

Briefing on Ring-Fencing

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Outline

- ◆ Affiliated Interest and Ring-Fencing
- ◆ Financing Controls (Laws and Rules)
- ◆ Transfer Pricing Policies
- ◆ Audit and Code of Conduct Reviews
- ◆ Potential for New Techniques

Affiliated Interest Issues

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

Definition of Affiliated Interest:

- A financial link either up, down or across a corporate chain, to a public utility with no less than five percent ownership interest.
- A corporation that has two or more officers or directors in common with such public utility.

Ring-Fencing – Credit Enhancements

According to Standard & Poor's:

- ◆ The two strongest means of insulation are through regulatory or legal barriers, which prevent excessive dividend upstreaming, intercompany loans, or any “non-arm’s-length” transactions.
- ◆ Any action state regulators takes that provides support a utility and/or isolates it (most importantly financial obligations) from a parent company will be positive for credit. With sufficient protection, the “stand-alone” rating is the important factor.

Statutes - Financing

- ◆ 757.405-415 – Power to regulate issuances and approved uses of finances
- ◆ 757.440 – Approval required before utility may guarantee another's indebtedness
- ◆ 757.480 – Approval needed prior to sale, mortgage or disposal of operative utility property
- ◆ 757.485 – Purchase of property or stocks of one utility by another
- ◆ 757.500 – Contracts between certain public utilities

Statutes – Affiliated Interest

- ◆ ORS 757.015 – Definition of an affiliated interest.
- ◆ 757.490 to 495 – Approval for contracts involving utilities and persons with affiliated interests
- ◆ ORS 757.506 – Findings and policy regarding exercise of influence over utility by person not engaged in utility business.
- ◆ ORS 757.511 – Application for authority to exercise influence over utility – Pertains to utilities that provide heat, light or power.

Contracts must be fair, reasonable and not contrary to the public interest.

Oregon Administrative Rules, Chapter 860

- ◆ 860-027-0025 – Applications for authority to sell lease, assign, mortgage, merge, consolidate, or otherwise dispose and or encumber property, or to acquire stock, bonds, or property of another public utility.
- ◆ 860-027-0035 – Applications by a Utility for authority to guarantee indebtedness
- ◆ 860-027-0040 to 0044 – Applications for approval of transactions between affiliated interests
- ◆ 860-027-0100 – Reporting of affiliated transactions
- ◆ 860-027-0200 – Energy Utility Acquisition

Affiliated Interest

◆ Requirements on transactions with an affiliated interest:

- When the utility is the buyer of goods or services, or when it issues notes, loans, etc., the utility must receive Commission approval. This is sometimes referred to as a forward service. (OAR 860-027-0040)
- When the utility is the seller of goods and services, the utility does not need Commission approval, but must file an “informational filing.” This is sometimes referred to as a reverse service. (OAR 860-027-0041)

A.I. - Transfer Pricing Policy

When an utility buys from an affiliate, the price must be the lower of cost or market.

- When an utility sells to an affiliate, the price must be the higher of cost or market. Any profit from a sale must be shown as a gain.
- The transfer pricing policy is outlined in several Oregon Administrative Rules. (e.g. 860-027-0052)

Current Ring-Fencing Tools

- ◆ Oregon has been recognized by rating agencies for successful ring-fencing activities:
 - PGE and PacifiCorp required to operate on a stand-alone basis; they must maintain their own long-term debt and preferred stock ratings.
 - PGE must maintain common equity portion of its capital structure at 48% or higher; PacifiCorp at 38% (39% after 12/31/2003).
 - PGE must notify the commission in advance of certain dividends and distributions to Enron.
 - The extent to which the Commission's reputation for supportive regulation has assisted PGE from harm is unknown.

Current Ring-Fencing Tools, Cont.

- The Golden Share
 - ◆ The Commission approved the issuance of a \$1.00 Par, Junior Preferred Share for PGE.
 - ◆ The intent was to limit or prevent Enron from forcing the Company to file for “voluntary” bankruptcy.
 - ◆ The holder of the share has the sole right to decide whether voluntary bankruptcy occurs.

- The Commission placed a \$200 million (aggregated) ceiling on loans that PacifiCorp could make to affiliates.

Current Ring-Fencing Provisions

- ◆ PGE and Enron must provide complete access to books and records (of both companies) and maintain records locally, i.e., in Portland
- ◆ PacifiCorp must provide, in Portland, all books and records and ScottishPower must provide those that are reasonably calculated to lead to discovery
- ◆ For Affiliate Transactions, both PGE and PacifiCorp must provide access to books and records that are pertinent to the transaction

Potential Ringfencing Tools:

- Required Freeze on Dividends to Parent upon Credit-Rating Downgrade or other trigger event, such as limits on other financial ratio (e.g., coverage ratio)
- Require Additional Equity Offering upon certain event
- Prescribe conditions in the event of default or other credit-diminishing event
- Broaden Definition of Dividends

Audit Program

◆ Team Audits

- The PUC recently completed comprehensive audits that reviewed all aspects of utility operations prior to rate cases.
- The audits resulted in numerous rate case recommendations, adjustments and greatly assisted Staff involved in the rate cases.

Code of Conduct

◆ Purpose

- Establish safeguards to govern the interactions/ transactions between electric companies and their affiliates engaged in competitive operations, both during the transition to and after the introduction of competition, to avoid potential market abuses and cross-subsidization between regulated and unregulated activities.

Conclusion

- ◆ There are several tools that have been successfully used to shield regulated utilities from undue harm caused by parent companies or affiliates.
- ◆ Whether via merger Conditions or via statutory constructs, it is possible to limit negative influences and protect the utility and ratepayers.