary Order do more than set the twenty-four issues for hearing?
15 A. Yes. The Preliminary Order also is important because it addressed key threshold
16 legal policy determinations. The most relevant policy question for our discussion
17 is:

18 What remedies are available to the Commission under PURA if the
19 Commission determines that the proposed merger would impair
20 competition in the wholesale market for electricity?[52]
21

22 The Commission stated its conclusion on this matter as follows:

---

[47] Docket No. 14980, *Application of Southwestern Public Service Company Regarding Proposed Business Combination with Public Service Company of Colorado* (Feb. 14, 1997).
[48] Docket No. 19265. Preliminary Order at 3(July 2, 1998).
[49] Id. at 3, 4.
[50] Id.
[51] Id. at 4.
[52] Id. at 5.

1 The Commission rejects the arguments of the Applicants and agrees with
2 the positions taken by the other parties. **The Commission has authority**
3 **to adopt merger safeguards in addition to disallowance of the**
4 **ratemaking impacts of the merger**. The Legislature has granted the
5 Commission both specific authority and responsibility *and* implied
6 authority over merger transactions through PURA §§ 14.001 and
7 31.001(c). Moreover, to the extent that the Applicants cannot (or will not)
8 comply with the Commission's findings and/or any conditions imposed on
9 the merger, the Commission would be compelled to find that the merger is
10 not in the public interest.[53] [Emphasis added]
11

12 Q. Were commitments or conditions set?

13 A. Yes. The commitments made through the ISA were quite broad in scope. The

14 Commission summarized them in the following manner:

15 The ISA resolves all the merger-related issues among the Signatories and
16 also resolves some regulatory proceedings of the Texas operating
17 companies as well. The ISA contains merger-related rate reductions, as
18 well as rate reductions arising from the settlement of other cases. It
19 provides for additional amortization of Excess Cost Over Market (ECOM)
20 of CPL. It contains a market power mitigation plan and provides affiliate
21 standards. It sets detailed customer service standards. It includes a rate
22 moratorium for the Texas Operating companies that will last until January
23 1, 2003, subject to certain force majeure provisions. It contains provisions
24 regarding jurisdictional issues between the PUC and federal agencies. It
25 provides for Applicants to implement a Customer Education Plan and an
26 expanded Low-Income program. It includes a sharing of off-system sales
27 margins and other provisions relating to the operations of the merged
28 companies.[54]
29

30 Q. Were any of the twenty-four issues set for the hearing found to be not applicable?

31 A. No. All of the issues set for hearing were addressed in the Commission Order;

32 none were said to be "not applicable" as was done in the TNP case.

33 Recall that, in the TNP case, the question concerning "tangible benefits" was

34 deemed to be not applicable. Notably, in the AEP/CSW case the Commission

[53] Id. at 7.
[54] Docket No. 19265. Final Order at 8 (Nov. 18, 1999).

1 found that the merger did indeed produce "tangible benefits to Texas

2 customers."[55] Interestingly, the Commission included in its definition of benefits

3 a long list of the commitments made – contained in Order Paragraphs 19 through

4 65. The Commission summarized these benefits as follows:

5 The ISA will produce timely benefits for Texas customers in the areas of
6 rate reductions, ECOM amortization, market power mitigation, affiliate
7 standards, customer service standards, rate moratorium, jurisdictional
8 issues, customer education, low-income programs, off-system sales
9 margins, and other ISA provisions.[56]
10

11 Q. Were the benefits quantified?

12 A. Yes, to some extent. The most readily quantified benefits are the rate reductions

13 cited by the Commission – the ISA states that these sum to about $221 million.[57]

14 In addition, the ISA requires a moratorium on base rate increases through 2002.[58]

15 Moreover, the Commission notes that net cost savings for the merger were

16 expected to be about $2 billion over ten years.[59]

17

18 Q. Please describe some of the more relevant commitments in the ISA.

19 A. The ISA contains several commitments related to finance. Among the more

20 important in this regard is the prohibition on non-utility affiliates taking on debt

21 that would allow recourse, upon default, to the assets of an operating company.

22 The ISA states in part:

23 An AEP operating company shall not allow a non-utility affiliate to obtain
24 credit under any arrangement that would permit a creditor, upon default, to

[55] Id. at 19, ¶ 68.
[56] Id. at 19, ¶ 67.
[57] Docket No. 19265. *Integrated Stipulation and Agreement* at 1 (May 4, 1999).
[58] Id. at 5.
[59] Docket No. 19265. Final Order at 12, ¶ 34 (Nov 18, 1999).

have recourse to the operating company's assets. The financial arrangements of an AEP operating company's affiliates are subject to the following restrictions:

> (1) Any indebtedness incurred by a non-utility affiliate will be without recourse to the operating company.
>
> (2) An AEP operating company shall not enter into any agreements under terms of which the operating company is obligated to commit funds in order to maintain the financial viability of a non-utility affiliate.
>
> ...
>
> (5) An AEP operating company shall not assume any obligation or liability as guarantor, endorser, surety, or otherwise in respect of any security of a non-utility affiliate.
>
> (6) An AEP operating company shall not pledge, mortgage or otherwise use as collateral any assets of the operating company for the benefit of a non-utility affiliate.[60]

Q. Was there mention of the cost of capital?

A. Yes. In addition, the commitments include protection against the transaction increasing the cost of capital for ratemaking by the Texas operating companies. Specifically, the ISA states:

> The Merged Company commits and agrees that the cost of capital as reflected in CPL's, WTU's, and SWEPCO's rates shall not be increased or adversely affected as a result of AEP's acquisition of CSW. The Merged Company also agrees that subsequent to the completion of the merger, the cost of capital for CPL, WTU and SWEPCO should be set commensurate with the risk of those utilities and should not be affected by the merger. The Merged Company agrees that it will not oppose, in either a regulatory proceeding or an appeal, the application of the principle that the determination of the cost of capital can be based on the risk attendant to the regulated operations of CPL, WTU and SWEPCO.[61]

Q. Was access to books and records addressed?

---

[60] Docket No. 19265. *Integrated Stipulation and Agreement* at 11 at E (May 4, 1999).
[61] Id. at 29 at J.

1 A. Yes. The Commission also required access to books and records of affiliates.

2 Specifically, the ISA states:

3 The PUCT and other municipal regulatory authorities under PURA shall
4 have access to the books and records of any affiliate of a Texas operating
5 company to the same extent and in like manner that the PUCT has over a
6 public utility operating company if the affiliate has had direct or indirect
7 transitions with the Texas operating company.[62]
8

9 Q. Were payments for services among affiliates of concern?

10 A. Yes. The Commission required that services provided by an affiliate be

11 conducted under a contract and result in detailed billing statements. The ISA

12 states:

13 Any good or service provided by a non-utility affiliate to an AEP
14 operating company shall be by itemized billing statement pursuant to a
15 written contract or written arrangement. The operating company and non-
16 utility affiliate shall maintain and, upon request, make available for
17 inspection in Austin, Texas by the PUCT, copies of each billing statement,
18 contract and arrangement between the operating company and its non-
19 utility affiliates that relates to the provision of such goods and services in
20 accordance with applicable PUCT document retention requirements.[63]
21

22 The ISA also calls for an audit of affiliate transactions. The ISA states:

23 AEP shall contract with an independent auditor who shall conduct biennial
24 audits for eight years after merger consummation of affiliated transactions
25 to determine compliance with these affiliate standards. The results of such
26 audit shall be filed with the PUCT. Prior to the initial audit, AEP will
27 conduct an informational meeting with the PUCT regarding how its
28 affiliates and affiliate transactions will or have changed as a result of the
29 proposed merger.[64]
30

31 Q. Was the issue of using the same corporate names for regulated and unregulated

32 affiliates addressed?

[62] Id. at 10 at C.
[63] Id. at 12 at F.
[64] Id. at 14 at X.

1 A. Yes. The ISA also restricts the use of the corporate logo by requiring a

2 disclaimer. Specifically, the ISA states:

3 An affiliate may use an AEP operating company's name or logo only if, in
4 connection with such use, the affiliate makes adequate disclosures to the
5 effect that (i) the two entities are separate; (ii) it is not necessary to
6 purchase the non-regulated product or service to obtain service from the
7 operating company; and (iii) the customer will gain no advantage from the
8 operating company by buying from the affiliate.[65]
9

10 Q. Were performance standards set?

11 A. Yes. The ISA contains detailed customer service standards and reliability

12 standards comparable to those discussed above for the TNP transaction.[66]

13

14 Q. How would you characterize the public interest standard used in this case?

15 A. The AEP/CSW case reflects a public interest standard of requiring a net benefit

16 rather than a mere showing of no harm. As to my subsidiary questions: (a)

17 benefits to whom? – benefits are to ratepayers; (b) benefits of what nature? – a

18 broad range of benefits are counted; and (c) do the benefits have to be unique to

19 the transaction? – no, there is no mention of benefits being achieved absent the

20 transaction.

21

22 In addition, as with the TNP case, the AEP/CSW case had a significant number of

23 detailed commitments or conditions to assure the transaction was consistent with

24 the public interest. And many were enforceable in the sense (a) the commitment

[65] Id. at 12 at J.
[66] Id. at 18-25.

1 was stated in terms of a quantifiable measure or metric and (b) there were explicit
2 penalties for failing to meet the commitment.
3

4 **C. An Oregon Commission Case Concerning the Acquisition of PGE by**
5 **TPG**
6

7 Q. Please briefly describe the first Oregon case.

8 A. In 2004, investors related to Texas Pacific Group (TPG) proposed to acquire
9 Portland General Electric Company (PGE) from Enron Corporation (Enron).[67]
10 PGE was an electric utility serving about 750,000 customers in Portland, Salem,
11 and neighboring areas in Oregon.[68]
12

13 Q. How did the Oregon Commission rule?

14 A. The Oregon Commission denied the proposed acquisition.
15

16 Q. Was Enron in bankruptcy?

17 A. Yes. In 2001, Enron had filed for bankruptcy. Of considerable note is the fact
18 that *PGE was not in bankruptcy and had kept its investment grade rating with*
19 *Moody's and Standard & Poor's*. The Oregon Commission stated:

20 PGE is not in bankruptcy and continues to operate in a manner that
21 effectively serves its customers. In terms of daily operations, Enron has
22 let PGE operate as a stand-alone company. *See* ICNU/906. As explained
23 by Peggy Fowler, PGE's CEO and President, Enron has "allowed us to
24 stay focused on providing safe, reliable and cost-efficient energy to our
25 customers, and the bankruptcy process has pretty much just gone on while

[67]OPUC Docket No. UM 1121, *In the Matter of Oregon Electric Utility Company, LLC, et al, Application for Authorization to Acquire Portland General Electric Company*, Final Order at 2 (March 10, 2005).
[68] Id. at 10.

1 we've continued to operate." *Id* at 5. PGE has also maintained and
2 invested in its system and made long-term commitments. *Id* at 15.
3
4 Financially, PGE has retained investment-grade credit ratings from
5 Moody's and from Standard & Poor's. *See* PGE/100, Piro/13. It has
6 adequate liquidity and stable operating cash flow. *See* Staff/200,
7 Morgan/50. Enron's bankruptcy has not impacted PGE's ability to access
8 capital and the utility is expected to operate over the foreseeable future
9 without problems. *See* ICNU/906 at 6; Staff/200, Morgan/56.[69]
10

11 Still, it was the Bankruptcy Court that had to approve the disposition of PGE
12 assets and it had, in fact, approved the proposed TPG acquisition.[70]
13
14 Q. How large was the proposed acquisition?
15 A. According to the Oregon Commission, the purchase price, fees and expenses for
16 this acquisition were about $1.47 billion and this would be financed from three
17 sources: (a) about $525 million in equity, (b) about $707 million in new debt, and
18 (c) about $240 million in dividends from PGE that had gone unpaid to Enron.
19 PGE had an additional $1.06 billion in debt.[71]
20
21 Q. What public interest standard did the Oregon Commission use?
22 A. This topic was addressed in detail by the Oregon Commission. First, the Oregon
23 Commission said the standard it used was founded on a 1985 Oregon law which
24 assured that financial acquisitions like this came under the purview of the Oregon

[69] Id. at 11.
[70] Id.
[71] Id. at 13.

Commission and that specific concerns would be addressed.[72] The legislation stated in part:

> (c) An attempt by a person not engaged in the public utility business in Oregon to acquire the power to exercise any substantial influence over the policies and actions of an Oregon public utility which provides heat, light or power could result in harm to such utility's customers, including but not limited to the degradation of utility service, higher rates, weakened financial structure and diminution of utility assets.[73]

Then, the Oregon Commission pointed to additional language which linked its ruling to the public interest and allowed for conditions to be required for winning of approval.

> If the commission determines that approval of the application will serve the public utility's customers in the public interest, the commission shall issue an order granting the application. The commission may condition an order authorizing the acquisition upon the applicant's satisfactory performance or adherence to specific requirements. The commission otherwise shall issue an order denying the application. The applicant shall bear the burden of showing that granting the application is in the public interest.[74]

However, the Oregon Commission noted that the PGE case "is one of first impression" because the Commission had applied the relevant law only in cases in which settlement had been achieved among the parties.[75]

Q. Did the Oregon Commission make an explicit choice of a net benefit or no harm standard?

---

[72] Id. at 14-15.
[73] Id. at 15.
[74] Id.
[75] Id. at 16.

1 A. Yes. The Oregon Commission called its public interest standard a *net benefit*

2 standard and described it as follows:

3 *Net benefit*. The meaning of "serve the public utility's customers in the
4 public interest" was the subject of a Commission investigation in docket
5 UM 1011. Utilities, consumer groups, and Staff provided input on the
6 applicable standard under the statute. The Commission resolved the
7 docket by issuing Order No. 01-778, which adopted a two-pronged legal
8 standard under ORS 757.511(3). After reviewing the text and context of
9 the statute, the Commission "read the verb 'serve' to indicate a net benefit
10 standard for merger approval." *See* Order No. 01-778 at 10. The
11 Commission went on to state that providing net benefits is a specific way
12 to cure the general concern enunciated in ORS 757.506 that a transaction
13 could harm customers. The order then set out a second requirement: "in
14 addition to finding a net benefit to the utility's customers, we must also
15 find that the proposed transaction will not impose a detriment on Oregon
16 citizens as a whole." *See* Order No. 01-778 at 11.[76]
17

18 Q. Which harms were of concern to the Oregon Commission?

19 A. The Oregon Commission began with a focus on four potential harms which it

20 described as follows:

21 The parties have identified several sources of harms to PGE and its
22 customers that arise from this transaction. Of the arguments raised by the
23 parties, the allegations that we find worth discussing include the debt
24 service requirements to finance this acquisition, TPG's short-term
25 ownership of PGE, lack of final financing terms, and lack of transparency.
26 We analyze those claimed harms to determine if the record supports
27 them.[77]
28

29 Q. How did the Oregon Commission describe the possible harm from "debt service

30 requirements to finance this acquisition?"

31 A. As to debt service, the Oregon Commission noted that the transaction would

32 increase the share of debt in PGE's capital structure from 51% to 77% on a

[76] Id. at 17.
[77] Id. at 21.

1 consolidated basis.[78] The Oregon Commission took note of several possible

2 harms driven by the increased reliance on debt:

3 Staff and Intervenors contend that the large amount of debt held by
4 Oregon Electric would result in the following potential harms: lower credit
5 ratings for PGE, undue pressure on PGE to make dividend payments to
6 Oregon Electric, and the risk of bankruptcy to Oregon Electric and PGE.
7 Staff and ICNU also raise concerns about the amount of variable rate debt
8 Oregon Electric expects to use.
9
10 We find these potential harms point to the possibility that PGE will not be
11 able to raise capital as cheaply as it would as a stand-alone company,
12 resulting in a weakened financial structure. Imprudent cost cutting and
13 reduced capital expenditures could also occur. Therefore, the possibility
14 of higher customer rates or reduced reliability arises from these potential
15 harms.[79]
16

17 Indeed, the Oregon Commission found the primary source of potential harm to be

18 "excessive amount of debt."

19 We identified several sources of harm in this application. The primary
20 source stems from Applicants' proposal to finance the purchase of PGE
21 with an excessive amount of debt. As discussed above, the high debt
22 percentage in the consolidated capital structure would likely result in
23 lower credit ratings for PGE than it would in absence of this transaction.
24 This large debt service requirement also presents the possibility that
25 Oregon Electric's debt will be less than investment grade, which increases
26 the likelihood that PGE may engage in imprudent cost cutting and reduced
27 capital investments if earnings drop. Moreover, this debt increases the
28 risks associated with the lack of final financing terms. We are also
29 concerned about imprudent cost cutting and reduced capital investment
30 due to the short term ownership of PGE.[80]
31

32 Q. What did the Oregon Commission say about possible benefits?

33 A. The Applicants had pointed to seven possible benefits: (a) a conditioned rate

34 credit of $43 million; (b) provisions providing some indemnification against

[78] Id.
[79] Id.
[80] Id. at 33-34.

1 Enron creditor claims; (c) continuation of service quality measures; (d) a "local
2 focus" for the Board of Directors; (e) TPG assistance with PGE's "transition"; (f)
3 continued donations to low-income customer programs; and (g) the end of Enron
4 ownership.[81]
5
6 Q. How did the Oregon Commission rule and on what basis?
7 A. The Oregon Commission denied the application. Again, the net benefit public
8 interest standard used by the Oregon Commission means that "[i]f the benefits
9 outweigh the harms, then the net benefit standard has been met and the
10 application must be granted. The Commission has discretion to issue a
11 conditional order approving the acquisition if certain requirements are met. If
12 those hurdles cannot be overcome, then the application must be denied."[82]
13
14 The Oregon Commission denied the application for the proposed acquisition by
15 TPG because it did not "provide a net benefit to PGE's customers."
16 We conclude that the collective risk these harms represent outweigh the
17 potential benefits of the acquisition, which we have shown are minimal.
18 Applicants have failed to establish that customers would be better served
19 under this acquisition than they would be if PGE remained as a separate
20 and distinct entity. Accordingly, the application, as presented, does not
21 provide a net benefit to PGE's customers.[83]
22
23 **D. An Oregon Commission Case Concerning the Merger of PGE and Enron**
24
25 Q. What is the next case?

[81] Id. at 29-33.
[82] Id. at 33.
[83] Id. at 34.

1 A. I mentioned above Enron's ownership of PGE, so I thought it would be useful to
2 review the Oregon Commission's case precedent which allowed Enron's
3 purchase. My primary interest is what commitments in the case helped PGE keep
4 its financial health despite Enron's bankruptcy.
5
6 Q. Please briefly describe that case.
7 A. In 1996, Enron Corp. (Enron) filed an application to merge with Portland General
8 Electric Company (PGE), under ORS 757.511. PGE was an Oregon public utility
9 owned by Portland General Corporation (PGC). After the merger, Enron would
10 be left as the surviving corporation.[84]
11
12 In 1996, Enron's headquarters were in Houston, Texas and held over $13 billion
13 in assets, while producing over $13 billion in annual revenue and $584 million of
14 net income. After the merger, PGC would make up around 20% of the assets and
15 income of Enron.[85]
16
17 Q. The Oregon Commission approved the merger with Enron. Were commitments
18 made to protect against harm or to assure benefits?
19 A. Yes. The Staff of the Commission (Staff) and Enron originally differed on what
20 commitments should be required. The final discussions occurred on April 24 and

---

[84] OPUC Docket No. UM 814, *In the Matter of the Application of ENRON CORP for an Order Authorizing the Exercise of Influence Over Portland General Electric Company,* Final Order at 1 (June 4, 1997).
[85] Id.

April 29, 1997, with the final issues being settled and the staff recommending that the Commission approve Enron's application.[86]

The last stipulation to be settled was determining how much monetary compensation and benefit Enron needed to guarantee for PGE's retail customers. The final number was put at $141 million.[87] The Oregon Commission stated the three components that the Staff and Enron used to come up with the final number. Those components were:

> The first component anticipated a clear benefit from the merger – a reduction of PGE costs resulting from Enron's oversight and the efficiencies resulting from combining similar corporate functions.
>
> Future trading floor margins, the second component, was compensation to PGE customers to offset a potential harm, namely the loss of these margins after the merger. Enron and PGE clarified in a letter to all parties in January that PGE intended to terminate certain term wholesale and retail trading activities after the merger. Because PGE customers had partially supported utility operations, including the trading floor, to acquire necessary resources to meet retail load, Staff argued that PGE customers were entitled to compensation for the margins this business unit would have generated and which would have been used to reduce PGE customer rates.
>
> The third component consisted of both compensation and benefits – compensation to PGE customers for the margins PGE would have made in the WSCC [Western Systems Coordinating Council] without the merger, and benefits of retail non-franchise margins resulting from Enron's use of PGE's name, customer relationships, and reputation as a skilled distributor of electric power.[88]

Q. Were there other commitments or, as the Oregon Commission termed them "stipulations"?

[86] Id. at 2.
[87] Id.
[88] Id. at 4.

1 A. Yes. There were an additional 21 stipulations made, making a total of 22
2 stipulations.[89] In addition to the commitment to provide ratepayers with monetary
3 compensation, six of the stipulations, Stipulations 4 through 9, were used to
4 enhance the Commission's ability to protect PGE from potentially being
5 weakened by Enron. These included (a) merger costs could not be imposed on
6 PGE, (b) PGE's cost of capital would not rise as a result of the merger, (c) PGE
7 must maintain its own debt rating, (d) the Commission must be notified of certain
8 dividends and distributions to Enron, (e) the common equity portion of capital
9 structure must be maintained at 48%, and can only be changed with Commission
10 approval, and (f) the Commission will have access to information provided to the
11 financial community including stock and board analysts.[90]
12
13 Stipulation 11 addressed multiple service quality measures that PGE needed to
14 meet.[91] To ensure that these measures were met, "PGE will be subject to revenue
15 requirement reductions if it does not meet certain performance targets established
16 annually."[92]
17
18 Q. Were there other important mitigation measures?
19 A. Yes. The Commission also was given significant authority by Enron and PGE to
20 monitor PGE and impose penalties. For example, the Commission had the power
21 to audit both Enron and its unregulated subsidiaries regarding the bases for

[89] Id. at 5-7.
[90] Id. at 5, 6.
[91] OPUC Docket No. UM 814. Final Order, Exhibit A at 3 (June 4, 1997).
[92] OPUC Docket No. UM 814. Final Order at 6 (June 4, 1997).

1 charges to PGE (Stipulation #1), and it had access to all of PGE's books
2 pertaining to the transactions with affiliated interests (Stipulation #2).[93] In
3 addition, the Commission had the ability to enforce the compliance of Enron and
4 PGE with the conditions and commitments, and to impose penalties. As stated in
5 the Order:

6 To facilitate the Commission's enforcement of Enron's and PGE's
7 compliance with the conditions and commitments 1 through 20 (except 11
8 and 18), condition 21 of the Stipulation allows the Commission to impose
9 penalties, under certain circumstances, without first obtaining a court
10 order.[94]
11

12 Q. How would you characterize the public interest standard used by the Oregon
13 Commission?
14 A. Ultimately, I see it as a net benefits standard, but mitigation of harm was a crucial
15 part of meeting the standard. In making the decision to approve the merger, the
16 Oregon Commission stated:

17 Based on the record in this proceeding, the Commission finds that
18 approval of the merger on the conditions set forth in the Stipulation will
19 not harm PGE's customers, will not result in the degradation of PGE's
20 service, will not result in higher rates to PGE customers, will not weaken
21 PGE's financial structure and will not diminish PGE's utility assets. The
22 Commission finds that approval of the merger will provide benefits to
23 PGE's customers and will serve PGE's customers in the public interest.[95]
24

25 The Oregon Commission was clearer on the net benefits when it tallied up the
26 $141 million compensation. The final dollar value that was agreed upon was
27 made up of:

[93] OPUC Docket No. UM 814. Final Order, Exhibit A at 2 (June 4, 1997).
[94] Id.
[95] Id. at 9.

> $36 million in cost-of-service savings which would otherwise not be available to PGE customers, and $105 million in compensation and additional benefits. Based on the record, we find that this level of compensation and benefit satisfies the higher 'benefit' standard. Therefore it necessarily satisfies the lower 'no harm' standard.[96]

Q. What is the broader purpose you mentioned for reviewing this case precedent?

A. More broadly, in looking at this case I wanted to figure out what measures were put in place that allowed PGE to survive Enron's bankruptcy and maintain investment grade ratings with two of the three rating agencies.[97] From PGE's 2003 10-K, we were able to extract a number of points that PGE believed helped it to maintain its status.

First, as a result of the structures in place, PGE had not paid cash dividends to Enron since the second quarter of 2001 because of Enron's bankruptcy. This allowed it to have more cash on hand, thus giving it more liquidity and the ability to secure financing. PGE stated:

> Both regulatory 'ring fencing' provisions and the establishment of a bankruptcy remote structure have effectively insulated PGE and its customers from adverse affects of Enron's bankruptcy. PGE has not paid a cash dividend since the second quarter of 2001, increasing the Company's equity position and strengthening its balance sheet. The added protection helps secure financing and positions the Company for investment in any new power supply resources.[98]

Q. Were there other measures PGE pointed to?

A. Yes. When listing the "structural and regulatory mechanisms to protect the Company's assets from Enron and its creditors," PGE included: (a) PGE had

---

[96] Id. at 5.
[97] *Portland General Electric Company 10-K, 2002*.
[98] *Portland General Electric Company 10-K, 2003* at 28.

separate, full responsibility for day-to-day operations; (b) PGE financed itself separately for both short- and long-term; (c) there was no inter-company debt or debt guarantees; and (d) Enron's access to PGE cash and assets was explicitly limited by conditions set by the Oregon Commission. PGE stated:

> Although measures of PGE's financial performance, including financial ratios, remain strong, due to continuing uncertainty regarding the impact of Enron's bankruptcy on PGE, management is unable to predict what actions, if any, will be taken by the rating agencies in the future. However, PGE management believes there are sufficient structural and regulatory mechanisms to protect the Company's assets from Enron and its creditors and there are no economic incentives for Enron to cause PGE to file for bankruptcy protection. PGE, as a separate corporation, owns or leases the assets used in its business and PGE's management, separate from Enron, is responsible for PGE's day-to-day operations. PGE maintains its own cash management system and finances itself separately from Enron, on both a short and long-term basis. Neither PGE nor Enron have guaranteed the obligations of the other and there are no loans between them. Under Oregon law and specific conditions imposed on Enron and PGE by the OPUC in connection with Enron's acquisition of PGE in the merger of Enron and Portland General Corporation in 1997, Enron's access to PGE cash or utility assets (through dividends or otherwise) is limited. PGE is a solvent enterprise whose greatest value is as a going concern. In a bankruptcy, Enron would lose most, if not all, control over PGE. It would merely continue to be the holder of PGE's common stock, and PGE, as a Debtor in Possession, would be managed by its management or, as is the case with Enron in its bankruptcy, new management brought in for that purpose. Any plan of reorganization would be devised by PGE management and approved by PGE's creditors, not Enron or its creditors. No dividends could be paid to Enron, no assets could be sold, and no other transfer of funds could be made except with the approval of the PGE creditors and the Bankruptcy court. PGE believes that the OPUC would challenge any attempt in the bankruptcy proceedings to sell assets, transfer stock, or otherwise affect the activities of PGE without the approval of the OPUC.[99]

E. An Arizona Commission Case Concerning the Acquisition of Unisource By KKR

Q. Finally, please describe the Arizona case precedent.

[99] Id. at 39, 40.

1 A. In December 2003, Unisource Energy Corporation (Unisource) and Saguaro
2 Acquisition Corp. proposed a Plan of Merger.[100] Unisource was the holding
3 company for Tucson Electric Power Company (TEP) as well as for UniSource
4 Energy Services, UNS Gas, UNS Electric and other non-utility affiliates.[101] TEP
5 was an electric generation, transmission and distribution company which serves
6 customers in Pima and Cochise Counties in Arizona.[102] Saguaro Acquisition
7 Corp. was ultimately controlled by KKR, J.P. Morgan Partners, and Wachovia
8 Capital Partners.[103]
9
10 Q. How did the Arizona Commission rule?
11 A. The Arizona Commission rejected the proposed acquisition.
12
13 Q. What was the price offered in this acquisition?
14 A. Saguaro planned to provide about $1.2 billion in capital to the merged companies,
15 reflecting the combination of about $556.7 million in equity and $660 million in
16 debt. Of the $1.2 billion, about $880 million would be paid to buy the
17 outstanding stock of UniSource and up to $263 million would be an equity
18 infusion to TEP with the purpose of bringing TEP's capital structure to 60% debt
19 and 40% equity.[104] The equity share had been 25%.[105]

---

[100] Arizona Corporation Commission Docket No. E-04230A-03-0933, *In the Matter of the Reorganization of Unisource Energy Corporation*, Final Order at 2 (Jan. 4, 2005).
[101] Id.
[102] Id.
[103] Id. at 3.
[104] Id. at 4.
[105] Id. at 9.

1 Q. Did the Arizona Commission address the nature of the public interest standard to

2 be used?

3 A. Yes. In its Order, the Arizona Commission reflected significant discussion of the

4 public interest standard to be used. UniSource argued that the "No Harm Rule"

5 borrowed from Affiliate Interest Rules should be the sole standard.[106] Unisource

6 said that rule – referred to as Rule 803(C) – provided for the following:

7 At the conclusion of any hearing on the organization or reorganization of a
8 utility holding company, the Commission may reject the proposal if it
9 determines that it would impair the financial status of the public utility,
10 otherwise prevent it from attracting capital at fair and reasonable terms, or
11 impair the ability of the public utility to provide safe, reasonable and
12 adequate service.[107]
13
14 UniSource claimed that Rule 803(C) defined the "public interest."[108] The Arizona

15 Commission disagreed, saying a broadly defined public interest standard must be

16 used. The Arizona Commission stated:

17 Although Rule 803(C) establishes a minimum standard for Commission
18 consideration of affiliate transactions, it is not the only applicable standard
19 of review. The Commission has a constitutional duty to make and enforce
20 reasonable rules, regulations and orders to protect the convenience,
21 comfort, safety and health of employees and patrons of public service
22 corporations. Ariz. Const. Art. 15 § 3. The Commission must act in the
23 "public interest." *James P. Paul Water Co. v. Arizona Corporation*
24 *Commission*, 137 Ariz. 426, 429, 671 P.2d 404, 407 (1983). The inquiry
25 into the "public interest" is broad and the Commission should examine all
26 the evidence available in determining what is in the public interest.[109]
27

28 Q. Did the Arizona Commission choose a no harm or a net benefit standard?

[106] Id. at 6.
[107] Id. at 6-7.
[108] Id. at 7.
[109] Id. at 28.

1 A. The Commission emphasized that the public interest must be determined case-by-
2 case and, in this case before it, ratepayers must receive "tangible benefits." It
3 stated:

4 The individual circumstances of each case influence the scope and breadth
5 of the "public interest" inquiry. In some case, the guidelines of R14-2-
6 803(C) may comprise the entire analysis of whether a proposal is in the
7 public interest. In other cases, circumstances may dictate that the analysis
8 of the "public interest" go beyond the specific language of Rule 803
9 (C).[110]
10

11 The Arizona Commission discussed an episode from the 1990s where TEP was
12 near bankruptcy and the Arizona Commission took action under the public
13 interest standard to help. One of the actions was to allow the cost of capital
14 reflected in rates to include a 44% equity share – which increased rates because
15 equity is more expensive – when in reality the company was leveraged with 100%
16 debt.[111] The Arizona Commission found that this historical fact – that benefits
17 once flowed from ratepayers to TEP – in part required the Commission to assure
18 "that ratepayers are not only protected from harm, but also receive tangible
19 benefits as a result of the proposed sale."[112]
20
21 In response to the claim by UniSource that it had no way of knowing the tangible
22 benefits standard, the Arizona Commission said that it was rooted in the
23 requirement to act in the public interest, a requirement set by the Arizona
24 Constitution which had been in place since Arizona statehood was established:

---

[110] Id. at 29.
[111] Id. at 30-31.
[112] Id. at 31.

1 Our discussion of "tangible benefits" in the context of this case is not
2 intended as a discussion of the law; it is, instead, part of our evaluation of
3 the facts. In response to UniSource's claim that it was not provided with
4 notice of the standard to be applied in this case, we would note that Article
5 XV of the Arizona Constitution, which is the source of our constitutional
6 duty to consider the public interest, has been in place since Arizona's
7 statehood. We must therefore conclude that UniSource had appropriate
8 and adequate notice of the applicable legal standards.[113]
9

10 Q. Were conditions set for approval?

11 A. Yes. To help win Arizona Commission approval for the proposed transaction,

12 UniSource and the KKR investors offered several conditions or commitments.

13 Arizona Commission Staff recommended that these conditions should be

14 strengthened and that some conditions should be added.[114]

15

16 The conditions offered by Unisource ranged from financial ring-fencing to

17 commitment involving service quality and reliability and corporate governance.

18 The Arizona Commission summed up these conditions as follows:

19 After receiving the comments of Commission Utilities Division Staff
20 ("Staff ") and the Residential Utility Consumer Office ("RUCO") in their
21 direct testimony, UniSource presented numerous conditions that it
22 believed would address the concerns of Staff and RUCO. (A-2) The
23 commitments and conditions that UniSource has agreed to as part of the
24 proposed Merger are set forth in Exhibit B, attached hereto and
25 incorporated herein. (A-3) The proposed conditions include terms and
26 commitments intended to safeguard the financial integrity of the utilities
27 often referred to as "ring-fencing"; service quality and reliability;
28 relationships between affiliates; corporate governance, oversight and
29 community presence; and the non-recoverability of merger and affiliate
30 costs.[115]
31

[113] Id. at 41.
[114] Id. at 46.
[115] Id. at 5.

1 Q. What sort of strengthening of commitments was proposed by Arizona
2 Commission Staff?
3 A. The strengthening proposed by the Arizona Commission Staff was summarized
4 by the Arizona Commission as follows:

5 Staff has recommended a number of conditions, attached hereto as Exhibit
6 C, all of which Staff believes are necessary if the Commission determines
7 to approve the reorganization. Staff would oppose the proposed Merger if
8 its recommended conditions are not adopted. Even if all of Staff's
9 recommended conditions are adopted, Staff is neutral on whether the
10 reorganization should be approved. Staff believes that the conditions
11 UniSource proposed are critical components of the transaction, but fall
12 short in several areas. Staff believes the areas that need strengthening
13 include the amount of debt reduction at TEP through 2008; bankruptcy
14 protection for the utility affiliates; how to determine the appropriate level
15 of operations and maintenance expenditures; Commission approval for
16 changes in the limited partners; and how to define community support.[116]
17

18 Q. What condition did Arizona Commission Staff want with respect to bankruptcy
19 protection?
20 A. With respect to bankruptcy protection, Staff wanted to assure "separateness
21 covenants" would be included in all new debt agreements. Specifically, Staff
22 wanted the following language:

23 All Saguaro and UniSource debt will include separateness covenants,
24 which will remain effective as long as TEP and UES are owned by
25 Saguaro and UniSource, and which will state that: (a) Saguaro and
26 UniSource and separately TEP and its utility affiliate UES are being
27 operated as separate corporate and legal entities and that lenders to
28 Saguaro and UniSource, in agreeing to make loans, are relying and have
29 relied solely on the creditworthiness of Saguaro and UniSource based on
30 the assets and equity interests owned by those entities. The repayment of
31 Saguaro and UniSource indebtedness will be made solely from assets of
32 Saguaro and UniSource and not from any assets or pledge of assets of TEP
33 or UES. Saguaro, UniSource, and their respective lenders will not take
34 any steps for the purpose of procuring the appointment of an
35 administrative receiver or the making of an administrative order for

[116] Id. at 12.

1 instituting any bankruptcy, reorganization, insolvency, wind up or
2 liquidation, or any like proceeding under applicable law which includes
3 TEP or UES or any of the assets or liabilities of these utilities; and (b)
4 Saguaro and UniSource agree that any future material indebtedness will
5 comply with the foregoing restrictions. (Antonuk Surrebuttal at 7)[117]
6

7 Q. Were Unisource and KKR willing to accept this?

8 A. No. Unisource was willing only to offer that it would "use their reasonable best
9 efforts to ensure that all material debt facilities entered into after the date hereof
10 will include separateness covenants or acknowledgements."[118]
11

12 Q. Did Arizona Staff agree with Unisource's proposed minimum for capital
13 expenditures?

14 A. No. Arizona Staff also had concerns about Unisource's commitments to O&M
15 and capital expenditures. Staff proposed a Commission-sponsored management
16 and operations audit. In response, UniSource proposed that it spend a minimum
17 of $1.5 billion in capital investment over the four year period from 2005 through
18 2008.[119] Staff felt that there was no way of judging whether this level was "too
19 much or too little."[120]
20

21 Q. Did Unisource and KKR propose restrictions on dividends?

[117] Arizona Corporation Commission Docket No. E-04230A-03-0933, *In the Matter of the Reorganization of Unisource Energy Corporation*, *Final Order*, Staff Attachment A at 4 ("Necessary Conditions").
[118] Arizona Corporation Commission Docket No. E-04230A-03-0933, *In the Matter of the Reorganization of Unisource Energy Corporation,* Final Order, Exhibit B at 4 ("Unisource Energy's Modifications to the Proposed Conditions").
[119] Arizona Corporation Commission Docket No. E-04230A-03-0933, Final Order at 16.
[120] Id. at 17.

1 A. Yes. UniSource proposed restrictions on dividend payments such as this one in
2 which dividends could not be more than 75% of earnings if its capital structure
3 was not at least 40% equity:

4 TEP, UNS Electric and UNS Gas, without prior approval of the
5 Commission, will not issue dividends which compromise more than
6 seventy-five percent (75%) of its current year's earnings if its equity
7 capitalization equals less than 40% of total capital, calculated as stated in
8 Decision No. 66028.[121]
9

10 Q. What governance conditions were proposed?

11 A. Unisource and KKR proposed that all the entities have separate Boards and that
12 all Boards have at least some independent members:

13 Separate Utility-Level Boards with Independent Directors.
14
15 TEP, UES, UNS Electric and Gas each will have a Board of Directors
16 comprised of at least five (5) persons. At least two (2) of the Board
17 members will be Arizona residents and at least two (2) will qualify as
18 "independent" of UniSource Energy, Saguaro Holdings, Saguaro LP, and,
19 any of Saguaro LP's partners and KKR, JPMP and WCP and any entities
20 they control, as the term "independent" is interpreted under Section 303A
21 of the New York Stock Exchange Listing Company Manual.[122]
22

23 Q. Are there any other commitments worth noting?

24 A. Yes. UniSource also allowed for considerable Arizona Commission authority
25 over non-utility investments:

26 Commission Authority Over Non-Utility Investments.
27
28 Saguaro LP, Saguaro Holdings and UniSource Energy will not, without
29 prior Commission approval, make any new, material non-regulated, non-
30 utility investments (other than investments in Millennium ventures) that
31 are not part of the electric energy business.[123]
32

[121] Arizona Corporation Commission Docket No. E-04230A-03-0933. Final Order, Exhibit B at 1.
[122] Id. at 6.
[123] Id.

Q. How did the Arizona Commission rule?

A. In the end the Arizona Commission found that, despite the commitments, the proposed transaction was not in the public interest because there were insufficient tangible benefits. Specifically, it found the following:

> As it is presently structured, we do not find the ratepayers receive a tangible benefit as a result of the proposed Merger. We also find based on all the evidence, that the proposed reorganization, as it is presently structured, is not in the public interest. The purported benefits claimed by the Merger's proponents of an improved TEP capital structure; increased liquidity; a continued local community presence; and retention of current management; are clearly not sufficient to outweigh the potential detriments and risks of the transaction. The risks of increased leverage, and the detriments of the partnership structure with a concentration of power in a general partner inexperienced in the public utility sector, and uncertainties concerning Commission oversight over the new entities, outweigh the claimed benefits.[124]

The Arizona Commission noted its concern that the transaction – because UniSource would no longer be a public company – would mean too little access to the information needed by the Commission to do its job. It noted, too, that the behavior of the investors in the case itself aggravated the Commission's concerns.

> One of our major concerns about the proposed transaction is the limited partnership structure. The Commission has the constitutional and statutory authority to examine, inspect and investigate the books and records of public service corporations. The limited partnership structure is not as conducive to the disclosure of information as a publicly traded corporate structure. As a publicly traded corporation, UniSource is currently subject to broad disclosure requirements. As has been demonstrated in the course of this proceeding, the Investors believe they can shield otherwise relevant information from the Commission merely by keeping it at a level of the organization an additional step above the public service corporation on the organization chart.[125]

[124] Arizona Corporation Commission Docket No. E-04230A-03-0933, Final Order at 31.
[125] Id. at 34.

1 **IV. NATURE AND IMPACT OF THE ACQUISITION**

2

3 Q. What topics do you address in this section?

4 A. In this section, I first describe the nature of the proposed acquisition in terms of
5 the parties involved and, more importantly, the financing of the transaction. I
6 then turn to the possible impact of the transaction as seen by bond rating agencies.
7 I conclude with a list of ten possible harms from the transaction that must be
8 mitigated.

9

10 **A. Overview of the Acquisition**

11

12 **1. The companies involved**

13

14 Q. Please provide a brief description of the companies involved in the acquisition.

15 A. The companies were described by the Applicants as follows:

16

17 • Texas Energy Future Holdings Limited Partnership (TEF) is owned by
18 affiliates of KKR and TPG. TEF was formed solely for the purpose of
19 acquiring TXU.[126]

20

21 • Texas Energy Future Merger Sub Corp (Merger Sub) is a subsidiary of TEF
22 formed solely for the purpose of completing the proposed transaction. It will
23 not exist after consummation of the transaction and will merge into TXU.[127]

[126] Proxy at 12 (as defined).

1 • TXU Corp. (TXU) is a holding company that mainly conducts its operations
2 through its portfolio of competitive and regulated energy businesses
3 (respectively, Competitive Holdings, Oncor, and their subsidiaries).[128]
4
5 • Oncor Electric Delivery Holdings (Oncor Holdings) is a holding company
6 inserted by TEF to further insulate Oncor from TXU.[129]
7
8 • Oncor Electric Delivery Company (Oncor), formerly TXU Electric Delivery
9 Company[130] provides transmission and distribution services to retail electric
10 providers that sell power in the north-central, eastern and western part of
11 Texas. Oncor provides power to over 3 million electricity delivery points
12 using more than 100,000 miles of distribution lines and 14,300 miles of
13 transmission lines.[131]
14
15 • Oncor Electric Delivery Transition Bond Company, LLC is a wholly owned
16 subsidiary of Oncor. It is a bankruptcy-remote financing subsidiary, created
17 for the purpose of issuing securitization bonds to recover generation-related
18 asset stranded costs and other qualified costs.[132]
19

---

[127] Id. (as defined).
[128] Id. (as defined).
[129] Joint Report at 6. (as defined).
[130] Id. at 5. (as defined).
[131] TXU Electric Delivery Company 10-K, 2006 at 1. (as defined).
[132] Oncor Electric Delivery Company 10-Q at 4 (March 3, 2007). (as defined)

1 • Texas Competitive Electric Holdings Company, LLC (Competitive Holdings) – formerly TXU Energy Company, LLC (name change effective June 29, 2007[133]) – is a holding company for the retail electric provider (TXU Energy Retail) and for the wholesale and power generation businesses (Luminant).[134]

6 • TXU Energy Retail Company, LLC (TXU Energy Retail) is a subsidiary of Texas Competitive Holdings and is engaged in the sale of retail power.[135] It provides electricity and related services to over 2.1 million customers in Texas.[136]

11 • TXU Portfolio Management Company, LP (Luminant Energy) is a subsidiary of Texas Competitive Holdings and is currently doing business as Luminant Energy.[137] Luminant Energy is TXU Corp's wholesale business, which optimizes the purchases and sales of energy for TXU Energy and Luminant Power.[138]

17 • Luminant Power is TXU Corp's generation business, which has over 18,300 MW of generation in Texas, including 2,300 MW of nuclear generation capacity and 5,800 MW of coal generation capacity.[139]

20

[133] Texas Competitive Electric Holdings Company 8-K at Item 8.01 (June 29, 2007). (as defined)
[134] Proxy at 12. (as defined)
[135] TXU 10-Q at page v (June 30, 2007). (as defined)
[136] Proxy at 12. (as defined).
[137] TXU 10-Q at page v (June 30, 2007). (as defined).
[138] Proxy at 12. (as defined).
[139] Id. (as defined).

1 **2. Financing the acquisition**

2

3 Q. When was the acquisition announced?

4 A. On February 25, 2007, the acquisition of TXU by TEF was announced. On that
5 day TEF entered into an Agreement and Plan of Merger (the "Merger
6 Agreement").[140]

7

8 Q. What does the Merger Agreement call for?

9 A. The Merger Agreement is an extensive document, but there are two key actions
10 relevant at the outset. First, TEF tells us it will pay $69.25 per share to buy the
11 existing shares of the publicly traded stock for TXU.[141]

12

13 Second, TEF states: "As a result of the Merger, TXU Corp. would become a
14 subsidiary of Parent [TEF] and no longer be a publicly held corporation, and its
15 Common Stock would be delisted from the New York and Chicago stock
16 exchanges."[142]

17

18 Q. How much will the acquisition cost and how will that cost be financed?

19 A. TEF estimated that the amount of funds required to complete the transaction is
20 approximately $46.7 billion.[143] The question of most concern is how much debt

---

[140] Id. at A-1.
[141] Id.
[142] Id.
[143] Id. at 84

1 will be incurred to fund the acquisition. From a high-level view, I come at that
2 from two perspectives which result in a nearly identical number.
3
4 First, after telling us it will need $46.7 billion to complete the transaction, TEF
5 tells us it will raise $8 billion in equity.[144] Given this, the remainder of the funds
6 will be funded with debt so the total debt will be $38.7 billion ($46.7 billion
7 minus $8 billion).
8
9 Second, TEF tells us it has commitments for up to $26.1 billion in new debt.[145]
10 As of June 30, 2007, TXU and its subsidiaries reported $12.7 billion in existing
11 long-term debt.[146] Again, that is a total of $38.8 billion of new, assumed,
12 refinanced, or redeemed debt ($26.1 billion plus $12.7 billion).
13
14 Based on this, I conclude that the acquisition would approximately triple the debt
15 of TXU and its affiliates from about $12.7 billion today to about $38.7 billion if
16 the acquisition is completed.
17
18 Q. Who will provide the new debt?
19 A. Those committed to arrange the $26.1 billion in new debt include affiliates of
20 Citigroup, Credit Suisse, Goldman Sachs Credit Partners L.P., JP Morgan Chase,
21 Lehman, and Morgan Stanley. These same parties stand ready with $11.25 billion

[144] Id.
[145] Id.
[146] TXU 10-Q at 19 (June 30, 2007).

1 in "bridge financing".[147] These bridge loans would be used in lieu of the high
2 yield new debt if it was not secured when needed.[148]
3
4 Q. Who will provide the equity?
5 A. Of the $8.0 billion in equity financing for the acquisition, $6.5 billion of cash at
6 closing will be from "KKR 2006 Fund L.P. and TPG Partners V, L.P. The
7 remaining $1.5 billion cash will come from three bridge investors (J.P. Morgan
8 Ventures Corporation, Citigroup Global Markets Inc. and Morgan Stanley & Co.
9 Incorporated)."[149]
10
11 These equity investors can in turn assign all or a portion of their equity
12 commitment obligations to other investors, provided that they remain obligated to
13 perform to the extent not performed by assignee.[150]
14
15 Q. Which TXU subsidiary will incur the new debt?
16 A. The majority of the new debt is anticipated to be incurred by Competitive
17 Holdings (formerly TXU Energy Company LLC), secured and guaranteed by
18 substantially all of the assets of Competitive Holdings and its subsidiaries.[151]

---

[147] Proxy at 84.
[148] Id. at A-36.
[149] Id. at 84.
[150] Id. "As of the date of this proxy statement, the Sponsors and Bridge Investors have obtained approximately $1.8 billion in equity commitments from other existing investors in the Sponsors' private equity funds, which commitments are expected to be used at closing to reduce the commitments of the Sponsors and Bridge Investors. In addition, investment vehicles affiliated with each of Goldman Sachs and Lehman Brothers have committed to contribute directly or indirectly through other vehicles, up to $1.5 billion of cash and $400 million of cash, respectively, to Parent in connection with the Merger. These committed amounts are expected to be used at closing to reduce the commitments of the Sponsors."

1 Q. Which TXU subsidiaries hold the existing debt?

2 A. TXU's approximately $12.7 billion of long-term debt as of June 30, 2007 was
3 composed approximately of: $3.74 billion TXU, $1.03 billion Oncor Electric
4 Delivery Transition Bond Company, $3.83 billion Oncor Electric Delivery, $3.89
5 billion Competitive Holdings, and $0.22 billion U.S. Holdings. Note that these
6 amounts also include $0.8 billion of long-term debt to be paid this year.[152]
7
8 Q. How will the new debt be used?

9 A. The bulk of the new debt will be used to purchase all existing shares of TXU
10 stock. The stock purchase will cost an estimated $31.9 billion. This reflects the
11 facts that the offer price per share is $69.25 and there are approximately 461
12 million shares.[153]
13
14 **B. The Bond Rating Agencies' Views**
15
16 Q. Have concerns been raised about the increase in debt you have cited?

17 A. Yes. After the announcement of the acquisition, all three rating agencies
18 indicated their concerns about the amount of debt to be undertaken by TXU and
19 took some action regarding credit ratings for TXU and its subsidiaries:
20 Standard & Poor's lowered TXU's corporate credit rating to speculative grade
21 (from BBB- to BB) and placed it on watch for a possible further downgrade.
22 Standard & Poor's stated:

---

[151] Proxy at 84.
[152] TXU 10-Q at 18-19 (June 30, 2007).
[153] Proxy at 13.

1 On March 2, 2007, Standard & Poor's Ratings Services lowered its
2 corporate credit rating on Dallas, Texas-based TXU Corp. to 'BB' from
3 'BBB-'. Standard & Poor's also lowered its senior unsecured debt rating
4 on the company to 'BB-' from 'BB+'. The ratings on TXU remain on
5 CreditWatch with negative implications.[154]
6

7 Moody's placed the ratings for TXU and all of its subsidiary entities, including

8 Oncor (TXU Delivery) and TXU Competitive Holdings (formerly TXU Energy

9 Company, LLC) on review for possible downgrade. Moody's stated:

10 On February 26, 2007, TXU announced that it had entered into an
11 agreement to be acquired by a consortium of private equity investors in
12 what we anticipate will be a highly leveraged transaction. …As a result,
13 the ratings for TXU and all of its subsidiary entities, including TXU
14 Delivery and TXU Energy, were placed on review for possible
15 downgrade.[155]
16

17 Fitch downgraded the ratings of TXU and its subsidiaries, including Oncor. Fitch

18 stated:

19 Fitch downgraded the ratings of TXU and its subsidiaries; Energy,
20 Delivery and TXU US Holding (IDR 'BB+' by Fitch), on Feb. 26, 2007.
21 The rating actions followed the announcement that a Kohlberg, Kravis and
22 Roberts (KKR) and Texas Pacific Group-led consortium have signed an
23 agreement to acquire TXU for $45 billion. The rating actions were based
24 on Fitch's concerns that the acquisition of TXU would be funded through
25 a highly levered entity or result in the incurrence of substantial
26 indebtedness at the TXU holding company or subsidiary levels.[156]
27

28 Q. Are additional actions expected if the acquisition is completed?

[154] Standard & Poor's RatingsDirect, "TXU Corp. Ratings Cut To 'BB' On Acquisition Capital Plan; Rating Still On Watch Neg" at 2 (March 2, 2007).
[155] Moody's Investor Service, "Credit Opinion: TXU Electric Delivery Company," at 2nd page (Feb. 27, 2007).
[156] FitchRatings, "Fitch Rates TXU Subsidiaries' New $1B Notes; Remain on Negative Watch" at 1st page (March 13, 2007).

1 A. Yes. The rating agencies indicated that it is very likely that they would further
2 downgrade TXU if the transaction was completed with the debt levels
3 contemplated at the time of announcement.
4
5 Standard & Poor's indicated that it would likely downgrade TXU to well below
6 investment grade level. Standard & Poor's stated: "If the acquisition is successful
7 and the capitalization plan defined by management is established, we expect to
8 further downgrade TXU and TXU Energy. The corporate credit ratings will
9 likely fall to somewhere in the 'B' category."[157]
10
11 Moody's issued a special comment titled "Proposed Acquisition of TXU Corp by
12 a Consortium of Private Equity Investors Raises Potential for a Multi-Notch
13 Ratings Downgrade."[158]
14
15 Fitch indicated that it could further downgrade TXU to well below investment
16 level. Fitch said: "Fitch may take interim rating actions ahead of the
17 consummation of the transaction as further details are disseminated and TXU's
18 ratings may end up deep in the non-investment grade area."[159]
19
20 Q. Where did bond ratings stand for Oncor at the time of the announcement?

---

[157] Standard & Poor's RatingsDirect, "TXU Corp. Ratings Cut To 'BB' On Acquisition Capital Plan; Rating Still On Watch Neg" at 2 (March 2, 2007).
[158] Moody's Investors Service, Global Credit Research, "Proposed Acquisition of TXU Corp by a Consortium of Private Equity Investors Raises Potential for a Multi-Notch Ratings Downgrade," (March 2007).
[159] FitchRatings, "Fitch Downgrades TXU and Affiliates & Places All Ratings on Rating Watch Negative." at 1st page (Feb. 26, 2007).

1 A. Oncor had investment grade ratings from all three rating agencies.[160] For example, Standard & Poor's had the Oncor Corporate Rating and its Senior Unsecured Notes at triple B minus (BBB-) which is its lowest investment grade rating.[161]

5

6 Q. Could Oncor be downgraded by Standard & Poor's and Moody's as a result of this transaction?

8 A. Yes. Standard & Poor's did have both ratings on Credit Watch negative.[162] And Moody's indicated that it would also likely downgrade Oncor to below investment grade. Moody's said "The ratings for TXU Delivery are likely to be downgraded due to our expectation that the key financial credit ratios are going to deteriorate from current levels."[163]

13

14 Q. What will influence ratings for Oncor going forward?

15 A. The rating agencies indicated that future actions to downgrade Oncor would largely depend on the robustness of the ring-fencing measures implemented to protect its assets from other TXU affiliates and to provide assurances to meet PUCT requirements.

19

---

[160] Standard & Poor's RatingsDirect, "TXU Corp. Ratings Cut To 'BB' On Acquisition Capital Plan; Rating Still On Watch Neg" at 2 (March 2, 2007). Moody's Investor Service, "Credit Opinion: TXU Electric Delivery Company" at 1st page (Feb. 27, 2007). FitchRatings, "Fitch Downgrades TXU and Affiliates & Places All Ratings on Rating Watch Negative," at 2nd page (Feb 26, 2007).

[161] Standard & Poor's RatingsDirect, "TXU Corp. Ratings Cut To 'BB' On Acquisition Capital Plan; Rating Still On Watch Neg" at 2 (March 2, 2007).

[162] Id.

[163] Moody's Investor Service, "Credit Opinion: TXU Electric Delivery Company," at 2nd page (Feb. 27, 2007).

1 Standard & Poor's indicated that it did not lower the ratings for Oncor because its
2 management had strongly expressed an intention to maintain its investment grade
3 credit rating. However, it did place Oncor on the CreditWatch listing indicating a
4 potential that management could fail in meeting this intention. Standard & Poor's
5 stated:

6 The reason we did not lower the ratings on TXU Delivery is
7 management's strongly expressed intention to maintain TXU Delivery's
8 current credit rating by various means, including a ring-fencing structure
9 to separate it from TXU and affiliates and by a pledge not to increase debt
10 at this entity. The potential for management to fail in this goal is reflect
11 [sic] in the CreditWatch listing.[164]
12

13 Moody's views the Commission's reaction to the transaction as the most critical
14 aspect of a review for a possible downgrade. It also emphasized the need for
15 stand alone credit facilities for Oncor. Moody's stated:

16 Moody's incorporates a view that the new private equity owners will make
17 numerous assurances to regulators and market investors that they will
18 strive to maintain an investment grade capital structure for TXU Delivery,
19 which would be viewed positively by Moody's. Rating downgrades could
20 also be mitigated by establishing stand alone credit facilities for TXU
21 Delivery. However, the most critical aspect of the review for downgrade
22 will be the reaction of the PUCT, in our opinion, and we expect the
23 regulatory authorities to take a very active role throughout the approval
24 process.[165]
25

26 Fitch also highlighted the importance of PUCT regulation in helping to maintain a
27 higher rating for Oncor. Fitch said "Because of the continued regulation of

[164] Standard & Poor's RatingsDirect, "TXU Corp. Ratings Cut To 'BB' On Acquisition Capital Plan; Rating Still On Watch Neg" at 2 (March 2, 2007).
[165] Moody's Investor Service, "Credit Opinion: TXU Electric Delivery Company" at 2nd page (Feb. 27, 2007).

1 Delivery by the PUCT, Fitch expects that any further ratings actions on Delivery
2 may be more limited than those taken for its parent and affiliates."[166]
3
4 Q. Even with ring-fencing, do the ratings for TXU and its subsidiaries influence
5 Oncor's rating?
6 A. Yes. Even with robust ring-fencing measures, Oncor still faces the possibility of
7 a downgrade to below investment grade because of its affiliation with its more
8 risky parent, TXU. Standard & Poor's indicates that the "linkage usually
9 constrains the rating of an otherwise advantaged subsidiary to one full rating
10 category (three "notches") above the credit quality of the consolidated entity."[167]
11
12 Moody's indicates that "Where regulated utility entities are not well insulated
13 from unregulated affiliates, the ratings of these entities will be notched fairly
14 closely, generally within one or two notches… Where regulated utility entities
15 are strongly insulated the ratings will be driven more by the stand-alone credit
16 quality of each entity, and may be three or more notches apart."[168]
17
18 Fitch indicates that "If ring-fencing efforts are viewed as effective, then within
19 investment-grade categories, the debt ratings of a regulated utility subsidiary are
20 usually 1-2 notches higher than the ratings of its parent company."[169]

---

[166] FitchRatings, "Fitch Downgrades TXU and Affiliates & Places All Ratings on Rating Watch Negative" at 1st page (Feb. 26, 2007).
[167] Standard & Poor's RatingsDirect, "Ring-Fencing a Subsidiary" at 3 (Oct. 19, 1999).
[168] Moody's Investor Service, "Rating Methodology: Global Regulated Electric Utilities," at 12-13 (March 2005).
[169] FitchRatings, "U.S. Utilities Survey of State Public Service Commissions" (February 2004) at 2.

Another concern is that Oncor shares credit facilities with other TXU affiliates. These credit facilities have cross default provisions.[170] They also have provisions for interest rate hikes for downgrades in credit ratings.[171] For example, Moody's noted:

> We note that TXU Delivery shares its credit facilities with its more risky, non-regulated affiliate, TXU Energy Company LLC (Baa2 senior unsecured / on review for possible downgrade). The shared credit facilities had previously been viewed as a modest constraint to the rating for TXU Delivery, but now, as a result of the acquisition and likelihood for rating effects on both TXU as well as TXU Energy, these shared facilities are now being viewed as a major credit negative for TXU Delivery.[172]

Q. Do the rating agencies state other concerns?

A. Yes. Another concern raised by Fitch is the fact that 47% of Oncor's revenue comes from TXU Energy Retail Company. Fitch explained that:

> The concentration of customer receivables is a primary rating concern. Delivery's customers are not the end-users of the electricity, as is the case of distribution companies in other states, but rather, it is paid by the retail electric providers (REPs) that sell power directly to end-users. Affiliate TXU Energy is Delivery's largest customer, accounting for approximately 47% of revenues. The second-largest REP customer is Reliant Energy Inc. (senior unsecured rated 'B' by Fitch).[173]

Q. What are the most important points you take away from this review?

A. There are three points I take away from the review. First, the tripling of debt for TXU is a major concern for the debt rating agencies. Second, robust ring-fencing is key to keeping an investment grade rating for Oncor, but there are no

---

[170] TXU 10-Q, at 81 (June 30, 2007).
[171] TXU 8-K, at 2 (August 16, 2005 and March 31, 2005).
[172] Moody's Investor Service, "Credit Opinion: TXU Electric Delivery Company" at 2nd page (Feb. 27, 2007).
[173] FitchRatings, "Global Power/North America Credit Update TXU Electric Delivery Company" at 1 (Feb. 1, 2007).

1 guarantees. Third, PUCT regulation of Oncor also is a key factor in keeping an
2 investment grade rating for Oncor.
3
4 **C. Ten Possible Harms to Oncor from the Proposed Transaction**
5
6 Q. Do you agree with the bond rating agencies that the increased debt of TXU and its
7 subsidiaries could do harm to Oncor?
8 A. Yes. My concerns for Oncor arise from the role that it could be required to play
9 in helping TXU service the substantial amount of new debt that it will incur to
10 finance this transaction.
11
12 Q. Please lay out in specific terms how this possible harm might occur.
13 A. Yes. In summary, I see ten harms faced by Oncor *absent mitigation*.
14
15 1. Additional debt may be imposed on Oncor to finance the acquisition or
16 Oncor's assets may be pledged to guarantee new debt.
17
18 2. To service debt incurred by TXU, cash may be extracted from Oncor through
19 excessive dividends, management and shared services fees and/or inter-
20 company loans.
21
22 3. To generate more cash, Oncor may have to cut jobs.
23

4. To generate more cash, Oncor may have to defer or eliminate operation and maintenance (O&M) expenditures.

5. To generate more cash, Oncor may have to defer or eliminate capital expenditures (CapEx).

6. Cuts in jobs, O&M expenditures and CapEx can result in a decline in the reliability of the system.

7. Cuts in jobs, O&M expenditures and CapEx can result in higher risk to the health and safety of customers and/or employees.

8. Decline in the reliability of the system and higher risks to the health and safety of customers and/or employees may force the Commission to have to increase rates so that these harms can be mitigated.

9. Oncor may lose its investment grade rating which would result in higher borrowing costs, and thereby, Oncor's customers may pay higher rates.

10. Oncor faces the risk of being drawn into a TXU bankruptcy proceeding.

1 **V. MITIGATING THE TEN POSSIBLE HARMS**

2

3 Q. What topics do you address in this section?

4 A. In this section, I start with my list of the ten possible harms to Oncor from the
5 proposed acquisition, identify which of the fifteen commitments made by TEF, if
6 any, address each of these harms, and determine if the commitments substantially
7 mitigate the harm. If they do not, I recommend additional mitigation measures.
8 A summary of this section can be found earlier in my testimony in Table One.

9

10 **1. Additional debt may be imposed on Oncor to finance the acquisition**
11 **or Oncor's assets may be pledged to guarantee new debt**
12

13 Q. What is your first concern?

14 A. The first concern is that some of the new debt used to finance the acquisition will
15 be imposed directly on Oncor and/or that Oncor's assets will be pledged to
16 guarantee that new debt.

17

18 Q. Do any of the Applicants' fifteen commitments address this concern?

19 A. Yes. The Applicants' address this concern constructively with their No
20 Transaction-Related Debt at Oncor Commitment, which indicates that no new
21 transaction-related debt will be placed on Oncor and that none of Oncor's assets
22 will be used to guarantee any of the new debt related to this transaction.

23

24 The statement of the commitment is as follows:

1 **No Transaction-Related Debt at Oncor Commitment** - Oncor will not
2 incur, guaranty or pledge assets in respect of any incremental new debt
3 related to financing the Transaction at the closing or thereafter. Oncor's
4 financial integrity will be protected from the separate operations of TXU
5 Energy Retail and Luminant. [174]
6
7 Q. Are additional mitigation measures required?

8 A. Yes. The commitment must be extended to state that no transaction costs will be

9 recovered through Oncor.

10

11 **2. To service debt incurred by TXU, cash may be extracted from Oncor**
12 **through excessive dividends, management and shared services fees**
13 **and/or inter-company loans**
14

15 **a. Dividends**

16

17 Q. What is your second concern?

18 A. The second concern comes in three parts and the first part is that, to service (pay

19 the interest and principal on) debt incurred by TXU and its other affiliates,

20 excessive cash will be extracted from Oncor through excessive payments of

21 dividends by Oncor through Oncor Holdings to TXU.

22

23 Q. Do any of the Applicants' fifteen commitments address this concern?

24 A. Yes. The Separate Board commitment and the Independent Board commitment

25 address the concern.

26

27 These two commitments are stated as follows:

[174] Joint Report at 5.

1 **Separate Board Commitment** - At closing and thereafter, Oncor will
2 have a separate board of directors that will not include any members from
3 the boards of directors of TXU Energy Retail or Luminant.[175]
4
5 **Independent Board Commitment** - Each of Oncor Electric Delivery
6 Holdings and Oncor will have a board of directors comprised of at least
7 nine persons. A majority of the board members of each of Oncor Electric
8 Delivery Holdings and Oncor will qualify as "independent" in all material
9 respects in accordance with the rules and regulations of the New York
10 Stock Exchange ("NYSE") (which are set forth in Section 303A of the
11 NYSE Listed Company Manual and in Exhibit FMG-3) from TXU Corp.
12 and its subsidiaries (including TXU Energy Retail and Luminant), TPG
13 and KKR. Consistent with TEF's commitments, the directors of Oncor
14 and Oncor Electric Delivery Holdings will also not include any members
15 from the boards of directors of TXU Energy Retail or Luminant."[176]
16

17 I agree that these are constructive commitments, but they are not sufficient to
18 substantially mitigate this concern.
19
20 Q. What are your remaining concerns?
21 A. TEF indicates that Oncor will be protected from excessive dividends by having a
22 Board of Directors with the authority to prevent Oncor from paying a dividend if
23 the Board determines that it is in the best interest of Oncor not to do so.[177]
24 However, TEF appears to place a condition on how the Board can make such
25 dividend decisions. When asked if TEF would commit that the Oncor Board will
26 have an unrestricted right to determine whether to declare dividends or not, TEF
27 responded "yes" but, then, implied Oncor's Board could only restrict dividends
28 within the constraints of maintaining the debt-to-equity ratio at or below that

[175] Id.
[176] Id. at 7.
[177] Docket No. 34077, Direct Testimony of Frederick Goltz at 11.

1 prescribed by the Commission.[178] Specifically, here is the question we asked and

2 TEF's response:

3 Will TEF commit that the Oncor Board will have an unrestricted right to
4 determine whether to declare dividends or not? If not, please explain.[179]
5
6 Yes. Within the constraints of the debt-to-equity ratio established from
7 time-to-time by the Commission for rate-making purposes, Oncor's
8 independent board of directors is positioned to restrict dividends to
9 achieve a capital structure such that the debt component remains at or
10 below the prescribed debt-to-equity ratio, giving due regard to the current
11 and future cash needs and financial performance of Oncor in its
12 determinations, thus ensuring that Oncor maintains a conservative capital
13 structure going forward.[180]
14

15 Q. What should the role of Oncor Board be?

16 A. The Oncor Board must (i) have exclusive rights to declare dividends, (ii) commit

17 to maintain Oncor's investment grade ratings, and (iii) in pursuit of (ii) set cash

18 flow metrics that must be met before declaring dividends. The Commission must

19 approve the cash flow metrics.

20

21 Further, dividends may not be paid by Oncor if (a) Oncor does not maintain its

22 investment grade debt rating, (b) cash flow metrics are not met, (c) Reliability and

23 Safety Standards are not met, or (d) if TXU or any subsidiary is in bankruptcy.

24 The Commission must approve the reliability and safety standards.

25

[178] Attachment CRR-2, at item A.
[179] Id.
[180] Id.

1 If these additional mitigation restrictions are not required by the Commission,
2 there is a substantial risk that Oncor or its parent company could authorize
3 excessive dividends paid by Oncor.
4
5 Q. What do you mean by "cash flow metrics"?
6 A. An example of possible cash metrics can be obtained from Moody's credit rating
7 methodology for regulated electric utilities. Moody's identifies four primary
8 ratios: (i) Retained Cashflow / Adjusted gross debt, (ii) Funds From Operations
9 (FFO) / Adjusted gross debt, (iii) FFO / Interest, (iv) Adjusted gross debt /
10 Regulated Asset Value, or Capitalization. For each of these, Moody's provides a
11 range of values that it expects should be met by an investment grade company.[181]
12
13 Q. What do you mean by the Reliability and Safety Standards you cite?
14 A. Reliability and Safety Standards are discussed later in this section.
15
16 Q. Do you have other related concerns about the Board?
17 A. Yes. Another concern is that TEF will be able to influence the initial selection of
18 Members for the Oncor Board. TEF bases the independence of Oncor's Board on
19 the fact that six out of the (at least) nine directors will be independent directors in
20 accordance with the rules and regulations of the New York Stock Exchange

[181] Moody's Investors Service, Global Credit Research, "Rating Methodology: Global Regulated Electric Utilities," at 7,8, and 28 (March 2005).

1 (NYSE). However, the six independent directors will initially be selected by TEF
2 representatives through Oncor Electric Delivery Holdings.[182]
3
4 My concern is that the commitment, as stated, would only require independence
5 from TXU and its subsidiaries, TPG and KKR and this contradicts the NYSE
6 rules. There must also be independence from all parties to this transaction. The
7 mitigation for this concern is to require that, at a minimum, the term independent
8 when applied to Oncor Board Members must include independence from any
9 party to the acquisition or any affiliate of any party to the acquisition.
10
11 I note that TEF has already agreed to this broader condition as it relates to
12 potential minority investors. TEF indicates that it might sell a minority stake of
13 Oncor to an independent third party. TEF agrees that a minority stake "will be
14 sold to an investor not affiliated with any of the companies owned by TXU or the
15 parties involved in this transaction."[183]
16
17 Q. Any other concerns in this context?
18 A. Yes. TEF must commit that no other Board from TXU or any of the TXU
19 affiliates, including Oncor Holdings, can override the Oncor Board of Directors
20 when it comes to essential decisions, including but not limited to those about
21 dividend policy, and also about debt issuance, capital expenditure, management
22 and service fees, and appointment of board members.

[182] Attachment CRR-3, at item A.
[183] Attachment CRR-4, at item B.

1 Q. Any final concerns on this topic?

2 A. Yes, one that related to the Debt-to-Equity Ratio Commitment. As the result of
3 the acquisition, TEF estimates that an accounting entry of about $4 billion in
4 "goodwill" will be reflected on Oncor's balance sheet.[184] Goodwill reflects the
5 extent to which the acquisition price plus fees exceeds the fair value of Oncor.[185]
6 Adding goodwill could mean that Oncor could add substantial new debt – about
7 $7.6 billion – and still meet the commitment for a 60%/40% debt/equity capital
8 structure.[186]

9

10 The mitigation for this concern is that Oncor must pledge that calculations for the
11 Debt-to-Equity Ratio Commitment may not allow this goodwill to justify
12 increased debt.

13

14 **b. Management and Shared Services Fees**

15

16 Q. What is the second part of your concern about cash being extracted from Oncor?

17 A. The second part of the concern is that TXU will extract cash from Oncor by
18 having Oncor pay management fees or excessive fees for shared services.

19

20 Q. Do any of the Applicants' fifteen commitments address this concern?

---

[184] Attachment CRR-5, at introduction.
[185] Id. at item A.
[186] Docket No. 34077, Direct Testimony of Richard Hays at 9. (Calculation uses figures from Long-Term Debt and Total Equity with a target debt-to-equity ratio of 60/40).

1 A. Yes. This is addressed to some extent by the Applicants' Arm's Length
2 Relationship Commitment. The Applicants state this commitment in the
3 following terms:

4 **Arm's Length Relationship Commitment** - Each of the Ring-Fenced
5 Entities will maintain an arm's length relationship with the TXU Group
6 (as defined below) consistent with the Commission's affiliate standards
7 applicable to Oncor.[187]
8

9 Ring-Fenced Entities refers to Oncor Holdings, Oncor, and its subsidiaries.[188]
10 TXU Group is defined as TXU and its subsidiaries, other than the Ring-Fenced
11 Entities.[189]
12

13 Q. Do the Commission's existing affiliate rules address this area of concern?
14 A. Yes. The Commission's existing *Code of Conduct for Electric Utilities and Their*
15 *Affiliates* is certainly relevant and constructive.[190] However, my concern is that
16 these rules do not cover all services.[191] In particular, the rules exempt corporate
17 support services which I would cover under additional mitigation measures.[192]
18

19 Specifically, the requirement under existing affiliate rules for contemporaneous
20 written records and the right to audit must be extended to corporate support
21 services.
22

[187] Joint Report at 7.
[188] Docket No. 34077, Direct Testimony of Frederick Goltz at 8 lines 7-8.
[189] Id. at 8 lines 8-10.
[190] P.U.C. SUBST. R. 25.272.
[191] Attachment CRR-6, at item A.
[192] P.U.C. SUBST. R. 25.272.

1 **c. Inter-Company Loans**

2

3 Q. What is the third part of your concern about cash being drained from Oncor?

4 A. The third part of the concern here is that TXU could potentially charge excessive
5 rates on a loan that it provides to Oncor. A reciprocal concern is that Oncor will
6 lend money to TXU affiliates, who will have a lower level of creditworthiness
7 than Oncor after the transaction.

8

9 Q. Do any of the Applicants' fifteen commitments address this concern?

10 A. The Arm's Length Relationship Commitment may be relevant here, but it is not
11 sufficient to adequately mitigate this concern.

12

13 Q. What additional mitigation measures are required?

14 A. Oncor has indicated that it does not intend to enter into inter-company debt
15 transactions with TXU affiliates.[193] This intent must be made into a commitment.

16

17 Similarly, Oncor must not share any credit facility with any unregulated affiliate.
18 Credit facilities are short-term financing vehicles used to finance working capital
19 needs and general corporate purposes, including issuances of commercial paper
20 and letters of credit.[194] As of June 30, 2007, Oncor and Texas Competitive
21 Holdings had joint credit facilities with a limit of $4.5 billion, of which Oncor had

---

[193] Attachment CRR-7, at item D.
[194] Oncor Electric Delivery Company, 10-Q at 9 (June 30, 2007).

1 access to $3.6 billion.[195] These contain a provision whereby "A default by Texas
2 Competitive Holdings or Oncor Electric Delivery or any subsidiary thereof in
3 respect of indebtedness in a principal amount in excess of $50 million may result
4 in a cross default under joint credit facilities."[196] As of June 30, 2007, Oncor had
5 $155 million in cash borrowings outstanding under the credit facility.[197] Here,
6 again, it appears Oncor agrees that it will not share credit facilities going forward,
7 but this needs to be formalized.[198]
8
9 **3. To generate more cash, Oncor may have to cut jobs**
10
11 Q. What is the next possible harm in your list of ten?
12 A. The next possible harm (the third of 10) is that a reduction of Oncor's cash flow,
13 caused by either cash flowing to TXU affiliates or by having to support higher
14 interest rates as a consequence of a downgrade, can lead to job cuts at Oncor as a
15 measure to generate more cash.
16
17 Private equity transactions typically implement staff reductions as a cost cutting
18 measure. For example, Moody's incorporates the following view in its
19 assessment of this acquisition: "we believe private equity investors will seek to

[195] Id.
[196] TXU, 10-Q at 81 (June 30, 2007).
[197] Id. at 16.
[198] Attachment CRR-8, at item A.

1 maximize their return opportunities as fast as possible, which could result in
2 employment reductions, cost-cutting and the extraction of special dividends…"[199]
3
4 Q. Do any of the Applicants' commitments address this?
5 A. No. None of the Applicants' fifteen commitments address this issue. TEF did
6 state in its response to a RFIs that it has "no plans to reduce Oncor's workforce,
7 change Oncor's management or change any of Oncor's business practices as a
8 result of this transaction, except again as required to accomplish the 'ring-
9 fencing'."[200] However, when asked if they were willing to make any specific
10 commitments or provide certain incentives to retain staff, TEF indicated that they
11 were not willing to do so.[201]
12
13 Q. What additional mitigation measures are required?
14 A. To ensure that cuts in jobs do not result in a deterioration in system reliability, an
15 additional mitigation measure must establish Reliability Standards and require
16 Commission approval of the standards. I will address this further in harm number
17 six below.
18
19 On a related note, prior to the transaction, TXU and InfrastruX Group had
20 announced the formation of a joint venture, InfrastruX Energy Services that
21 would provide utility construction, power restoration, maintenance and other

---

[199] Moody's Investors Service, Global Credit Research, "Proposed Acquisition of TXU Corp by a Consortium of Private Equity Investors Raises Potential for a Multi-Notch Ratings Downgrade," at 9 (March 2007).
[200] Attachment CRR-9, at response.
[201] Attachment CRR-10, at item F.

services nationwide. Oncor was expected to obtain services from InfrastruX and more than 2,000 of Oncor employees were expected to become employees of InfrastruX Energy Services.[202] The joint venture transaction was being reviewed by the Commission in Docket No. 33156.[203] That transaction was suspended indefinitely and TXU announced that, upon closing of the merger, it plans to terminate that transaction.[204]

4. To generate more cash, Oncor may have to defer or eliminate operation and maintenance (O&M) expenditures

Q. Please explain the fourth possible harm that you have identified.

A. The concern here, similar to the third possible harm, is that a reduction in Oncor's cash flow, caused by either cash flowing to TXU affiliates or by having to support higher interest rates as a consequence of a downgrade, can lead to a cut in O&M expenditures as a measure to cut costs.

Q. Do the Applicants' commitments address this concern?

A. No. None of the Applicants' commitments address this concern. However, TEF indicates that it "does not plan to reduce the Company's operating or capital budget. As such, TEF expects no impact from the transaction on the quality, reliability, system security or cost effectiveness of service to customers."[205]

[202] TXU Electric Delivery Company, 10-K at 8 (2006).
[203] Attachment CRR-11, at introduction.
[204] Id., at response.
[205] Attachment CRR-9, at response.

1 Q. Are additional mitigation measures required?

2 A. To ensure that cuts in O&M expenditures do not result in a deterioration in system
3 reliability, an additional mitigation measure must establish Reliability Standards.
4 I will address this further in harm number six below.

5

6 **5. To generate more cash, Oncor may have to defer or eliminate capital**
7 **expenditures (CapEx)**
8

9 Q. Please explain the fifth possible harm you identified.

10 A. The concern here, similar to that in the third and fourth above, is that a reduction
11 of Oncor's cash flow, caused by either cash flowing to TXU affiliates or by
12 having to support higher interest rates as a consequence of a downgrade, means
13 that Oncor will have less cash available for capital expenditures (CapEx). This
14 could lead Oncor to postpone investments in certain infrastructure projects
15 including expansions, rebuilds or maintenance programs.

16

17 This link between CapEx and internal cash is seen in the Applicants' responses to
18 Requests for Information (RFIs). Mr. Goltz states that "CapEx will be made from
19 funds generated from the operations of Oncor. In addition, Oncor will have a
20 large unfunded revolver available for draws to meet unexpected or seasonally
21 large capital requirements."[206]

22

23 Q. Do any of the Applicants' commitments address this concern?

[206] Attachment CRR-12, at item B.

1 A. Yes. Applicants address this concern in the Capital Expenditure Commitment.

2 This commitment states:

3 Following the closing of the Transaction, Oncor will continue to make
4 capital expenditures consistent with the capital expenditures in Oncor's
5 business plan. Total capital spending will depend in part on economic and
6 population growth in Texas, as well as permitting and siting outcomes.
7 However, in any event, over the five years following the year in which
8 closing of the Transaction occurs, Oncor will make capital expenditures in
9 connection with its transmission and distribution business in an aggregate
10 amount of more than $3.0 billion.[207]
11

12 If the standard is CapEx *before and after* the acquisition, then the proposed

13 minimum investment of $3 billion seems reasonable. Capital expenditures for

14 Oncor for the years 2002 through 2006 were, respectively, $513 million, $543

15 million, $600 million, $733 million, and $840 million, which sums to $3.23

16 billion for the five-year period.[208] I am not providing an opinion on whether the

17 $3 billion is adequate to meet future CapEx needs.

18

19 Q. Are additional mitigation measures required?

20 A. Yes. While having a commitment which indicates a minimum CapEx investment

21 amount provides some level of assurance, the real objective is that CapEx

22 investments are sufficient to ensure a reliable system. Therefore, the emphasis

23 should be placed on defining and meeting Reliability Standards such as those

24 presented below in number six.

25

[207] Joint Report at 6.
[208] TXU Electric Delivery Company, 10-K at A-2 (2002 and 2006).

1 In addition, this commitment must be complemented with language that states that
2 there are no restrictions on how Oncor spends the $3 billion (or more) and that
3 Oncor's Board is the ultimate decision-maker (consistent with all applicable
4 Commission requirements) on which CapEx expenditures should be made.
5 Unless this additional mitigation measure is required, the Applicants could
6 circumvent the commitment that Oncor will spend $3 billion in CapEx
7 expenditures during the next five years.
8
9 Q. Are there other commitments relevant to this concern?
10 A. Yes. Another concern is that in order to maximize the short-term cash balance,
11 some essential expenditures could be postponed. This concern is accentuated by
12 the notion that private equity firms typically do not hold onto their investments
13 for long and might be tempted to minimize CapEx investments during the time
14 during which they maintain ownership so that there can be more cash available to
15 pay dividends.
16
17 In this case, the Applicants have addressed this concern with the Continued
18 Ownership Commitment which states that:
19 TEF will hold a majority of its ownership interest in Oncor, in the current
20 regulatory system, for a period of more than five years after the closing date
21 of the Transaction.[209]
22
23 The Continued Ownership Commitment should be rejected because it is
24 unnecessary and may result in unintended negative consequences. Under

[209] Joint Report at 6.

1 amendments enacted earlier this year to PURA 39.262 (l) and (m), the
2 Commission has authority to approve or reject any future sale or merger of Oncor,
3 and may do so only upon a finding that the transaction is in the public interest. It
4 is unknown whether such a future transaction would ever take place or what
5 additional public benefits would be offered by a purchaser. However, because the
6 Commission could only approve a future sale or merger that would be in the
7 public interest, there is no need in this proceeding for the Commission to opine on
8 the time frame in which such a transaction could occur. Approving a five-year
9 Continued Ownership Commitment could have unintended negative
10 consequences of precluding subsequent prospective buyers from offering
11 additional public benefits within that time frame.
12
13 **6. Cuts in jobs, O&M expenditures and CapEx can result in a decline in**
14 **the reliability of the system**
15
16 Q. What is the sixth possible harm you have identified?
17 A. The concern expressed by the sixth possible harm is that cuts in jobs, O&M
18 expenditures, and CapEx will lead to a decline in customer service quality and
19 reliability.
20
21 Q. Did the Applicants address this concern?
22 A. Yes, but only in a vague manner. In the Service and Safety Commitment, the
23 Applicants indicate that "Oncor will support the inclusion of negotiated
24 commitments with appropriate stakeholders regarding reliability, customer service

and employee safety." However, the Applicants make no specific offer of additional commitments or even say when such a negotiation could take place. The commitment states:

> **Service and Safety Commitment** - Oncor will support the inclusion of negotiated commitments with appropriate stakeholders regarding reliability, customer service and employee safety in any final order regarding the Transaction issued pursuant to PURA Section 14.101.[210]

Q. Are additional mitigation measures required?

A. Yes. An additional mitigation measure should be made to establish a Reliability Standard. The Commission should adopt a reliability standard to guarantee reliable service will be provided following the proposed merger. The Commission should decide this standard, based on existing rules and input from Staff and Intervenors. In his testimony, Staff witness Mr. Brian Almon outlines Commission Staff's recommended reliability standards.[211]

Q. Why should specific additional reliability standards be established in this case?

A. As background, note that TXU's Chairman and CEO, Mr. Wilder, in an EEI presentation that took place on November 7, 2006 defined Oncor's reliability objectives as: "i) Achieve top-decile reliability with SAIDI of less than 60 minutes per year, ii) Ensure operating performance goals while maintaining top-quartile cost performance, and iii) Achieve congestion reductions of 50% through grid management and investment."[212]

[210] Joint Report at 6.
[211] Docket No. 34077, Direct Testimony of T. Brian Almon, P.E.
[212] Attachment CRR-13, at response, slide 13.

1 However, when asked if Oncor would commit to continue to support the
2 objectives as stated by Mr. Wilder, Oncor responded that it would not commit to
3 performance standards as stated by Mr. Wilder or otherwise, but will only commit
4 to those set by the Commission.[213]
5
6 Q. Are there existing reliability standards set by the Commission?
7 A. Yes. There are system-wide standards in terms of SAIFI and SAIDI, and there
8 are Distribution Feeder Performance Standards.[214] These could serve as the
9 Reliability Standard here and be formally incorporated as a commitment.
10
11 Q. How are SAIFI and SAIDI defined?
12 A. The Commission defines them as follows:
13 Reliability Indices:
14 (A) System Average Interruption Frequency Index (SAIFI) - The
15 average number of times that a customer's service is interrupted.
16 SAIFI is calculated by summing the number of customers interrupted
17 for each event and dividing by the total number of customers on the
18 system being indexed. A lower SAIFI value represents a higher
19 level of service reliability.[215]
20
21 (B) System Average Interruption Duration Index (SAIDI) – The average
22 amount of time a customer's service is interrupted during the
23 reporting period. SAIDI is calculated by summing the restoration
24 time for each interruption event times the number of customers
25 interrupted for each event, and dividing by the total number of
26 customers. SAIDI is expressed in minutes or hours. A lower SAIDI
27 value represents a higher level of service reliability.[216]
28
29 Q. What are the SAIFI and SAIDI standards?

[213] Attachment CRR-14, at item B.
[214] P.U.C. SUBST. R. 25.52(f)(1), (f)(2).
[215] P.U.C. SUBST. R. 25.52 (c)(6)(A).
[216] P.U.C. SUBST. R. 25.52 (c)(6)(B).

1 A. The Commission states them as:

2 (A) SAIFI. Each utility shall maintain and operate its electric
3 distribution system so that the SAIFI value for the 2000 reporting
4 year does not exceed the interim system-wide SAIFI standard by
5 more than 10%. For the 2001 reporting year and thereafter, the
6 SAIFI value shall not exceed the system-wide SAIFI standard by
7 more that 5.0%.
8
9 (B) SAIDI. Each utility shall maintain and operate its electric
10 distribution system so that the SAIDI value for the 2000 reporting
11 year does not exceed the interim system-wide SAIDI standard by
12 more than 10%. For the 2001 reporting year and thereafter, the
13 SAIDI value shall not exceed the system-wide SAIDI standard by
14 more that 5.0%.[217]
15

16 Note that the "standards shall be unique to each utility based on the utility's
17 performance, and may be adjusted by the commission if appropriate for weather
18 or improvements in data acquisition systems…. The resulting standards will be
19 the average of the three reporting years 1998, 1999, and 2000."[218]
20

21 Q. What are the Commission's standards for Distribution Feeder Performance?

22 A. The Commission states them as follows:

23 (A) Each utility shall maintain and operate its distribution system so that
24 no distribution feeder with more than ten customers sustains a SAIDI
25 or SAIFI value for a reporting year that is among the highest (worst)
26 10% of that utility's feeder for any two consecutive reporting years.
27
28 (B) Each utility shall maintain and operate its distribution system so that
29 no distribution feeder with more than ten customers sustains a SAIDI
30 or SAIFI value for a reporting year that is more than 300% greater
31 than the system average of all feeders during any two consecutive
32 reporting years.[219]
33

[217] P.U.C. SUBST. R. 25.52 (f)(1)(A),(B).
[218] P.U.C. SUBST. R. 25.52 (f)(1).
[219] P.U.C. SUBST. R. 25.52 (f)(2)(A),(B).

1
2
3

7. Cuts in jobs, O&M expenditures and CapEx can result in higher risk to the health and safety of customers and/or employees

4 Q. Please explain the seventh possible harm you identified.

5 A. The concern here is that cuts in jobs, O&M expenditures and CapEx can result in
6 higher risk to the health and safety of customers and/or employees. The specific
7 concern is an increase in accidents.

8 Q. Did the Applicants address this concern?

9 A. Yes, but only in the vague terms of its Service and Safety commitment.

10

11 Q. Are additional mitigation measures required?

12 A. Yes. TEF must commit that Oncor will maintain employee safety (perhaps as
13 measured by a quantitative metric such as the number of OSHA Reported
14 Accidents) equal to, or better than, Oncor's historical performance using a five
15 year rolling average. That is, an employee Safety Standard should be defined for
16 this transaction and approved by the Commission.

17

18 The Applicants state they would not agree to standards based on OSHA
19 indices.[220] Unless the Commission imposes an additional mitigation measure
20 which requires Oncor to meet a measurable safety standard, the Applicants can
21 circumvent their commitment to Service and Safety.

22

[220] Attachment CRR-15, at item A.

8. Decline in the reliability of the system and higher risks to the health and safety of customers and/or employees may force the Commission to have to increase rates so that these harms can be mitigated

Q. What is the eighth possible harm you identified?

A. The concern here is that a decline in quality of service or in the reliability of the system as well as higher risks to the health and safety of customers and/or employees, may force the Commission to increase rates so that these problems can be remedied.

Q. Do the Applicants address this concern?

A. No. The Rate Case Commitment does not address this concern as it merely requires only Oncor to file a rate case by July 1, 2008 which the company has done, but it does not prevent it from seeking increases in rates in the future.[221]

The commitment is stated as follows:

> **Rate Case Commitment -** If, for any reason, the Commission has not initiated a general rate proceeding for Oncor or its predecessor prior to July 1, 2008, Oncor will not later than that date file a general rate case consistent with its currently effective settlement agreement with certain municipalities.[222]

Q. Are additional mitigation measures required?

A. Yes. But I should say at the outset that the adoption of the commitments and additional mitigation measures discussed so far can help mitigate this concern, too. That is, those commitments and additional mitigation measures will help

[221] Docket No. 34040, Oncor Electric Delivery Company's Response and Rate Filing Package.
[222] Joint Report at 6.

1 mitigate concerns about extraction of cash from Oncor that could result in a
2 decline in service and higher risks to the health and safety of customers and
3 employees. This is the most direct mitigation for our eighth possible harm.
4
5 Q. Are there other concerns related to rate increases that should be addressed?
6 A. Yes. The Applicants have made several clarifications regarding the effect of the
7 transaction on future rates. For example, they have addressed the concerns that
8 arise from the estimated $4 billion in "goodwill" and offsetting equity that will be
9 allocated to Oncor as a result of this transaction.[223] As already noted, goodwill is
10 the dollar amount by which the purchase price plus transaction costs exceeds the
11 fair value of the acquired company.
12
13 TEF indicates that Oncor's future rate requests will not be impacted by goodwill,
14 intangible assets or transaction costs that arise from the Transaction.[224] Further,
15 "Oncor commits that the goodwill assets will not be included in rate base."[225]
16 Similarly, they indicate that Oncor does not intend to include goodwill or the
17 offsetting paid-in-capital entry into future calculations of debt-to-equity ratio for
18 rate making purposes.[226] It should also be made clear that the expense resulting
19 from the impairment of goodwill will never be reflected in rates.[227] These
20 clarifications should be part of any additional mitigation measures set by the
21 Commission.

[223] Docket No. 34077, Direct Testimony of Richard Hays at 5 lines 10-11.
[224] Id. at 6 lines 26-30.
[225] Id.
[226] Attachment CRR-5, at item C.
[227] Id. at item E.

1 Q. Do you have remaining concerns?

2 A. Yes. My chief remaining concern is triggered by Oncor's CEO statement which
3 implies that Oncor will soon have to raise rates when he states "It is important to
4 note that Oncor has made significant investment in electric infrastructure that is
5 not reflected in its current rates, has regulatory assets for which it is authorized to
6 seek recovery, and faces the same increasing costs as do other businesses."[228]
7 To prevent large rate increases in the near term, an additional mitigation measure
8 should be put in place to limit future annual rate increases to some level keyed to
9 inflation. For example, for some specific period, rate increases will not exceed
10 annual inflation plus 2.5% or some such figure. This will prevent sharp increases
11 in rates in any one year. Any allowable cost or return that is not recovered in a
12 particular year because of the limit can be deferred to future years.
13

14 Q. Has Oncor agreed to a cap on rate increases going forward?

15 A. No. Oncor and TEF have indicated that they "cannot commit to meeting any
16 maximum rate threshold."[229]
17

18
19
20
21

9. Oncor might lose its investment grade rating which would result in higher borrowing cost, and thereby, Oncor's customers may pay higher rates

22 Q. What is the ninth possible harm?

[228] Docket No. 34077, Direct Testimony of Robert Shapard at 24 lines 11-14.
[229] Attachment CRR-16, at item A.

1 A. The concern here is that, as a consequence of the proposed acquisition, Oncor will
2 lose its investment grade credit rating. If this happens, Oncor will have to support
3 a higher cost of debt when it refinances or acquires new debt.
4
5 In the short term, Oncor might face a higher cost of debt when it refinances the
6 $800 million loan issued on March 2007 which has a provision that it must be
7 refinanced upon closing of the transaction.[230] Beyond this, Oncor would face a
8 higher cost for any new debt it obtains. Ratepayers would be adversely impacted
9 if Oncor attempts to recover the increased interest expense through rates.
10
11 Q. Do the Applicants address this concern?
12 A. Yes. In the second part of the Debt-to-Equity Ratio Commitment, TEF indicates
13 that it will not seek to recover a higher cost of debt during the next rate case. The
14 second part of this commitment states:

15 **Debt-to-Equity Ratio Commitment** - […] For ratemaking purposes, in
16 its scheduled rate cases in 2007 and 2008, Oncor will support a cost of
17 debt that does not exceed Oncor's actual cost of debt immediately prior to
18 the announcement of the Transaction.[231]
19

20 Q. Are additional mitigation measures required?
21 A. Yes. While this commitment may provide short-term relief to Oncor's customers
22 in that, in its current case, customers will not see the impact of Oncor's higher
23 cost of debt, it provides no assurances to ratepayers that Oncor will not seek to
24 recover the higher cost of debt beyond the near future. In fact, TEF admits that

[230] Attachment CRR-17, at response, attachment 1.
[231] Joint Report at 6.

1 ratepayers can be subject to an increase in rates due to the higher cost of debt
2 when they indicate that "Subsequent to the 2007 and 2008 cases, TEF anticipates
3 that Oncor will make a determination of the appropriate cost of debt to seek in its
4 rate filings taking into account then-prevailing interest rates as well as Oncor's
5 specific borrowing costs and any impact on Oncor's cost of borrowing
6 attributable to Oncor's relationship with TXU Corp."[232]
7
8 An additional mitigation measure should be set which acknowledges the
9 Commission's authority, for a specified period of time, to allow in rates only a
10 cost of capital which reflects an investment-grade rating. Above, I already
11 recommended that the Oncor Board commit to maintaining an investment grade
12 rating. I believe this restriction on rate calculations will add to the incentive for
13 Oncor to do all that it takes to maintain the current investment-grade rating.
14
15 Q. Are there other implications of this added mitigation measure?
16 A. Yes. While this additional mitigation measure would provide ratepayers relief
17 from the higher cost of debt that can result from this transaction, it has a negative
18 effect on Oncor's cash flow. If rates are not increased to cover an increase in the
19 cost of debt, Oncor's free cash flow will be decreased by any portion of the higher
20 interest expense that is not recovered by rates. This impact will be unfavorable to
21 Oncor's coverage ratios and may further harm Oncor's bond ratings.
22

[232] Attachment CRR-18, at item D.

TEF admits this when it indicates that "An increase in the interest expense will decrease cash flow from operations by the amount of the increase in interest expense, net of applicable income taxes."[233] TEF also states that "Funds From Operations (FFO) will decrease by the amount of the increase in interest expense, net of applicable income taxes… Therefore, such an increase in interest expense would slightly decrease Oncor's coverage ratios."[234]

An additional mitigation measure needs to be made that TXU must compensate Oncor for additional debt expense (due to lower bond ratings) that is not reflected in rates. The purpose of the cash compensation would be to restore Oncor's coverage ratios. Otherwise, the Commission will be faced with a dilemma of having to choose between two negatives: (a) do not allow the increased cost of debt to be recovered by rates, which means that the increased interest expense will worsen Oncor's financial profile or (b) allow Oncor to recover the increased cost of debt, which means higher rates to customers as a result of the transaction.

10. Oncor faces the risk of being drawn into a TXU bankruptcy proceeding

Q. Let us turn to the last of ten possible harms.

A. The concern here is that the substantial new debt incurred to finance this acquisition could lead to the bankruptcy of TXU and/or its other affiliates and that

[233] Id., at item C.
[234] Id.

1 Oncor, even if it was not bankrupt itself, would be drawn into the bankruptcy
2 proceeding.
3
4 Q. Do the Applicants address this concern?
5 A. Yes, but only in a very general way. TEF's Holding Company commitment
6 indicates that a new holding company will be created between Oncor and TXU.
7 The commitment states:

8 **Holding Company Commitment** - A new holding company, Oncor
9 Electric Delivery Holdings, will be formed between TXU Corp. and
10 Oncor.[235]
11

12 The purpose of this new Holding Company is to "enhance Oncor's ability to
13 achieve legal and structural separateness, which is intended to protect Oncor and
14 its ratepayers from the effects of a bankruptcy at TXU or TXU's other
15 subsidiaries."[236]
16
17 TEF believes the Holding Company will have "stringent limitations on the ability
18 of the company to take certain material actions (including a voluntary bankruptcy
19 petition)."[237] This provision would be included in the organizational documents
20 of Oncor and Oncor Holdings to be effected on or before the closing. The
21 provision would be similar to that in Oncor Bond Co. which requires "the
22 unanimous approval of the directors present and voting (which in any event will

[235] Joint Report at 6.
[236] Attachment CRR-19, at item A.
[237] Attachment CRR-20, at response.

include each of the six independent directors) in order for [Oncor or Oncor Electric Delivery Holdings] to file a voluntary petition for bankruptcy."[238]

Q. Does TEF claim this commitment will guarantee that Oncor will not be drawn into bankruptcy?

A. No. TEF admits that there are scenarios in which the proposed structural protections would not prevent an Oncor bankruptcy. "A bankruptcy court presiding over the bankruptcy case of TXU Corp. or one of its subsidiaries (other than Oncor Holdings and its subsidiaries) could, acting as a court in equity, conclude that equitable principles weighed in favor of bringing Oncor Holdings into the bankruptcy case by substantively consolidating Oncor Holdings' assets and liabilities with those of the bankrupt entity."[239]

Even more to the point, TEF admits that, while, Oncor Holdings adds one additional step before Oncor itself can be brought into a bankruptcy proceeding, it does not guarantee that Oncor will not be brought into the proceeding. TEF states:

> If Oncor's double layer of protection fails, and Oncor is substantively consolidated with the bankrupt entity, the assets and liabilities of each entity would be combined into a survivor entity. As a result, the creditors of the bankrupt entity would, in broad terms, be treated as unsecured creditors of Oncor and would have access, along with Oncor's own creditors, to Oncor's assets for satisfaction of the obligations owed by the bankrupt entity.[240]

[238] Attachment CRR-21, at response.
[239] Attachment CRR-20, at response.
[240] Id.

1 Q. Are there specific features of Oncor Holdings that will help protect Oncor in this
2 regard?
3 A. Yes. TEF indicates that "the organizational documents of Oncor Holdings will
4 include 'separateness covenants,' which are generally recognized as minimizing
5 the risks of substantive consolidation. However unlikely, the possibility
6 nonetheless remains that Oncor Holdings could be subject to a substantive
7 consolidation with TXU Corp. or its other subsidiaries."[241]
8
9 Q. Are additional mitigation measures required?
10 A. Yes. However, no one can guarantee that Oncor would not be drawn into the
11 bankruptcy proceeding. TEF admits that it cannot "guarantee" that Oncor
12 Holdings or Oncor will not be included in a bankruptcy proceeding, "because
13 TEF cannot control the future actions of a bankruptcy trustee or TXU Corp.
14 creditors."[242] Still, as one additional measure, we believe Oncor should be
15 required to include separateness covenants in all existing and new debt.
16
17 For example, in the TNP case precedent discussed above, there was a
18 commitment to including separateness covenants in TNP existing and future debt
19 which stated that:

20 (a) TNP and TNMP are being operated as separate corporate and legal
21 entities and that the Lenders, in agreeing to make the loans, are relying
22 solely on the creditworthiness of TNP based on the assets owned by it and
23 the repayment of the loan will be made solely from the assets of TNP and
24 not from any assets of TNMP and that they will not take any steps for the
25 purpose of procuring the appointment of an administrative receiver or the

[241] Id.
[242] Attachment CRR-21, at response.

> making of an administrative order for instituting any bankruptcy, reorganization, insolvency, wind up or liquidation or any like proceeding under applicable law.[243]

Q. Have TEF and Oncor agreed to include this added measure?

A. No. TEF said the following:

> TEF will seek, but cannot commit, to include such language in its loan covenants, as the language is not in the current commitment letters and its inclusion would require agreement from those lenders, at the lenders' discretion.[244]

Q. Do you have any other concerns related to bankruptcy of TXU or its affiliates?

A. Yes. TXU Energy Retail is Oncor's largest customer.[245] Its bankruptcy, at a minimum, would harm Oncor through failure by Texas Energy Retail to pay Oncor for outstanding invoices. P.U.C. SUBST. R. 25.107(f) does not require retail electric providers like TXU Energy Retail to post collateral if they have $50 million in assets, which TXU Energy Retail has. Furthermore, Oncor's tariff prevents it from collecting a deposit until after a REP goes into default. TEF says that it understands collateral cannot be required "until after an actual default by the REP has occurred."[246] Because the acquisition increases the probability of default, to protect Oncor customers, the Commission should include an additional mitigation measure stating that Oncor may not seek rate recovery of any expense

[243] Docket No. 21112-191, Joint Stipulation Agreement at 18, commitment 9.
[244] Attachment CRR-22, at item A.
[245] Docket No. 34077, Direct Testimony of Robert Shapard at 21, lines 11-12.
[246] Docket No. 34077, Direct Testimony of Frederick Goltz at 13 line 3 to 16.

1 resulting from bad debts related to Texas Energy Retail; we understand TEF will

2 agree to this.[247]

[247] Attachment CRR-23, at item B.

1 **VI. ASSESSING THE POTENTIAL BENEFITS OF THE PROPOSED**
2 **TRANSACTION**
3
4 Q. What is the purpose of this section of your testimony?
5 A. In this section of the testimony, I assess the Applicants' claim that the proposed
6 acquisition would result in tangible benefits to Oncor ratepayers.
7
8 Q. What tangible benefits are listed by the Applicants?
9 A. When asked "What tangible benefits will Oncor customers receive as a result of
10 the transaction?"[248] Mr. Goltz lists five and says that none of these would be
11 available absent the transaction.[249]
12
13 Q. Please respond to each of the five in turn.
14 A. In the first, he points to new ring-fencing provisions. He states:

15 New ring-fencing provisions of Oncor that will provide enhanced
16 separation from the other TXU Group businesses, increasing Oncor's
17 financial strength and providing increased protection to Oncor and its
18 customers from the financial and operational performance of TXU's other
19 businesses.[250]
20

21 While I agree that ring-fencing – as reflected in the commitments and additional
22 mitigation measures – is essential to mitigate the possible harm from the
23 transaction, I would be hard pressed to call them *tangible benefits* resulting from
24 the transaction. These ring-fencing measures could be put in place absent the

[248] Docket No. 34077, Direct Testimony of Frederick Goltz page 25, lines 12 to 13.
[249] Id. at 25 line 14 to page 26 line 23.
[250] Id. at 25 lines 16 to 20.

1 acquisition, but, even if we give the transaction full credit for them, I cannot
2 characterize them as a benefit. It is the significant increase in debt brought on by
3 the proposed acquisition that necessitates such ring-fencing, so I view them
4 entirely as mitigation of possible harm.
5
6 Q. What is the second tangible benefit listed?
7 A. In the second, Mr. Goltz points to the commitment to maintain a capital structure
8 with 60% debt and 40% equity. He states:
9 Oncor's commitment not to incur debt above the regulatory debt-to-equity
10 ratio established from time to time by the Commission for ratemaking
11 purposes, which is currently set at 60% debt: 40% equity. This provides
12 greater assurance to the financial strength of Oncor going forward.[251]
13
14 Again, I do not see this as a tangible benefit resulting from the transaction. This
15 commitment only becomes relevant because of the substantial increase in debt
16 that TXU will undertake to finance the transaction. I see this commitment as
17 helping to prevent harm that Oncor might incur should TEF seek to fund or
18 service part of the transaction related debt through Oncor. Moreover, the
19 60%/40% commitment does not address the central concern about debt. The
20 concern is not about the share of debt in capital structure, it is whether Oncor has
21 sufficient cash flow to service debt whatever its level.
22
23 Q. What is the third listed benefit?
24 A. In the third, Mr. Goltz highlights the improved governance that can be achieved
25 by Oncor by having independent directors. He states:

[251] Id. at 25 lines 21 to 25.

1 Improved governance of Oncor, with a majority of independent directors
2 at the Oncor board and no directors being employees of TXU Corp. or its
3 subsidiaries (other than Oncor and Oncor Electric Delivery Holdings).
4 These independent directors will not have solely the interests of Oncor's
5 shareholders in mind, but rather the interests of all stakeholders (debt
6 holders, customers and suppliers) given their independence. This is in
7 contrast to Oncor's board today, which consists solely of representatives
8 of Oncor's sole ultimate shareholder, namely TXU Corp. [252]
9

10 Again, I do not see this as a tangible benefit resulting from the transaction.
11 Having independent directors does help ensure that Oncor's Board focuses on
12 Oncor's interests without entertaining conflicting interests from other related
13 affiliates. However, this is something that could have been implemented absent
14 the transaction. Even if we give the transaction the full credit, however, I cannot
15 characterize this as a benefit. I would characterize it as a commitment
16 necessitated by the possible harm that Oncor faces due to the transaction.
17

18 Q. What is the fourth listed benefit?

19 A. In the fourth, Mr. Goltz mentions the commitment to spend at least $3 billion in
20 capital expenditures over the next five years. He states:

21 A commitment to spend at least $3.0 billion of capital over the next five
22 years provides Oncor customers with a base level of capital expenditures
23 in order to meet system growth and ensure that system reliability and
24 service levels continue to improve. Today, Oncor has no requirement to
25 spend a minimum level of capital expenditures and so could spend less
26 than $3.0 billion of capital over the next five years in the absence of the
27 Transaction.[253]
28

29 Again, I do not see this as a tangible benefit resulting from the transaction. If
30 during the next five years Oncor invests $3 billion, it is simply in a pattern

[252] Id. at 25 lines 26 to 30 and page 26 lines 1 to 4.
[253] Id. at 26 lines 5 to 11.

1 consistent with its actual CapEx investments over the past five years.[254] I do not
2 agree that a tangible benefit can be seen in doing after the transaction exactly
3 what you did before. Also, it should be noted that the funds for CapEx will come
4 from Oncor itself, not TEF.[255] At best, this commitment, if kept, would ensure
5 Oncor ratepayers that no harm will be done, in the sense that the new owners will
6 not spend less on CapEx after the acquisition as compared to before.
7

8 Q. What is the fifth and final listed benefit?

9 A. In the fifth, Mr. Goltz indicates that for the next rate cases, Oncor will not seek to
10 recover in rates a cost of debt higher than the cost of debt prior to the transaction.
11 He states:

12 Protection against higher interest rates increasing Oncor's allowed rates in
13 Oncor's next scheduled rate cases (both the 2007 Commission rate inquiry
14 and the 2008 municipal rate case). Since Oncor will not seek to recover a
15 cost of debt higher than Oncor's cost of debt in effect prior to the
16 Transaction, even if interest rates rise in the ordinary course without
17 relation to the Transaction, and as a result Oncor's cost of borrowing
18 increases, Oncor will not seek to recover this higher cost of borrowing in
19 its 2007 and 2008 rate cases. Instead, Oncor will seek to recover no more
20 than the cost of borrowing immediately prior to the Transaction, which
21 may reflect a lower interest rate. Oncor customers will still have the
22 opportunity to get the benefit of decreased interest rates in their rates.[256]
23

24 I do not see this as a tangible benefit resulting from the transaction. Absent the
25 commitments and additional mitigation measures, Oncor's cost of debt could
26 increase as a result of its affiliation with TXU, because of the large amount of
27 debt used to finance this transaction. Even with the proposed commitments and

---

[254] Docket No. 34077, Direct Testimony of Brenda Pulis at 22.
[255] Attachment CRR-12, at item B.
[256] Docket No. 34077, Direct Testimony Frederick Goltz at 26 lines 12 to 23.

1 additional mitigation measures, Oncor faces the risk of being downgraded to
2 below investment grade and, as a consequence, of facing higher costs of debt. At
3 best, this commitment mitigates harm from the transaction; it would do so only in
4 the current rate case. This commitment does not prevent harm to Oncor's
5 customers due to a possible higher cost of debt beyond the current rate case.
6
7 Even if we assume that for the next rate case Oncor customers' receive a benefit
8 (which would only be achievable if interest rates in 2008 are higher than prior to
9 the transaction), this benefit could pale in comparison to the increase in rates that
10 customers might experience beyond the current rate case should Oncor's cost of
11 debt increase because of the transaction.
12
13 Q. Has TEF defined the pre-transaction cost-of-debt it will guarantee?
14 A. Yes. It defined the pre-transaction cost-of-debt as that calculated as of December
15 31, 2006. That cost of debt is 7.08%.[257]
16
17 Q. How would you sum up your response to the "tangible benefits" claimed by the
18 Applicants?
19 A. The tangible benefits cited by TEF are very limited. The Applicants readily admit
20 that there are no "merger savings" at Oncor because this is not a strategic merger
21 – that is, it is not the merger of two electric operating companies.[258] The tangible
22 benefits listed by Mr. Goltz are best seen as mitigation measures.

[257] Attachment CRR-24, at item A, attachment 1.
[258] Docket No. 34077, Direct Testimony of Robert Shapard at 24 line 17 to page 25 line 8.

1 Q. Does any other witness list tangible benefits?

2 A. Yes, Mr. Shapard does.

3

4 Mr. Goltz' list includes only mitigation of harm, not tangible benefits. I feel
5 about the same with Mr. Shapard's list, although he does list the only
6 commitment sufficiently defined to quantify as a tangible benefit; that is the
7 DSM/Energy Efficiency Commitment – a commitment to invest $200 million on
8 DSM/Energy Efficiency over the next five years over and above what Oncor
9 already reflects in rates and not to seek rate recovery for the extra $200 million.[259]

10

11 The key to the benefit is that Oncor will not seek rate recovery of the $200
12 million.[260] However, this benefit could be greatly diminished by the fact that TEF
13 says the $200 million could be spent *by any TXU subsidiary*.[261] If any of the $200
14 million was spent by any subsidiary other than Oncor, it would not have been put
15 in Oncor rates in any event.

---

[259] Id. at 25, lines 9 to 21.
[260] Id. at 13, lines 36 to 37.
[261] Id. at 13, lines 31 to 34.

1 **VII. ADDRESSING THE THIRTEEN ISSUES SET FOR THE HEARING**

2

3 Q. What are the topics addressed in this section of your testimony?

4 A. In this section, I address the thirteen issues set for hearing. For many of these, my

5 response to the issue draws heavily on my discussion of the commitments and

6 additional mitigation measures above in Section V.

7

8 **A. Statutory Issues In Accordance With PURA § 14.101(b)**

9

10 **1. What is the reasonable value of the property, facilities, or securities to**
11 **be acquired, disposed of, merged, transferred, or consolidated?**
12

13 Q. How do you respond to this issue?

14 A. The specific question implied by this issue is whether the offer price of $69.25 per

15 share for TXU common stock (the "securities to be acquired") is reasonable. In

16 this context, the term "reasonable" implies that the concern is that the purchase

17 price might be too low. My response is that the evidence is sufficient to conclude

18 that the price is not too low.

19

20 Q. How should reasonable value be judged?

21 A. The value of a publicly traded stock is best measured by the price willingly

22 determined by buyers and sellers in a public market – TXU is listed on the New

23 York and Chicago stock exchanges. In its Proxy Statement, TXU reports that its

24 offer price represents a 25% premium over the average closing stock price for the

1 twenty days ending on February 22, 2007, the day before the press speculation on

2 the proposed acquisition began.[262] As compared to the stock price one-day prior

3 to the press speculation, the stock price premium was 20%.[263]

4

5 Q. After the announcement of the proposed acquisition, how would value change?

6 A. After the announcement of the proposed acquisition, it would be reasonable to

7 expect the stock price to reflect the offer price less some discount reflecting an

8 expectation that the acquisition will not close. On July 23, 2007, the day before

9 the Proxy Statement was released, the price for TXU stock was $67.25 per share,

10 $2 per share (or 2.9%) lower than the offered price.[264]

11

12 Q. Are there other factors that should be noted when asking if the $69.25 per share

13 price offer is too low?

14 A. Yes. Under its Agreement and Plan of Merger, TXU was able to "go shop" for a

15 better price until April 16, 2007.[265] No better price was offered.[266]

16

17 Q. Have others opined on the reasonableness of the offered price?

18 A. Yes. TXU and its Board of Directors also received "fairness opinions" on the

19 price offer from Credit Suisse Securities (USA) LLC and Lazard Frères & Co.

20 LLC.

21

[262] Proxy at 22.
[263] Id.
[264] Id. at 5.
[265] Id. at 23.
[266] Id. at 25.

1 Q. How did Credit Suisse go about developing its opinion?

2 A. As reported by TXU, Credit Suisse took three different analytic approaches to
3 judging the per share offer. The first was a discounted cash flow (DCF) method in
4 which three different power plant construction scenarios and two different natural
5 gas price forecasts were assessed. In all but one of the six scenarios, the $69.25
6 per share price was above even the high end of the price range given; in the one
7 other price range, the high end was about $71, very close to the offer price.[267]
8 Other analyses looked at the value of TXU as compared to other comparable,
9 publicly traded companies and to the value of companies in other merger and
10 acquisition transactions.[268] Credit Suisse concluded that the offer price to be
11 fair.[269]

12

13 Q. How did Lazard Frères & Co. LLC go about developing its opinion?

14 A. Lazard also conducted quantitative analyses. For example, Lazard looked at the
15 price premium paid in other utility merger transactions. One measure was the
16 offered stock price as compared to the stock price one day prior to the public
17 announcement of the transaction. Looking at recent transactions, Lazard reported
18 that the median one-day price premium was 14.2%; this compares to a 15.4%
19 one-day price premium for this TXU acquisition (the price premium is 20% one
20 day before the press speculation).[270]

21

[267] Id. at 29.
[268] Id. at 30-31.
[269] Id. at 27.
[270] Id. at 5, 22, and 38.

1 Q. What did Lazard conclude?

2 A. As did Credit Suisse, Lazard concluded that the price is fair.[271] In judging the
3 weight to be given to the opinions, the Commission should consider the
4 involvement of Credit Suisse in the transaction itself.[272] The Commission will
5 also want to note that, in some of the analysis, the two advisors were depending
6 on information provided to them by TXU rather than on independently
7 determined information.[273]

8

9 Q. Is it useful to ask whether the price is *too high*, as opposed to too low?

10 A. Yes. While the issue as stated reflects a concern that the price is too low, it is fair
11 to ask whether there is a concern that the price is too high. In this context, the
12 concern would be that the price paid reflects unreasonable forecasts of cash flow
13 and, therefore, overstates the ability of TXU and its affiliates to pay debt service.
14 In this regard, TXU notes that the offer price reflects a projection of natural gas
15 price which exceeds that of TXU itself. TXU stated:

16 the future natural gas prices embedded in the implied value of TXU
17 Corp.'s generation assets based on the $69.25 Per Share Merger
18 Consideration were higher than the future prices TXU Corp. management
19 believed were likely, taking into account the inherently unpredictable
20 factors that impact long-term natural gas prices;[274]
21

22 **2. Will the transaction adversely affect the health or safety of customers**
23 **or employees?**
24

25 Q. How do you respond to this second issue?

[271] Id. at 22.
[272] Id. at 31.
[273] Id. at 29 and 33.
[274] Id. at 23.

1 A. My response is that, yes, without additional mitigation measures, the transaction
2 could adversely affect the health or safety of customers or employees. As stated
3 above, the concern is that, in an effort to find cash to service its increased debt,
4 TXU will take actions that lead to cuts in jobs, O&M expenditures and CapEx at
5 Oncor. These cuts could lead to an increase in employee accidents. As detailed
6 in Section V of this Testimony, I have proposed added mitigation measures to
7 address this concern. Specifically, related to the seventh possible harm, I
8 recommend that Safety Standards, based on historical performance, be set as an
9 additional mitigation measure for approving the acquisition. Because they
10 address the root cause of safety concerns, several other of my additional
11 mitigation measures also address this issue; these others include at least those
12 related to possible harms two, three, four, and five.
13
14 **3. Will the transaction result in the transfer of jobs of citizens of this**
15 **state to workers domiciled outside this state?**
16
17 Q. How do you respond to this issue?
18 A. I respond by answering, no. The Applicants did not make any formal
19 commitment to address this concern. However, one of its witnesses, Mr. Goltz
20 from KKR, stated that he would "confirm that the Transaction will not result in
21 the transfer of jobs to workers located outside of the state."[275] Since the new
22 owners do not have any other electric operations in any other state, at this time, I
23 see this as a credible response.[276]

[275] Docket No. 34077, Direct Testimony of Frederick Goltz at 3 lines 10-11.
[276] Docket No. 34077, Direct Testimony of Robert S. Shapard at 25, lines 4-6.

1 **4. Will this transaction result in the decline in service?**

2

3 Q. How do you respond to this issue?

4 A. My response is, yes, without additional mitigation, the transaction could result in
5 a decline in service. As stated above, the concern is that, in an effort to find cash
6 to service its increased debt, TXU will take actions that lead to cuts in jobs, O&M
7 expenditures and CapEx at Oncor. These cuts could lead to a decline in service in
8 the sense that system reliability or customer service could decline. As detailed in
9 Section V of this Testimony, I have proposed additional mitigation measures as
10 well as strengthening of existing commitments to mitigate this concern.
11 Specifically, related to possible harms three, four, and five, I recommend that a
12 Reliability Standard be defined as a condition for approval of the acquisition.
13 Because they address the root causes of the reliability concern, additional
14 mitigation measures also address this issue; these others include at least those
15 related to possible harm two.

16

17 **5. Will the public utility receive consideration equal to the reasonable**
18 **value of the assets when it sells, leases, or transfers assets?**
19

20 Q. How do you respond to this issue?

21 A. It is the stock of TXU that is being sold, not the assets of Oncor or any other
22 affiliate *per se*, so my response is that this issue is not applicable.

23

24 **6. Is the transaction consistent with the public interest?**

1 Q. How do you respond to this issue?

2 A. As discussed in detail in Section III, my response to this issue depends on the
3 public interest standard chosen by the Commission and what additional mitigation
4 measures the Commission imposes. As currently proposed, the transaction is not
5 consistent with any public interest standard along the ladder I described from a *no*
6 *harm* standard to a *net benefits* standard. That is, *as proposed*, the acquisition
7 does not meet the standard of even the lowest rung of the ladder because it does
8 not substantially mitigate the ten possible harms.
9
10 If the Commission chooses a no harm standard for public interest, and narrows the
11 concern to Oncor, then the proposed transaction may meet such a standard if and
12 only if the Applicants' commitments and my additional mitigation measures are
13 set as conditions for approval of the acquisition as detailed in Section V of my
14 testimony.
15
16 If the Commission chooses a net benefits standard for public interest, the
17 transaction does not provide benefits sufficient to meet such a standard. As
18 discussed in Section VI, what TEF and Oncor list as benefits, I see only as
19 mitigation for harm. The only tangible benefit is that arising from the
20 DSM/Energy Efficiency Commitment, but this is insufficient to create a net
21 benefit given (a) it is not necessarily to be spent for the benefit of Oncor
22 customers and (b) it is insufficient to offset the lengthy list of possible harms.
23

1 **B. Additional Issues Under the Public Interest Determination**

2

3 **1. Will the transaction result in Texas ratepayers bearing merger-**
4 **related costs unrelated to the corresponding benefits to Texas**
5 **ratepayers?**
6

7 Q. What is your response to this issue?

8 A. My response is that merger-related costs could be inappropriately imposed on
9 Texas ratepayers if the Applicants' commitment is not amended and additional
10 mitigation measures are not put in place. My response assumes the term "merger-
11 related costs" is defined literally and narrowly which means the issue concerns
12 passing on transaction costs to Oncor. The Applicants have stated that they will
13 not pass on transaction costs to Oncor ratepayers.[277] This should be formalized by
14 extending the *No Transaction-Related Debt at Oncor commitment* to include all
15 transaction costs, not just transaction-related debt.

16

17 Since transaction costs are reflected in goodwill, additional mitigation measures
18 are also required to block goodwill from having any effect on capital structure or
19 rates; my additional mitigation measures related to possible harms two (a) and
20 eight also address this issue.[278]

21

22 **2. Whether additional guarantees should be required to ensure that**
23 **service quality and customer relations are commensurate with the**
24 **requirements of PURA.**
25

[277] Attachment CRR-16, at item A-i.
[278] Docket No. 34077, Direct Testimony of Richard Hays at 4 lines 13-16.

1 Q. What is your response to this issue?

2 A. My response is, yes, additional guarantees should be required to ensure that
3 service quality is commensurate with the requirements of PURA. Since I take the
4 term "service quality" to include reliability, my answer here is the same as for the
5 fourth issue above under PURA.

6

7 **3. Whether additional guarantees or commitments should be required to**
8 **ensure that no cost-shifting, cross subsidies, or discriminatory**
9 **behavior occurs among affiliates of the acquired company.**
10

11 Q. What is your response to this issue?

12 A. My response is, yes, additional mitigation measures should be required to ensure
13 that no cost-shifting, cross subsidies, or discriminatory behavior occur among
14 affiliates. I look at this issue as asking for a broad assessment so all ten of the
15 possible harms are at issue here, and therefore, all the Applicants' commitments
16 and the additional mitigation measures related to all ten of the possible harms are
17 relevant.

18

19 **4. Whether the ring-fencing or other provisions proposed by the**
20 **applicants are adequate to separate and protect Oncor from**
21 **bankruptcy or financial distress of an unregulated affiliate.**
22

23 Q. What is your response to this issue?

24 A. My response is that as proposed, the ring-fencing and other provisions offered by
25 the applicants are not adequate to separate and protect Oncor from bankruptcy or
26 financial distress of an unregulated affiliate. Other than a provision calling for the

1 divestiture of Oncor to another unaffiliated entity, no provision can guarantee that
2 Oncor will not be drawn into bankruptcy or suffer financial distress due to
3 problems at an unregulated affiliate.[279] However, the added mitigation measures I
4 propose would substantially mitigate these concerns; the relevant additional
5 mitigation measures are those related to possible harms two, four, five, nine, and
6 ten.
7
8 **5. What guarantees or commitments should be required to ensure that**
9 **Oncor's debt ratings as a result of this transaction have no negative**
10 **effect on ratepayers?**
11
12 Q. What is your response to this issue?
13 A. My response is that the Applicants' commitments as well as my additional
14 mitigation measures should be required to mitigate the negative effects on
15 ratepayers of a reduction in Oncor's debt ratings; I say "mitigate" because
16 absolute protection cannot be ensured. Some of the mitigation helps by
17 decreasing the chances of a downgrade in Oncor's debt rating and other
18 mitigation works by blunting the effects if a downgrade occurs. The relevant
19 commitments and additional mitigation measures are those related to possible
20 harms one, two, eight, nine, and ten.
21
22 **6. How should commitments made by Oncor be quantified and**
23 **appropriately enforced?**
24
25 Q. How do you respond to this issue?

[279] Attachment CRR-20, at response and Attachment CRR-21, at response.

1 A. My response is that, as proposed, the commitments are not sufficiently quantified
2 and not able to be appropriately enforced. The additional mitigation measures I
3 propose strengthen these commitments in this regard. For example, the
4 Applicants claim that their commitments for a Separate Board, for an Independent
5 Board, and to a limited Debt-to-Equity ratio will block the use of excessive
6 dividends to extract cash from Oncor by TXU.[280] If dividend control is the goal,
7 enforcement is greatly enhanced by my additional mitigation measures which
8 state that dividends may not be paid by Oncor if (a) Oncor does not maintain its
9 investment grade debt rating, (b) cash flow metrics are not met, (c) reliability and
10 safety standards are not met, or (d) TXU or any affiliate is in bankruptcy. I see
11 such strengthening in the additional mitigation measures related to possible harms
12 two, three, four, five, six, seven, nine, and ten.
13
14 **7. Whether the commitments made by the applicants are consistent with**
15 **the public interest.**
16
17 Q. How do you respond to this issue?
18 A. My response is that, while the commitments are generally consistent with the
19 public interest, they are not sufficient to make the proposed acquisition itself
20 consistent with public interest. As explained in my response to the sixth issue
21 under PURA, under a no harm public interest standard, the proposed acquisition
22 might be found to be in the public interest with the additional mitigation measures
23 I propose. As explained above, the Continued Ownership Commitment should be
24 rejected because it is unnecessary and may result in unintended negative

[280] Attachment CRR-25, at items B and E, and Attachment CRR-26, at item B.

1 consequences. Under amendments enacted earlier this year to PURA 39.262 (l)
2 and (m), the Commission has authority to approve or reject any future sale or
3 merger of Oncor, and may do so only upon a finding that the transaction is in the
4 public interest. It is unknown whether such a future transaction would ever take
5 place or what additional public benefits would be offered by a purchaser.
6 However, because the Commission could only approve a future sale or merger
7 that would be in the public interest, there is no need in this proceeding for the
8 Commission to opine on the time frame in which such a transaction could occur.
9 Approving a five-year Continued Ownership Commitment could have unintended
10 negative consequences of precluding subsequent prospective buyers from offering
11 additional public benefits within that time frame.
12
13 The proposed acquisition would not be in the public interest if a net benefit
14 standard were used.

1 **VIII. RECOMMENDATIONS TO THE COMMISSION**

2

3 Q. What are your recommendations to the Commission?

4 A. Not surprisingly, as a threshold matter, the Commission's choice of an evaluation
5 standard can make a substantial difference in how it rules in this proceeding. My
6 recommendations take this into account and can be summarized with the
7 following three points.

8

9 First, the acquisition *as proposed* does not meet any of the public interest
10 standards along the ladder from no harm to net benefit and would not adequately
11 ensure that Oncor can provide adequate service.

12

13 Second, if the Commission chooses the no harm standard for this proceeding, and
14 limits its boundary for harm to Oncor alone, that standard may be met with a
15 combination of the Applicants' fifteen commitments plus additional mitigation
16 measures summarized in Table One. This standard would also ensure that Oncor
17 could provide adequate service. The relevant commitments and additional
18 mitigation measures should be incorporated as conditions of any Commission
19 order that concludes that the transaction is in the public interest. Absent such an
20 order that incorporates the commitments and additional mitigation measures, the
21 Commission should conclude that the transaction is not in the public interest.

22

1 Third, if the Commission chooses a net benefit public interest standard, that
2 standard may only be met with (a) a combination of the Applicants' fifteen
3 commitments and the additional mitigation measures summarized in Table One
4 plus (b) a requirement that the Applicants be required to provide substantial
5 benefits that exceed the mitigated harm.
6
7 Q. Are you making any other recommendations?
8 A. Yes. If the Commission finds the acquisition to be in the public interest, a full
9 review should be conducted of the *Limited Liability Company Agreement of*
10 *Oncor Electric Delivery*;[281] the purpose of that review would be to remove any
11 inconsistencies with testimony and statements made here.
12
13 Q. Are there other, broader points that you suggest the Commission consider in its
14 deliberations?
15 A. Yes. Although my review of the proposed acquisition is by necessity focused on
16 the details of the proposal – the "trees" if you will – I would not be doing my job
17 as an advisor, if I did not recommend that the Commission step back to look at the
18 forest as it makes its decision. I suggest four broader points be considered.
19
20 First, let us start with the obvious – this is not just another routine transaction. To
21 look at it as such would be like looking at New York City as just another city.
22 According to press accounts, this $46.7 billion deal is the largest leveraged buyout

[281] Docket No. 34077 response to RFI Staff 4 CR-6-01 (TEF) HSC (August 4, 2007 Draft).

1 ever.[282] As a point of comparison, the case precedents I cited above in Oregon
2 and Arizona involved TPG and KKR buyouts in the $1 billion to $3 billion range
3 – and, still, they appear to have evoked considerable soul searching by the state
4 Commissions.
5
6 Second, it is only fair to have a counterfactual in mind – what would happen in
7 the absence of the acquisition? The counterfactual can at least color the debate on
8 whether to approve or deny the Application. For example, it would not be
9 appropriate to assume (implicitly or explicitly) that TXU, if left with its current
10 ownership structure, could not suffer financial difficulties that could cause some
11 of the same ten harms listed above for the acquisition. Indeed, TXU suffered
12 financial distress with the bankruptcy of a European subsidy in 2002, and the
13 current management was brought in to remedy that situation.[283] However,
14 financial distress is made much more likely here with high levels of debt; this
15 makes it more difficult to weather difficulties resulting from outside events or
16 management missteps.
17
18 Third, the Commission should stop and think about where we are in the era of
19 private equity. The business press, including the *Wall Street Journal*, has been
20 filled with stories in recent issues saying the times have or will soon turn bad for
21 private equity. The recurring theme, in these articles, is that private equity

[282] Proxy at 84., Hall, Jessica. "Private equity buys TXU in record deal." Reuters (Feb. 26, 2007)., and Smith, Rebecca, Warren, Susan and Berman, Dennis K. "In TXU Deal, Texas Regulator Has Few Levers to Pull." The Wall Street Journal *Online* at A3 (February 27, 2007).
[283] Proxy at 105.

1 buyouts have been driven by a world awash with debt investors, which meant
2 private equity could easily get debt with low interest rates and flexible terms, and
3 now such debt will be harder to secure. Should the Commission find that such a
4 highly-leveraged acquisition is in the public interest during the very moment
5 conditions are likely to turn adverse for private equity transactions?
6
7 Fourth, for competitive markets to work to the benefit of consumers going
8 forward, these markets must attract innovative investors willing to place bets on
9 (invest in) the full range of answers for the future – demand-side to supply-side
10 technologies and renewable to nuclear technologies, as well as in brand new
11 science and technology. Financial institutions, with a clear appetite for risk, can
12 be just this kind of investor. It is fair to caution in this regard, however, that high
13 debt levels may constrain TXU investments.
14
15 Q. Does this conclude your Direct Testimony?
16 A. Yes.