OPEN MEETING COVER SHEET

MEETING DATE: **September 11, 2015**

DATE DELIVERED: August 20, 2015

AGENDA ITEM NO.:

CAPTION: Project No. 42750 – Matters Pertaining to or Arising Out of the Chapter 11 Bankruptcy of Energy Future Holdings

ACTION REQUESTED: Memo from Commissioner Anderson

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Public Utility Commission of Texas

Memorandum

TO: Chairman Donna L. Nelson
Commissioner Brandy Marty Marquez

FROM: Commissioner Kenneth W. Anderson, Jr. KWA

DATE: August 20, 2015

RE: **Open Meeting of September 11, 2015, Project No. 42750** – *Matters Pertaining to or Arising Out of the Chapter 11 Bankruptcy of Energy Future Holdings*

In 2008, this Commission approved transactions involving a $45 billion dollar leveraged buyout of TXU Corp. (TXU), its competitive operating subsidiaries, and Oncor Electric Delivery Company LLC (Oncor)[1] by Kohlberg Kravis Roberts & Co., Goldman Sachs Capital Partners, and Texas Pacific Group.[2] Central to the Commission's approval of the TXU transaction was the imposition of various conditions, restrictions and other provisions (the Oncor Ring Fence) designed to insulate Oncor and its captive ratepayers from the enormous debt obligation being created to finance the transaction.[3]

The prescience and sagacity of the then-Commission was confirmed by subsequent events as Energy Future Holdings Corp. (EFH), the successor to TXU, despite its herculean efforts was unable to shoulder the buyout debt in the face of low natural gas prices and the resulting power prices in the Electric Reliability Council of Texas's (ERCOT's) fiercely competitive wholesale power market. Finally succumbing to the inevitable, EFH filed for bankruptcy last year in Delaware. Throughout EFH's travails, the Oncor Ring Fence has been successful in protecting Oncor's financial integrity and its ratepayers.

EFH and its direct and indirect subsidiaries involved in the above-referenced bankruptcy proceeding have now submitted to the United States Bankruptcy Court in Delaware yet another plan of reorganization (Third Amended Plan) describing, among other things, a proposed sale of Oncor.[4] Under the terms of the Third Amended Plan, (1) EFH's competitive businesses held under its wholly-owned subsidiary Texas Competitive Electric Holdings LLC (TCEH)[5] will be spun off

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[1] As a rate-regulated transmission and distribution utility, Oncor has a state-granted monopoly to serve customers in its service territory. Oncor's largely exclusive license to provide electric delivery service comes with an obligation to provide continuous and adequate service to all customers in its certificated service area. Public Utility Regulatory Act, TEX. UTIL. CODE ANN. § 37.151 (Vernon's 2008 & Supp.) (PURA). In exchange, Oncor is eligible to recover its reasonable and prudent operating expenses and is afforded the opportunity to earn a reasonable rate of return from net invested capital assets that are used and useful to serve customers. PURA 36.051.

[2] The TXU merger transaction closed on October 10, 2007 and was approved by this Commission in April of 2008. *Joint Report and Application of Oncor Electric Delivery Company and Texas Energy Future Holdings Limited Partnership Pursuant to PURA § 14.101*, Docket No. 34077, Order on Rehearing (Apr. 24, 2008).

[3] *Id.*

[4] Documents filed in the bankruptcy proceeding describing the Third Amended Plan are available at efhcaseinfo.com.

[5] TCEH is the parent company of TXU Energy, Texas's largest competitive electricity retailer in ERCOT, and Luminant, ERCOT's largest competitive power generation business.

to TCEH's senior creditors, at least initially, as stand-alone business in ERCOT's competitive markets and (2) an affiliate of Hunt Consolidated, Inc., a consortium of certain creditors of TCEH, and certain other investors (collectively, the "Investor Group") will acquire the reorganized EFH. Among its other terms, the Third Amended Plan then contemplates the conversion of the reorganized EFH into a real estate investment trust (REIT), whereby Oncor will be reorganized so that distinct entities will own and operate certain Oncor assets.[6] The Third Amended Plan indicates that the REIT-electing entity will be organized in either Delaware or Maryland.[7] Finally, and importantly to this Commissioner, the Third Amended Plan contemplates that $5.5 billion dollars or more of debt incurred in the 2007 transaction will continue to remain at the reorganized EFH.[8] While the precise structure of the REIT transaction remains somewhat unclear, what is not in question is that the prior approval of this Commission will be required under the Public Utility Regulatory Act (PURA).[9]

PURA requires that we review change of control applications to determine if the proposed transaction is in the "public interest."[10] While PURA does spell out a number of specific issues that must be addressed by applicants, the public interest standard is broad and gives the Commission considerable leeway in deciding the merits of individual applications.[11] My own view is that the most critical question to be decided by us in such a proceeding is whether a proposed transaction results in tangible and quantifiable benefits to ratepayers that exceed the costs and risks to those same ratepayers over a medium- and long-term perspective. Furthermore, the applicants should remember that they will have the burden of proof in the proceeding.

The purpose of this memorandum is to inform the representatives of the Investor Group of some of the critical issues that I believe will need to be addressed in their change of control application because certain provisions of PURA require the Commission either to approve, with or without conditions, or reject the application within 180 days of the its filing.[12] Otherwise the application is deemed approved as filed. The practical effect of these PURA provisions is to force the Commission to reject an application if the applicants fail to meet their burden of proof. Consequently, it is particularly important that the applicants make a complete application that fully addresses any issues with direct and specific evidence. They should not try to hold back some benefits to "sweeten the deal" later if they run into opposition because, in the absence of a

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[6] Energy Future Holdings Corp. Form 8-K submitted to the United States Securities and Exchange Commission on August 9, 2015.

[7] Why this may be important will be discussed later in this memorandum.

[8] Technically, this debt is being raised by the Investor Group to capitalize the reorganized EFH and is to be used to satisfy obligations created by EFH largely after the 2007 leveraged buyout as EFH desperately refinanced portions of the 2007 acquisition debt. By doing so, EFH was able to buy time and delay its day of reckoning by extending maturities of certain obligations. Whatever the technicalities, this debt clearly was not incurred to provide capital assets used and useful in Oncor's business and thus neither principal nor interest may ever be included in its electric delivery rates. However, these refinancing transactions did illuminate one shortcoming to the Oncor Ring Fence that should be rectified in any new ring fence.

[9] PURA §§ 14.101, 39.262, 39.915.

[10] PURA §§ 14.101, 39.262, 39.915.

[11] *Nucor Steel-Texas v. Public Utility Comm'n of Texas*, 363 S.W.3d 871, 877-878 (Tex.App.–Austin 2012, no pet.).

[12] PURA § 39.262, 39.915. This memorandum is also intended to assist the Commission Advising and Docket Management Division staff of the issues that I will want addressed in any preliminary order.

unanimous settlement, the Commission will be unable to consider any new evidence after the close of the record in the case because of the time constraint. I should also point out that I am in no way suggesting that the issues that I believe are central to this case are the only ones that they will need to address. Parties to the case will be free to raise other issues and I anticipate that my colleagues will provide their input as well. Ultimately, the preliminary order in the case will spell out all of the issues that the applicants will need to address in the case.

I believe there are two over-arching issues that will be central to the proceeding considering any change of control of Oncor under the Third Amended Plan. First, is the continuing existence of a substantial amount of debt resulting from the 2007 TXU leveraged buyout.[13] Second, is the proposal to restructure Oncor so as to qualify EFH as a REIT. From those two global issues flow many sub-issues and questions to which I will need satisfactory answers. A starting point for me is that Oncor's ratepayers ought not to bear any real risk associated either with the preexisting EFH debt or the proposed REIT structure unless they receive at least commensurate benefits over the long-run for that risk. That premise will be at the heart of my public interest analysis.

I. 2007 TRANSACTION DEBT ABOVE ONCOR

The Third Amended Plan contemplates that a substantial amount of debt that was created to finance or refinance the purchase of TXU Corp. in 2007 will remain. For the reasons illustrated in footnote 8, this strongly suggests that the Oncor Ring Fence must continue and even be strengthened irrespective of how Oncor may itself be restructured. Accordingly, I will expect the following issues/questions to be addressed:[14]

1. Should the existing Oncor Ring Fence be continued? If so, what additional provisions ought to be added? Should an independent board continue to be required?

2. Have the applicants laid out any path for the eventual retirement of the debt above Oncor? Should such a plan be required as a condition for approval or termination of any provision of the Oncor Ring Fence?

3. Should a specific minimum investment grade rating be required to be maintained? If so at what level?

4. What additional conditions or restrictions should be added or restored to the Oncor Ring Fence? Should dividends or other payments from Oncor to affiliates require the prior approval of Commission?

5. Do the instruments creating the debt above Oncor such as loan agreements, notes, trust indentures, security agreements, pledge agreements and other collateral documents contain adequate acknowledgement that Oncor is not liable, directly or indirectly, for any such debt and

[13] *See* note 8, *infra*.
[14] Again, these and subsequent questions are not intended to be exhaustive.

provide that the creditors may not attempt to exercise any control over Oncor without the prior approval of the Commission?

6. Should any instrument creating a newly incurred debt obligation for the REIT entities require the Commission's prior approval? Should that approval include any restriction on creditor attempts to exercise control over Oncor?

7. Should any Ring Fence order provide the consequences that flow from a violation or other failure to comply? If so, what consequences or penalties?

II. REIT RELATED ISSUES

As presented in the Third Amended Plan, the Investor Group will seek approval for a REIT structure in which one entity will own most of Oncor's fixed assets (the "AssetCo") and a separate entity (the "OperatingCo") will lease and operate those assets operating under the name Oncor. The separation of assets and obligations between AssetCo and OperatingCo presents an additional level of complexity in a change of control proceeding, and ultimately presents additional risk to ratepayers. The Commission will need to evaluate the characteristics of AssetCo and OperatingCo in reaching its public interest determination for the transaction as a whole. For example, one aspect of the analysis will be whether AssetCo and OperatingCo will both need to obtain a certificate of convenience and necessity (CCN) so that they will both be bound by PURA's obligations on certificate holders. Accordingly, I will expect the following issues/questions to be addressed:

1. How does this proposed REIT structure benefit Oncor's ratepayers? Are the benefits tangible and quantifiable? For example, would a REIT result in a lower weighted average cost of capital? If so, by which components would the benefits flow; cost of debt, cost of equity, both? How are such benefits, if any, going to flow to ratepayers?

2. What rights do minority or majority equity owners have to replace the REIT's management team? How does the REIT ensure that there is no risk under the law of the state of its organization that a majority of equity owners can replace its management team without the Commission's approval?

3. Under the laws of the state of its organization, what rights and under what conditions can minority or majority equity owners in AssetCo replace the management team? How does the AssetCo manager ensure that there is no risk under the law of the state of its organization that a majority of equity owners can replace its management team without the Commission's approval?

4. Should AssetCo be required to obtain a CCN to own its assets and lease them to the OperatingCo? Does PURA require it to have a CCN?

5. Should the Commission explicitly approve any lease agreements between AssetCo and OperatingCo and any modifications or supplements to them? Do the lease agreements provide

sufficient protection to ratepayers such that their terms cannot be changed or terminated without the prior approval of the Commission?

6. How does the tax structure of the REIT benefit ratepayers, if at all?

7. How does the REIT structure ensure that Oncor will always have sufficient equity capital to make new capital investment in assets used and useful in providing service to its captive ratepayers?

8. Should both AssetCo and OperatingCo be required to be within a ring fence? If not, why not?

9. Should the Commission prohibit AssetCo from owning any transmission and distribution assets outside of ERCOT because of jurisdictional considerations relating to the Federal Energy Regulatory Commission's authority?

III. OTHER PUBLIC INTEREST CONSIDERATIONS

The Third Amended Plan contemplates a REIT structure in which both AssetCo and OperatingCo will organize as Delaware limited liability companies. AssetCo will enter into agreements with other REIT-related entities, including a Maryland or Delaware parent corporation that elects to be taxed as a REIT. Accordingly, the laws governing limited liability companies and corporations in Delaware (and possibly Maryland) will govern the obligations and responsibilities both with respect to intra-company disputes and potential inter-company disputes insofar as they affect the rights and privileges of equity owners and the duties owed to them by their respective internal management. Consequently, the business organization laws of these states will play a key role in this Commission's analysis of the transaction, and it will be incumbent upon the change of ownership applicants to demonstrate that those laws do not create risks that could negatively affect Oncor's service to ratepayers. For example, a fiduciary obligation of EFH's board of directors that conflicts with Oncor's obligation to provide continuous and adequate service creates a risk to ratepayers that should be avoided.

In addition, the choice of Delaware or Maryland law may affect the venue for any lawsuit arising out of the REIT-related entities. For example, the Delaware Limited Liability Company Act allows members to bring derivative actions in Delaware courts.[15] This means that an aggrieved member of AssetCo could potentially bring a lawsuit affecting AssetCo property in a foreign jurisdiction. However, Delaware courts may not recognize the significance of AssetCo property to Texas electricity customers. So another consideration for this Commission is whether certain legal actions relating to the REIT-related entities should be brought in Texas courts and, if so, how?

[15] DEL. CODE ANN. tit. 6 § 18-1001.

Finally, as previously noted, PURA imposes a 180 day determination timeline in a change of control proceeding.[16] Given the tight turnaround time in this type of case, it is critical that the applicants prepare their final and best application with evidence addressing the issues in this memorandum for the Commission's consideration at the outset of the change of ownership proceeding because the parties will have limited opportunity to negotiate the terms of the transaction during the pendency of the case. Furthermore, once the evidentiary record closes in the case it is unlikely that time will be available to re-open and supplement the record with additional evidence relevant to a public interest finding.[17]

At the next open meeting, unless my colleagues propose otherwise, I do not propose to discuss this memorandum. I merely wish to raise these issues for consideration by the persons preparing any change of control application.

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[16] PURA §§ 39.262, 39.915.

[17] *See Application of Entergy Texas, Inc., ITC Holdings Corp., Midsouth Transco LLC, Transmission Company Texas, LLC, and ITC Midsouth LLC for Approval of Change of Ownership and Control of Transmission Business, Transfer of Certification Rights, Certain Cost Recovery Approvals, and Related Relief*, Memorandum of Commissioner Kenneth W. Anderson, Jr. at 2-3, Docket No. 41223 (Aug. 9, 2013).