BEFORE THE PUBLIC UTILTIY COMMISSION

OF OREGON

UM 1121

In the Matter of OREGON ELECTRIC UTILITY COMPANY, LLC, et al., Application for Authorization to Acquire Portland General Electric Company	)))))))))	TESTIMONY OF THE CITIZENS'UTILITY BOARD OF OREGON

My name is Bob Jenks. My qualifications are listed in CUB Exhibit 101.

My name is Lowrey Brown. My qualifications are listed in CUB Exhibit 102.

I. Introduction

On March 8, 2004, Texas Pacific Group (TPG) put forth its proposal for acquiring PGE through Oregon Electric Utility Company (OEUC). The March 8 Application was disappointing in that the identification of benefits for customers was incomplete and inadequate and the risks of the double leveraged ownership structure were not addressed head on. TPG's supplemental testimony, filed May 27, 2004, better organized the asserted customer benefits, but by doing so, it clarified the paucity of customer benefits produced by the acquisition proposal.

It is as if TPG expects the Commission to approve this application, even though its risk are new and significant and its benefits are few and intangible, because TPG is not

Enron. The application seems to ask the Commission “what else are you going to do, hand PGE back to Enron and the bankruptcy court?” TPG is banking its approval not on who it is, but on who it isn’t.

Not being Enron is not good enough. The customers of PGE, the employees of PGE and the Oregon economy have suffered over the past four years because of Enron’s ownership. This does not simply argue that it is a net good to get rid of Enron. This experience argues that we must carefully consider who owns PGE and where is that owner likely to take us.

When TPG does tell us who it is, they refer to a Board of Directors, only very recently named, which consists of a number of prominent local dignitaries. TPG claims that this Board is not only a, but *the* biggest benefit for consumers. But as we will discuss below, a corporate board of directors does not exist for the benefit of the corporation’s customers, but for the corporation’s investors and shareholders. And, in fact, the consent rights reserved by TPG in this arrangement belie the assertion that customer interests will somehow be given a prominent role in corporate decision-making.

Underlying all this is a series of very serious risks associated with the new ownership. These risks include the enormous level of debt inherent in this double-leverage arrangement; a lack of transparency associated with a private investment firm that is not expected to file regular financial filings with the SEC; a relatively short-term owner with no certainty as to the next owner much less the next transition state; the problem of customers paying taxes to the company that the company doesn’t have to pay to the government; and the unfamiliar if not unpredictable incentives for investors established by an enterprise that is to make money through the capital gains from the sale of the utility rather than the traditional rate of return regulation.

In short, we cannot support this application. We have several layers of analysis in CUB's testimony and our analyses lead us to believe that the risks are too great and the benefits are too insubstantial to meet the net benefits test or to meet the needs of PGE customers. We have provided a number of conditions that we think would move us closer toward a net benefits result. The conditions are designed to reduce risks and increase benefits.

Our testimony is organized is the following manner:

Bob Jenks and Lowrey Brown offer testimony relating to the cost and benefits of the proposed transaction from a regulatory theory perspective. At the end, we identify conditions that go toward reducing risks and developing some benefits. CUB/100/Jenks-Brown.

Jim Dittmer, of Utilitech, offers testimony relating to the costs and benefits of the proposed transaction with more attention to the financial underpinnings and implications of the deal. CUB/200/Dittmer.

Jeff Bissonnette appears on joint testimony with Ann Gravatt, Susan Anderson, Jim Abrahamson, Mary Li, Steve Weiss, Andrea Fogue and Rebecca Sherman to discuss on-going commitments to Oregon's energy policies. Joint Public Interest Testimony of CUB, RNP, City of Portland, CADO/OECA, Multnomah County, NWEC, League of Oregon Cities, Hydropower Reform Coalition.

II. The Risks of the Transaction: Great and Small

A. An Inadvertent Change in the Regulatory Paradigm

1. Regulatory Paradigm shift via an Application to Exercise Influence

OEUC's application to acquire PGE is quite different from the acquisitions/mergers offered by Sierra Pacific and Northwest Natural, and indeed from the type of acquisition envisioned as the traditional regulatory paradigm was developed. A shift has taken place in the utility industry with the introduction of market principals and the lax enforcement of PUHCA. With this shift, higher-risk, higher-reward investors, who previously had been uninterested in utilities, are finding new ways to profit from the utility industry.

By moving away from the traditional paradigm, we set a precedent of short-term ownership, which is increasingly risk-tolerant and profit-driven, and put ourselves on a merry-go-round of management, which undercuts the fundamental, long-term incentive structure established by the traditional regulatory paradigm. This is not a shift we should make blithely. Careful consideration and preparation will be necessary to protect customers if we decide this shift is worth making.

2. The Traditional Paradigm Of The Regulated Utility

When utility regulation was first developed, utilities were seen as natural monopolies because of their infrastructure and capital intensity. It made little sense to have multiple sets of wires and poles serving the same area. By financing expensive power plants over their useful life, which is decades, not years, the regulatory structure made expensive investment affordable for customers. By ensuring a rate of return on prudent investments over their useful life, the regulatory structure made necessary investments attractive for investors. Utilities were vertically integrated, providing everything from the meter on up. Each utility had its service territory within which it was the sole provider. In exchange for this monopoly, the utility had an obligation to serve and regulated profits.

There was another reason to regulate. Electricity is an essential service upon which individuals, the community, and the economy depend. To leave such a backbone entirely exposed to the forces of the market puts far more than the utility at risk. So regulation was the compromise between economic efficiency, the capital demands of the utility industry, and the place of electricity in society.

The utility industry grew on profits coming from a rate of return on long-term investments to serve the community. The monopoly and the guaranteed return, within bounds of prudence, reduced the risk to investors. On the other hand, the rate of return was more modest than that provided by riskier investments. It was not the sexiest financial investment, but it was stable, and, over the long-term, profitable.

In part due to the long-term nature of a utility's investments, in part due to its role in powering society, and in part due to its regulated nature, utilities became community participants. Their long-term relationships with their customers, their employees, and the regulatory bodies, as well as with policy makers, provided a continuity and reliability not expected of other businesses.

3. New Investors and Their Different Expectations of Regulation

The Energy Policy Act of 1992 was the harbinger of a shift in the regulatory paradigm. Leaders envisioned a dismantling of vertical integration, and the introduction of market forces into the utility industry. Riding on the wave of this change, Enron swept into town. Enron was different than traditional utility ownership; Enron did not buy PGE to simply run a regulated utility; its plans were far grander. Suddenly, rather than being an entity unto itself, PGE became a pawn in a larger, profit-making scheme.

In the traditional regulatory paradigm, a utility investor's financial return was within a reasonable range of the allowed rate of return. Due to regulatory lag and costs that vary somewhat from normalized ratemaking, returns could be a bit higher or lower than the allowed rate of return, but over time it was expected that investors would earn that allowed return. The recent changes in the marketplace and the increasingly lax enforcement of PUHCA have attracted to utilities investors for whom the regulated rate of return is not enough.

These new investors have an entirely different mindset than those who invested under the traditional regulatory paradigm. They invest in a utility for reasons other than running a regulated utility. Their investment timeline is far shorter than the long-term utility investment timelines of the past. As these investors do not fit into the mold of traditional utility investors, the businesses they run do not fit into the mold of a traditional regulated business. Though Enron is only a sample of one, it does provide an example of what can happen when a utility is run by people whose primary goal is not running a regulated utility.

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B. Specific Risks Arising from the Application and the Regulatory Shift

1. Risk Tolerance and Rate of Return

The traditional regulatory paradigm was designed for a long-term investment horizon and a steady, if moderate, rate of return. The root of why this shift is unsettling lies in a regulatory regime which was not designed for the proposed ownership profile.

Simply stated, the regulated rate of return is not sufficient for the new investors. This means they have to find additional profits somewhere. If OEUC can improve PGE's short-term financial situation by cutting costs and improving earnings in the short run, they can turn around a sell the company for more than they paid, and pocket the capital gains. In addition, if OEUC can cut costs they can reap the benefit of these savings until their next rate case if filed or until they sell PGE. If OEUC can substitute low cost debt for the assumed equity without regulators recognizing the lower cost debt for ratemaking purposes, they can pocket the difference. If there are loopholes, such as the tax loophole we will discuss later, they can pocket this money as well. So, the authorized return on equity may not be enough for these new investors, but the combination of all these profits suddenly looks a little more interesting to a higher-risk, higher-return investor.

Which brings us back to the risk tolerance of these new investors. In order to buy PGE, they need capital; a lot of it. If this acquisition goes through, OEUC will be highly leveraged at the closing. But TPG's investors need not worry themselves about the long term implication of this debt load, because TPG doesn't intend to be around that long. OEUC comes in with a massive debt load, cuts some costs, reaps some tax benefits, improves the short-term balance sheet, and gets out quick with capital gains in tow. Yet

PGE's customers and employees are around for the long-term. There is little alignment of the owners' interest and the interests of the customers and employees.

2. Short-Timers Disease.

a. Cutting costs and investment in infrastructure.

In the traditional regulatory paradigm, the utility will earn approximately its allowed rate of return over a period of some years. Some years it will earn a little more, some years it will earn a little less, but, on average, over the long haul, it will earn its rate of return. An investment made for thirty years will pay off, just as investments made thirty years before are currently paying off. The Applicants don't care what happens in thirty years; they won't be around then. TPG's mandate from its limited investors only allows it to hold investments for 12 years. OE/3/Davis12. Many analysts think the time period is much shorter, from five to seven years.[1] For short-term investors, when push comes to shove, short-term profits will take precedence over long-term development. For these investors, their return is as much related to the specific timing of their investment as it is to the investment itself. This shift in the regulatory paradigm threatens to undercut the incentive for long-term investments in the utility's infrastructure.

CUB witness, Jim Dittmer, addresses the incentives for investors that this acquisition creates. See CUB/200/Dittmer/28-30. In brief, a short-term owner who has plans to resell the utility in five to ten years has every incentive to cut short-term costs and reduce capital expenditures well below the levels needed for the sake of efficient

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[1] See for example website of Powermarketers.com at:
http://powermarketers.netcontentinc.net/newsreader.asp?ppa=8kowu%5DZghmlgnsWUgc%7DGL%7Dbfej%5B!
and Business Journal of Portland at:
http://portland.bizjournals.com/portland/stories/2003/11/24/editorial2.html

operation in order to boost company earnings in the short run. This makes the utility more attractive to the next buyer. Concurrent with the incentive to cut costs to the bone, however, the short-term owner has a disincentive to invest in the utility infrastructure for the long-term. Overzealous cost cutting in the near term and no investment for the long-term spells disaster for those customers and employees who are still here years after OEUC has left.

Texas Pacific has argued with respect to rate credits that it does not have synergies to use to cut costs. In his supplemental testimony, Kelvin Davis argues that the reason Texas Pacific was not offering a rate credit was that there were no synergies that would produce such savings:

> In prior proposed mergers involving PGE, the proposed buyers were other energy companies, which meant there would be merger "synergies" resulting in cost savings and benefits to the applicants. These synergies formed the basis for settlements that featured fixed rate credits. By comparison, this is an acquisition by a non-energy related company with no other business. It is not a merger. Oregon Electric has no other holdings and there will be no synergies available to share with customers.

OE/22/Davis/26-27.

Thad Miller, on behalf of Oregon Electric, made a similar argument to the Oregonian on May 28th:

> Texas Pacific argues that because it's an investment firm and not a utility, it can't easily find savings in overlapping services or expanded operations that normally would allow an acquirer to reduce rates.
>
> "We don't have any of those synergies," said Thad Miller, an attorney for Oregon Electric Utility.

CUB Exhibit 103.

TPG's position misses two important points. First, in the past rate benefits have not been dependent solely on synergies from two similar energy utilities coming together. Enron was not a utility. ScottishPower did not have a US affiliate with which to share functions. Rate credits in the ScottishPower acquisition of PacifiCorp were based on efficiencies that the company was able to identify as sources of savings. Second, despite their statements to the contrary, we think TPG has identified "efficiencies" that they believe they can find with PGE.

For the purposes of Oregon regulation, there is a need to answer two questions: 1) are these really "efficiencies" that can be gained with no harm to customers or are they really cost-cutting efforts that over time will have a detrimental effect on PGE's ability to serve customers; and 2) how are the benefits of these costs cuts shared between investors and customers.

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See Conditions H and I, below.

<u>b. No long-term accountability</u>

Short-term investment in utilities threatens not only the incentive for long-term planning, but also the long-term accountability of the owners. The expression, "you reap what you sow," no longer applies. Investors who will be gone in five to ten years can afford to let maintenance slip. They can reap the saved dollars for a few years, a large percentage of their tenancy, and be long gone before the effect of neglect takes its toll. When poor maintenance finally catches up, and knocks a plant off line, these investors will be sipping martinis elsewhere. Long-term investors, on the other hand, will feel the repercussions of their actions.

c. No long-term investment in public policy

Because the proposed ownership arrangement is necessarily short term, it creates incentives for examination of short term issues such as cost cutting and short term investments, but it does not create either the prospects of a continuing management philosophy or a focus on a number of energy policy matters which are by necessity long-term in nature.

For example, SB 1149 and the Energy Trust of Oregon (the Trust) are manifestations of years and years of dialog, planning, negotiating, and development. See Joint Public Interest Testimony. Those systems and structures which preceded the Trust, and those systems and structures which will follow are a multi-generational undertaking. What role would an owner whose investment horizon is a few want to play?

There are numerous examples of long-term state, regional and federal policy initiatives and issues that will require a long-term investment of human and capital resources. The long-term role of the Bonneville Power Administration, long-term transmission planning and funding, global climate change initiatives are all examples of issues that benefit from long-range planning and long-term process participation. Focus on the short-term and failure to participate in the long-term processes will harm customers, the system and the region.

See Condition E, below.

3. Debt Levels

This deal is being financed primarily with debt. Mr. Dittmer calculates the practical debt load of PGE in his testimony at CUB/200/Dittmer/4. Even though debt is cheaper than equity, there are a number of reasons that we expect utilities to have nearly 50% of their investment in equity. A utility's actual return on equity will vary from year to year depending on fuel costs, market prices, hydro availability and other factors. Over time, a utility can expect to earn its return on equity but it won't happen every year like clockwork. In many respects, equity acts as a shock absorber to remove the bumps in the road that occur regularly.

Debt, on the other hand, must be paid on a specific schedule or lenders can seize collateral assets. It does not have much flexibility and cannot act as a shock absorber. TPG is counting on more lines of credit to act as a shock absorber, but this simply adds more debt to a structure already full of debt. This is tantamount to exhausting a second mortgage and turning to credit cards. This heavy debt structure has already affected PGE credit outlook as Standard and Poors has placed PGE on credit watch with negative implications. See CUB/208/Dittmer.

Yet this heavy debt structure spread between PGE and OEUC allows TPG to take advantage of Commission ratemaking traditions. By placing much of the debt at the OEUC level, where it can still have negative consequences for PGE, TPG can benefit from the Commission's adoption of PGE's stand-alone 48% equity even though the actual debt-heavy capital structure is a lower cost.

Finally, this highly leveraged utility will have a difficult time getting TPG, through its negative consent rights, to approve the long-term capital investments which are a fundamental part of the regulatory structure.

See Condition A, below.

4. The Tax Loophole

The current method of calculating PGE's taxes is to calculate PGE's taxes as though it were a stand-alone company. The rationale behind this is to protect customers from parent corporations who have multiple subsidiaries and diverse businesses with large potential tax liabilities. The current system was set up to protect PGE customers from paying any more taxes than they would have paid if PGE were a stand-alone company.

The problem with the current arrangement is that it does not protect customers from paying taxes which never reach the government. This happens when the consolidated tax liability is less than the utility's stand-alone liability.

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Because this shareholder tax advantage is not just an accidental by-product of the structural arrangement, but indeed is a key element of the proposed structure, and because this tax-advantage-by design is a direct burden on customers, the Commission should recognize this loophole as a harm of this transaction.

See Condition B, below.

5. A Private Company In A Public Process

It is still unusual to find throughout the nation a regulated electric utility owned by a privately held investment firm. The privately held investment firm has an "advantage" over the publicly traded corporation in that it is not required to make a number of financial filings to the SEC. Indeed some industry analysts see that the absence of a requirement for privately held investment firms to make SEC filings is a benefit for the utility owner.[2] The benefit, to the utility owner, is reduced costs and reduced transparency. Obviously, the customer of the monopoly utility does not see this as a benefit.

The regular SEC filings are very important. They provide create transparency and compel disclosure. A situation where the owner of PGE is not required to file the quarterly 10Q and annual 10K filings represents a loss of transparency and a reduction of information flow. This is an absolute harm in the context of a regulated monopoly utility. We must now rely on the Commission to require all forms of transparency and disclosure. We should not have a net loss of avenues of transparency and disclosure as a result of this transaction.

See Condition J, below.

6. The End Game

This proposal is different from other acquisition proposals. As we have stated, Texas Pacific's model is not the traditional regulatory paradigm where investors are

[2] See July 2, 2004, UtiliPoint International Issue Alert.

making long-term capital investments with a goal of earning a reasonable and steady rate of return. Instead Texas Pacific sees PGE as a commodity which it will dispose of within a matter of years. In this filing the Commission is being asked to approve this business model as appropriate and consistent with the public interest. In order to approve this business model, which does not exist with any other regulated utility in the state, the Commission must consider the end game. How will Texas Pacific dispose of PGE?

Because this ownership arrangement is necessarily short-term in nature, we consider it a transitional stage. In isolation, yet another transitional state is yet another problem with this proposed transaction. If this transitional ownership gives us no more, or perhaps even less, assurances as to the next ownership than the bankruptcy court process, then this transitional ownership is of little value. However, if the transition gets us to a better long-term, stable state, this transition could be of use.

Representatives of TPG and OEUC have stated publicly that the most likely exit options are resale to a strategic investor or a public offering of PGE stock. Indeed, Local Applicants say that the IPO is their “preferred choice.” OE/2/Local Applicants/8. The public offering option is of some interest because it returns PGE to the pre-Enron days and creates a Board which is free from the dictates of a single major investor and which can focus on its sole or primary holding, the traditional regulated utility. The resale to a strategic investor, however, creates a number of problems for and generates little interest from customers.

The resale to a strategic investor is problematic. Selling PGE for a significant profit could potentially contribute to upwards rate pressure for customers. Such a sale would create an even larger premium that the new owner will expect to recover from customers. While the new owner may well have some synergies that can be used to offset this premium, the size of the premium will make it difficult for the new owner to recover the purchase price without raising rates. TPG's plan to pay down its debt load early is meaningless to the customer who will simply be saddled with the next owner's debt.

In addition, we are not believers in the concept that bigger is always better. In the world of regulated utilities we have come to believe that there has to be reasonable balance between the size of a regulated company and the regulatory jurisdiction. Multi-state utilities are more difficult to regulate as we have seen over the last several years of dealing with PacifiCorp's multi-state problems. But while PacifiCorp is a multistate utility it is much smaller than some of the entities that Texas Pacific could look to as potential purchasers. The end game of a strategic sale could end up with an owner that is closer to the size of the big telecommunications companies. For many years, the OPUC has had difficulty with Qwest and its predecessor US West. The company cut costs and destroyed service quality for a number of years during the 1990's and the Commission had few tools beyond the bully pulpit to use to try to get the company to provide adequate service.

Texas Pacific is anticipating that PUCHA will be repealed and the strategic sale can be part of a large consolidation of the electric industry. At that point PGE will likely lose many of the benefits that are claimed in this application: it will no longer be headquartered in Portland, it will no longer have a Board containing a significant number of Oregonians, and it will not longer have local management.

Simply put, given a choice between a large multi-state utility and an independent company that is sized around PGE's current size, we would choose the latter. We believe that the company is large enough to enjoy the benefits of scale for power supply, without being so big as to make regulation difficult.

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III. TPG's Offered Net Benefit

A. TPG's Offering

In his original testimony and in his supplemental testimony, Kelvin Davis lists the benefits that are being claimed from this application and we will respond to the items on this list. However, throughout the application there is the general theme that the primary benefit is that PGE is no longer Enron. Claiming this as a benefit, however, is like claiming as a benefit that the sun will come up tomorrow. Certainly the sun will come. Certainly that is beneficial. It will even make Bob's tomatoes happy. However, it will happen regardless of how the Commission rules on this application. The same is true of the separation of PGE from Enron. Certainly it is beneficial. But it will happen regardless of whether the Commission approves this application.

The real question is whether this is the best of the available options to remove PGE from Enron, not whether PGE is removed from Enron. According to the bankruptcy court ruling, there are two choices currently on the table, selling PGE to TPG, or distributing PGE stock to Enron's creditors. Because the words "Enron's creditors" contain the word "Enron," we are supposed to be frightened of this option. But we should not be. Nor should we completely assume that it is the only option. If PGE is returned to the Enron bankruptcy process, another buyer could emerge. Even if another buyer does not emerge, the stock redistribution through the bankruptcy proceeding is a viable alternative to the proposed transaction.

We should not be in fear of a stock redistribution to the creditors. This option has been discussed by PGE for several months before this deal was announced in November 2003. According to PGE CEO, Peggy Fowler, PGE would have a bright future as an independent locally-managed company under this scenario:

> Our future is bright. Soon, we will take one of two paths – PGE will become an independent company, or we will be sold as an intact business. Either way, our employees will continue serving the communities where we live and work. We will remain locally managed, and our company will remain whole.

CUB Exhibit 111. Peggy Fowler, PGE CEO, Multnomah County Voters' Pamphlet, October 2003.

This doesn't sound frightening: an independent company, locally managed, and remaining whole. But it does reflect our understanding of the stock redistribution option. PGE stock would be placed in a trust where it would be distributed over a period of the next few years to Enron's creditors. The creditors would then begin publicly trading the stock. At the end of a period of 5 to 7 years (similar to the period of time that Oregon Electric would own PGE), PGE would be a fully independent, publicly traded company.

In other words it would return PGE to its pre-Enron days. This is a result that much of the public would support and would see as a true benefit.

Contrast this to the other benefits listed by Mr. Davis are as follows:

- Certainty of ownership and unified shareholder support
- Accountability to customers and community
- PGE management will have the resources of a dedicated, first-class board of directors to help it navigate the challenges ahead;
- Thoughtful and skilled strategic leadership and long-term planning, ensuring PGE's long-term health
- Enhanced reliability and efficiency from investment in utility assets and the acquisition and development of new resources
- Best-in-class safe, reliable and efficient electric service.

OE/3/Davis/22.

In his supplemental testimony, Mr. Davis adds to this list:

- Providing customers with the opportunity for a rate credit if PGE is earning above its authorized rate of return
- Adoption of service quality measures
- Periodic access to the PGE Board for certain advocacy groups
- Use of renewables for power supply
- Assistance to low income customers.

OE/22/Davis.

Unfortunately, there is little of substance behind this list.

B. A Review of Each "Benefit"

1. Certainty Of Ownership And Unified Shareholder Support

Texas Pacific application guarantees that PGE will be put up for sell in a few years. This is the opposite of certainty of ownership. Ownership will necessarily change again. We have seen how the uncertainty of ownership affects a utility in recent years. Since Enron put PGE up for sale several years ago, PGE has been frozen in place. It has been unable or unwilling to make long term commitments to new resources without knowing who would own it. Its primary focus has seemed to be to enhance its value by shifting risks onto customers through PCAs, deferrals and annual power cost rate cases. The application in front of this Commission simply guarantees that we will be back in this uncertainty in a matter of a few years when the Company is put up for sale and Texas Pacific begins shopping it around.

As for unified shareholder support, we are skeptical. The application and review process has already shown some disagreement as to the end game, which from a customer perspective may be the most important unresolved question. The local applicants testify that an initial public offering is "our preferred choice" for Oregon Electric's disposal of PGE. For a discussion of the likelihood of TPG's exit options, see above, p. 16 to 20.

2. Accountability To Customers And Community

The proposed acquisition does have accountability provisions, but they refer to the PGE and OEUC boards' accountability to TPG. They are listed in Oregon Electric Exhibit 7. They are the consent rights that guarantee that Oregon Electric and PGE will be accountable to their largest investor, Texas Pacific.

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The only accountability to customers and the community that this proposal offers is the accountability that comes from the regulatory compact between an investor-owned electric utility and the State of Oregon through the PUC process. But that accountability exists as long as PGE remains in the hands of investors whether it be this deal, stock redistribution to Enron creditors or another deal. The only proposal that would change this accountability structure would be a sale or takeover by a public body, but such a transaction would simply create a new system of accountability to customers and community through elected public officials.

In describing the standards for corporate board directors, ORS 60.357(1) says that the director shall act "in a manner the director reasonably believes to be in the best interests of the corporation." A board and a board member's primary duty are not to the customer and the community but to the best interests of the corporation and its investor. Every time there is a rate filing, the corporation's investor's interest is in conflict with the customer and the community. In fact some of the newly named PGE Board members already have a built-in conflict of interest as employees of PGE commercial or industrial customers while simultaneously acting in the best interests of the utility. But even if hypothetically OEUC's Board were able to and did act in customers' best interests, this benefit is as fleeting as the short-term nature of TPG's ownership and would end when TPG sells PGE.

3. PGE Management Will Have The Resources Of A Dedicated, First-Class Board Of Directors To Help It Navigate The Challenges Ahead

The problem with this as a benefit is that customers are already paying rates that assume this. The regulatory system assumes that companies are well-run, prudently managed and have strong, dedicated boards. No matter what happens to PGE coming out of the bankruptcy of Enron, we would expect this basic requirement to be fulfilled.

4. Thoughtful And Skilled Strategic Leadership And Long-Term Planning, Ensuring PGE's Long-Term Health

Again, this is something that we believe should be expected of all regulated utilities. A fundamental part of the regulatory compact is to ensure long-term planning and investment in a least cost manner. Electric utilities take a lot of capital investment and we must expect that capital is invested with skill and with the long-run interest in providing electric service to customers. This application, however, changes the regulatory paradigm by adding a conflicting goal, maximize the resale value of the utility in the short-term. The skill of the leadership is not primarily in electric production, but in the buying and selling of companies. What happens when these two goals are in conflict – which one takes priority is a key question that applicants have failed to address.

5. Enhanced Reliability And Efficiency From Investment In Utility Assets And The Acquisition And Development Of New Resources

This is exactly what utilities are supposed to do: project future load and ensure efficient, least cost investments in resources that are sufficient to provide reliable service. Promising to run a utility as a utility is not a benefit. It does, however, say something about this application that it needs to state the most basic roles of a utility as unique benefits. We think that the incentives for the investor built into this deal encourage disinvestment and lack of attention to the utility infrastructure.

6. Best-In-Class Safe, Reliable And Efficient Electric Service

A utility should be constantly examining its industry with a goal of learning from other providers and attempting to provide the best service possible. PGE, of course already offers reliable service. Where PGE is not best-in-class, particularly with respect to regional utilities, is in its rates. While promising best-in-class service, the application fails to address how it will obtain best-in-class rates for PGE. In fact, the applicants have suggested that because this application does not involve a merger of two electric companies and therefore has no synergistic benefits, rates will not be affected.

7. Providing Customers With The Opportunity For A Rate Credit If PGE Is Earning Above Its Authorized Rate Of Return

If PGE is earning above its authorized rate of return, the traditional regulatory compact allows the Commission to begin a show cause rate case to reduce the company's rates down to its authorized rate of return. In such a rate proceeding, customers would be entitled to all revenues above the authorized level, not some undefined share. By suggesting that Oregon Electric should be able to retain earnings above the authorized level, this “rate credit” could actually harm customers by realigning the regulatory compact so shareholders are allowed to keep excess earning. In addition, Oregon Electric’s proposal is based on the company first retaining the benefits of lower cost debt as compared to equity and to taxes that customers pay in excess of the actual tax bill. When these are taken into consideration, Oregon Electric is asking the Commission to change the regulatory paradigm to allow them to earn a return on equity well in excess of what is just and reasonable. See CUB Exhibit 200/Dittmer/12.

8. Adoption Of Service Quality Measures

First it is important to note that service quality measures are already in place and are assumed. The only additional service quality measure being discussed is one that deals with billing accuracy. This really is an issue of maintaining the existing status quo and not offering customers anything in addition. More importantly, these service quality measures are necessary because of the risks associated with this transaction. The short term nature of this deal creates incentives for the investors to cut costs and increase earnings that can be used to pay down debt and increase the capital gains when PGE is resold. In addition, cutting costs would “pretty up” PGE’s balance sheet and make the utility more attractive, thereby increasing the sales prices. TPG’s offer of service quality measures are not a benefit to customers, because they are already assumed and because they are a necessary protection due to the tremendous risks that this transaction places on customers.

9. Periodic Access To The PGE Board For Advocacy Groups

This is an idea that we have encouraged, but it is hard to attach a great deal of concrete benefit to it. It is a process, not a benefit in and of itself. If such access is given simply to provide a benefit necessary to get this acquisition approved, then there is no guarantee that the access will be anything more than an empty gesture. However, if the access is genuine, and the company acts on the advice that comes from such access, then both customers and shareholders could benefit. Unfortunately, if the investors are not willing to accept customer suggestions now, as part of the merger approval process it is doubtful that having them agree to listen to customers later is a significant benefit.

10. Use Of Renewables For Power Supply

There is little doubt that development of renewable power will benefit PGE's customers. The recent least cost plans of PGE and PacifiCorp prove that renewables are an important part of a well balanced portfolio of power supply. Costs for renewables have declined. Renewables avoid the fuel price risk of natural gas and avoid the environmental risks associated with coal. Currently PGE is underinvested in renewables and their LCP shows that an increased investment does lead to the least cost, least risk approach. It would be irresponsible for PGE not to invest in more renewables. As CUB stated in our comments on PGE's LCP, we believe that renewables investment is necessary to ensure a prudent portfolio of resources and we will argue that the company has been imprudent if it fails to live up to its renewable analysis from the LCP. Oregon Electric's commitment to invest in renewables "provided it can be accomplished economically" is a commitment to what is expected of a prudently managed utility. See Renewable Northwest Project's testimony on TPG's specific proposal.

11. Assistance To Low Income Customers

Oregon Electric makes three pledges with respect to low income customers. The first is to extend what it is already doing for ten years. This is simply a continuation of the status quo and not a real benefit. Second, Oregon Electric pledges to double its cash donation to Oregon HEAT for the next 10 years. Currently, PGE contributes $100,000 in cash and in-kind donations to Oregon HEAT. The supplemental testimony does not disclose how much of this $100,000 is cash (the component being doubled) so it is not clear what is the value of this commitment. Third, they promise a process to examine low income issues. However, whether this process will lead to better programs and real benefits for low income customers is uncertain.

IV. Conditions

The application as filed contains few if any benefits and very significant, very real risks. We believe that the following conditions are necessary in order to address the risks associated with the proposed application.

A. Recognition of consolidated capital structure for ratemaking purposes

In our testimony we discussed how this application is attempting to change the regulatory compact where a utility earns a modest regulated return on its shareholder equity. TPG is making a highly leveraged purchase of PGE, and parking much of the debt at the Oregon Electric. The capital structure at PGE will look like a typical utility with around 48% equity, even though the real purchase underlying PGE will be only 25% equity. Because interest rates of debt are lower than returns on equity, this structure forces customers to pay for a more costly capital structure than the one that actually represents the investment in PGE and allows TPG to earn well above the traditional return on equity.

BEGIN CONFIDENTIAL MATERIAL

END CONFIDENTIAL

Under the traditional regulatory compact, a return on equity of that level would violate the basic principle of just and reasonable rates.

Therefore CUB recommends as a condition that the Commission recognize Oregon Electric's consolidated capital structure adjusted to remove the amount of investment that is supporting the premium and transaction costs for ratemaking purposes in order to insure that customers pay a return on actual equity levels.

B. Recognition of the anticipated tax saving for ratemaking purposes

In our testimony we discussed the tax loophole that allows Texas Pacific to earn above the authorized rate of return by pocketing some of the money that customers pay as utility taxes rather than use it to pay taxes. Under Oregon Electric's structure adjusting to remove the overpayment of taxes needs to happen as a "known and measurable" adjustment to a utility test year in a rate filing.

BEGIN CONFIDENTIAL MATERIAL

END CONFIDENTIAL

Under the traditional regulatory compact, customers should not pay costs at levels that are known to be higher than the utility's actual costs. Such rates are not just and reasonable.

Therefore CUB recommends that the Commission recognize Oregon Electric's anticipated tax savings for ratemaking purposes.

C. Costs associated with the removal of PGE from Enron

Removal of PGE from Enron has the potential to increase costs, resulting in a clear harm to customers. CUB/200/Dittmer/44-45. There are two sets of costs to be concerned about. First, there are the one-time transaction costs, including the cost to develop systems necessary to replace the overhead functions provided by Enron. Then there are the on-going costs associated with the loss of Enron synergies.

When Enron purchased PGE, it was promised that there would be synergistic benefits stemming from combining similar corporate functions. Customers were provided rate credits of $9 million per year for the first four years after Enron's application to reflect these synergy benefits. After four years, it was expected that these benefits would show up and be incorporated into rates.

BEGIN CONFIDENTIAL MATERIAL

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CUB recommends that Oregon Electric be required to file with the Commission within 90 days of the close of the purchase of PGE, an analysis that documents the transaction cost associated with this acquisition and the on-going costs PGE was paying to Enron to support corporate overhead and corporate services. The company should identify how it expects that these functions will be supported with Enron removed from PGE's ownership structure.

CUB also recommends that PGE should be required in any rate filing to show it is not proposing higher costs in each of these function than customers paid during the average of Enron's last three years of ownership of PGE.

D. Rate credit or rate moratorium

In previous merger dockets, rate credits and/or rate moratoriums have been used to offset the risks associated with the proposed acquisition. While CUB is not currently proposing a specific credit, we do acknowledge that in lieu of Condition A and B, an alternative would be to establish a rate credit or rate moratorium that was sufficient to incorporate our proposed condition.

E. Support for public policy and goals of SB 1149

Consistent with CUB's participation with other parties in the Joint Public Interest Testimony, CUB recommends that TPG commit to abide by and support the public policy initiatives that are memorialized in SB 1149.

F. End Game

Because the short-term ownership creates no real stability and no continuity of management, and may well create disincentives to invest in the long-term, and because some of TPG's options to dispose of PGE are vastly inferior to others from a customer perspective, failure to address long-term ownership may be fatal to the application. We would suggest two possible conditions that would create more certainty for the customer and the community. There is a good argument that it is necessary to satisfactorily address the end game in order to identify a net benefit in this application.

First, CUB recommends that TPG could agree to a timeline to begin the process of a public stock offering and dates certain for process mile posts along the way. The first event would be an action plan setting out a detailed process to begin the public offering complete with action item deadlines.

Second, CUB recommends that TPG agree to an offer of a right of first refusal for the PGE assets to a qualified public entity. Such a public entity would be geographically representative of a significant percentage of PGE customers. See League of Oregon Cities testimony for their principles relating to public ownership of PGE. There are a number of possible permutations of the offer to a public body. The first is the establishment of a valuation through arbitration. This mechanism was used for example in the City of Winterpark, Florida, which included a right to purchase option in the city franchise agreement with Florida Power in 1927. CUB Exhibit 113. Another variation is a right to the qualified public entity to meet the highest bona fide offer in a competitive bidding process. Yet another variation is a call option whereby the qualified public entity has the right to buy PGE at a specified price at some point in the future. Finally, there is the concept of a negotiated purchase of PGE assets by a qualified public entity with operation and maintenance performed through a qualified management contract with a private entity, possibly even a restructured PGE.

G. Additional Service Quality Standard

Mr. Dittmer's testimony describes how adverse events could lead utility management to conserve cash by slashing operation and maintenance budgets and/or capital budgets. In order to prevent the utility from cutting costs to provide dividends to its holding company, we traditionally impose service quality standards and expect that this acquisition will contain such service quality standards. CUB believes that missing from service quality standards is a standard for billing accuracy. We have had discussions with staff over this issue and will be pursuing such a condition.

H. Capital and Operation and Maintenance budget approval to PUC

Our testimony and that of Mr. Dittmer's discusses how the company has an incentive to cut costs, including capital and O&M and how these cuts may not have an impact in the short term but could create significant long-term problems.

CUB recommends that the company should be required to submit its capital budget and its Operation and Maintenance budgets annually to the Commission for approval.

I. Cost cutting and monitor ROE

CUB recommends that the TPG agree that the Commission may cause PGE to file a rate case with 120 days notice with the burden of proof falling on the Company. When we have employed this kind of condition in the past, we have put time bounds on it.

However, because this ownership is potentially so short, we are suggesting that this condition not expire after a period of years.

J. SEC-Equivalent filings

In order to maintain a level of disclosure and transparency consistent with an SEC-regulated publicly traded corporation, CUB recommends that PGE and OEC be required to make filings equivalent to the SEC 10Q and 10K forms with the Commission. The Commission could consider any deviation from this requirement when setting rates.

V. Conclusion

Without further identification of benefits and without further mitigation of the new and substantial risks associated with this application, this filing has not met the net benefits requirement. The Commission should deny the application.

Measure No. 26-51 | Multnomah County PUD

ARGUMENT IN OPPOSITION

PGE has a bright future ahead.

For 114 years, PGE and our employees have been focused on serving our customers in Multnomah County. Through those years, we've been an important part of the communities where we live and work.

Our future is bright. Soon, we will take one of two paths – PGE will become an independent company, or we will be sold as an intact business. Either way, our employees will continue serving the communities where we live and work. We will remain locally managed, and our company will remain whole.

The biggest threat to our future – and to the future of safe, reliable, affordable electricity in Multnomah County – is a government takeover. Proponents of these measures will try to scare you into thinking that our company could be broken up. That is not going to happen – unless PGE is subjected to a hostile government takeover like it is facing in Multnomah County.

The ballot measures would break apart the electrical system in Multnomah County – considering by our industry to be one of the most reliable in the nation. Instead, we would have fragmented systems run by a fledging government entity with no experience operating an electrical utility. Not only would the reliability of your electrical service be in doubt, your costs are likely to go up.

PGE has been through a lot in the past two years. Through it all, our employees have never wavered in their commitment to our customers. You can count on us to be there for the next century and beyond.

We thank you for your ongoing support. We urge you to join us in keeping safe, reliable, affordable electricity in Multnomah County. Vote no on Measures 26-51 and 26-52.

(This information furnished by Peggy Y. Fowler, Portland General Electric)

does hereby give and grant to Florida Power Corporation, a corporation organized and existing under the laws of the State of Florida, and to its legal representatives, successors and assigns (herein called grantee), the right, privilege and franchise to construct, operate and maintain in the said City of Winter Park, all electric power facilities required by the grantee for the purpose of supplying electricity to grantor, its inhabitants and the places of business located within grantor's boundaries.

Section 2. [Term.]

That with respect to the right, privilege and franchise granted to grantee in section 1 above, said grantee shall have for a period of 30 years the right, privilege, franchise, power and authority to use the streets, avenues, alleys, easements, wharves, bridges, public thoroughfares, public grounds and/or other public places of grantor as they now exist or may hereafter be constructed, opened, laid out or extended beyond the present geographical boundary lines of grantor.

Section 3. [Rates.]

The rates to be charged by the grantee for electric service rendered under this franchise shall be the grantee's standard public tariffs now in effect or as subsequently approved by the Florida Public Service Commission or such other state agency as may have proper jurisdiction under the general laws of the State of Florida.

Section 4. [Payment to grantor.]

That within 30 days after the first anniversary of the effective date of this grant, and within 30 days after each succeeding anniversary of the effective date of this grant, the grantee, its successors and assigns, shall pay to the grantor and its successors an amount which added to the amount of all taxes, licenses, and other impositions levied or imposed by the grantor upon the grantee's electric property, business or operations, for the preceding tax year, will equal six percent of grantee's revenues from the sale of electrical energy to residential and commercial customers within the corporate limits of the grantor for the 12 months preceding the applicable anniversary date.

Section 5. [Purchase option.]

At and after the expiration of this franchise, grantor shall have the right to purchase the electric plant and facilities of grantee located within the corporate limits of grantor which are used under or in connection with this franchise or right, at a valuation of the property desired, real and personal, which valuation shall be fixed by arbitration as may be provided by law. Excepted from this reservation are power plants and high tension transmission lines owned by the corporation and connected with its general system of distribution and used for the purposes of serving communities other than the grantor herein. As a condition precedent to the taking effect of this franchise grant, grantee shall give and grant to the grantor the right to purchase herein so reserved. Grantee shall be deemed to have given and granted such right of purchase and satisfied this condition precedent by its acceptance of this franchise.

Section 6. [Liability.]

That grantor shall in no way be liable or responsible for any accident or damage that may occur in the construction, operation or maintenance by grantee of its facilities hereunder, and the acceptance of this ordinance shall be deemed an agreement on the part of grantee to indemnify grantor and hold it harmless against any and all liability, loss, cost, damage or expense, which may accrue to grantor by reason of the neglect, default, or misconduct of grantee in the construction, operation or maintenance of its facilities hereunder.

Section 7. [Annexed territory.]

In the event of annexation of any territory to the present corporate limits of grantor, any and all portions of the electric system of grantee located in said annexed territory shall be subject to all of the terms and conditions of this grant as though it were an extension made hereunder.

BEFORE THE
PUBLIC UTILITY COMMISSION OF OREGON

UM 1121

In the Matter of the Application of OREGON	)
ELECTRIC UTILITY COMPANY, LLC, TPG	)
PARTNERS, III, L.P., TPG PARTNERS IV, L.P.,	)
MANAGING MEMBER LLC, NEIL	)
GOLDSCHMIDT, GERALD GRINSTEIN, and	)
TOM WALSH for an Order Authorizing Oregon	)
Electric Utility Company, LLC to Acquire	)
Portland General Electric Company	)
	)
	)

DIRECT TESTIMONY OF JAMES R. DITTMER

On Behalf of the
Citizens' Utility Board of Oregon

July 2004

Q. Please state your name and address.

A. My name is James R. Dittmer. My business address is 740 Northwest Blue Parkway, Suite 204, Lee's Summit, Missouri 64086.

Q. By whom are you employed?

A. I am a Senior Regulatory Consultant with the firm of Utilitech, Inc., a consulting firm engaged primarily in utility rate work. The firm's engagements include review of utility rate applications on behalf of various federal, state and municipal governmental agencies as well as industrial groups. In addition to utility intervention work, the firm has been engaged to perform special studies for use in utility contract negotiations.

Q. On whose behalf are you appearing?

A. Utilitech, Inc. has been retained by the Citizens' Utility Board of Oregon ("CUB") to review the application of Oregon Electric Utility Company ("Oregon Electric") and three of its members, TPG Partners III, L.P., TPG Partners IV, L.P. and Managing Member LLC (collectively referred to as "Applicants") to acquire the common stock of Portland General Electric Company ("PGE") from PGE's current parent company Enron Corp. ("Enron"). Thus, my appearance within this docket is being made on behalf of CUB.

Q. What is the purpose of your testimony?

A. Within this testimony I will describe the transaction being proposed by the Applicants, discuss the claimed benefits of the transaction, as well as describe the disadvantages and risks of the proposed transactions. I also discuss why the transaction as now structured does not meet the “net benefits” test required by the Oregon Public Utility Commission (hereinafter “OPUC” or “Commission”). Finally, I recommend a number of conditions that should be considered before approval of the transaction occurs. However, Bob Jenks and Lowrey Brown, also appearing on behalf of CUB, will be providing a complete listing of conditions that CUB recommends be implemented before the transaction is approved.

Q. Have you prepared an exhibit which sets forth your qualifications?

A. Yes. Attached as CUB Exhibit No. 201 is a statement of my qualifications.

DESCRIPTION OF THE TRANSACTION

Q. Please describe the more significant elements and characteristics of the Applicants’ proposed acquisition of PGE stock?

A. Oregon Electric is proposing to acquire all of the issued and outstanding common stock of PGE for a total purchase price of approximately $1.4 billion.[1] It is anticipated that $70 million in transaction costs will be incurred in the acquisition such that, in total, Oregon Electric is anticipating initially raising $1.47 billion of capital to acquire all of PGE’s common stock.

[1] Pursuant to the Stock Purchase Agreement between Oregon Electric and Enron, the purchase price of the stock will be $1.25 billion plus the growth in PGE’s retained earnings from 1/1/03 through date of closing which is now estimated to be approximately $150 million.

The proposed transaction is a leveraged buyout of PGE's outstanding stock. Specifically, Oregon Electric's $1.47 billion of initial capital requirements is expected to consist of approximately $525 million of private equity funds, $582 million of senior secured term loans with maturities ranging from four to nine years, and approximately $125 million of senior unsecured notes which will have a term of ten years. The remainder of the purchase price is expected to come from the proceeds of a special dividend from PGE to Oregon Electric in the amount of approximately $240 million.

Q. Does the proposed transaction retain the existing PGE debt within the utility while adding substantial new indebtedness at the Oregon Electric parent level?

A. Yes. After the closing, Oregon Electric's stand alone capital structure is envisioned to consist of the approximate amounts shown on the table below:

Oregon Electric Post Closing Stand Alone Capital Structure		
Capital	$ in millions	% of Total Capital
Total Debt (Term Loans & Sr. Notes)	$707	57%
Shareholders' Equity	$525	43%
Total Capitalization	$1,232	100%

(Source: Oregon Electric's Application, Exhibit 20, page 2)

In addition to this new debt at the Oregon Electric parent level, PGE currently has, and will continue to have after the planned acquisition, outstanding long term debt issued in its own name. Immediately after closing, and the planned PGE dividend to Oregon Electric, it is anticipated that PGE will retain a stand alone capital structure approximately as follows:

PGE Estimated Post Closing Capital Structure		
Capital	$ in millions	% of Total

		Capital
Total Debt & Preferred Stock	$1,066	51%
Shareholders' Equity	$1,040	49%
Total Capitalization	$2,107	100%

(Source: Oregon Electric's Application, Exhibit 20, page 1)

Q. Considering the Oregon Electric parent debt, how will PGE assets ultimately be capitalized after the planned transaction?

A. As shown on the table below, on a consolidated basis PGE's utility assets will be financed by a higher percentage of debt than most publicly traded energy utilities:

Oregon Electric/PGE Estimated Post Closing Consolidated Capital Structure		
Capital	$ in millions	% of Total Capital
Total Debt	$1,773	75%
Shareholders' Equity	$582	25%
Total Capitalization	$2,355	100%

Q. What is the source of the new equity capital?

A. Oregon Electric's private equity funds are expected to come from three sources. Approximately $465 million, or 79.9% of the total $582 million of private equity funds, will be raised from two investment funds being managed by Texas Pacific Group ("TPG"). According to TPG such funds are managed for and on behalf of state and corporate pension funds, university endowments, and other institutional investors. Approximately $113 million, or 19.43% of the private equity funds, will be supplied by passive investors that will have no voting interests. The remaining .67% of equity funds – approximately $3.5 million – will be supplied by five individuals referred to as Managing Members. The Managing Members are intended to consist of five local Oregon business persons and residents, and as such, are sometimes also referred to as the "Local Applicants."

Q. What parties will exercise control over PGE?

A. The transaction has been strategically designed to avoid Securities and Exchange Commission ("SEC") regulation under the Public Utility Holding Company Act ("PUCHA"). Pursuant to this strategy, 95% of the voting interest in Oregon Electric will be exercised by the Managing Members even though, as noted, they are collectively only providing approximately .67% of the equity capital. The TPG funds, which are providing approximately 79.9% of the capital, will retain only 5.0% of the voting interests in Oregon Electric. As previously noted, the passive investors who are providing approximately 19.43% of the equity capital will have no voting interest in Oregon Electric.

Even though the five local Oregon business persons comprising the Managing Members control 95% of the voting interests of Oregon Electric, TPG will retain *effective* control of PGE.

Q. Please explain how TPG will retain *effective* control over PGE?

A. First, two partners from TPG will sit on PGE's Board of Directors. Second, TPG is to select the Member Managers who will formally hold 95% of the voting interest of Oregon Electric and also sit on PGE's Board of Directors. Third, there is an extensive list of *consent rights* that will be held by TPG that effectively secure TPG control over Oregon Electric, and in turn, PGE. The entire listing of events and decisions that require the consent of TPG are included as Exhibit No. 7 in Oregon Electric's Application. Some of the more noteworthy events included within the list of consent rights include:

- Any authorization, sale, issuance or reduction of equity securities of Oregon Electric or its subsidiaries – which of course would include PGE
- Any incurrence of indebtedness by Oregon Electric or its subsidiaries
- Any material change in accounting policies, practices or principles, or change in Oregon Electric's outside auditors
- Any employment contracts with executive officers of Oregon Electric or its subsidiaries, including any material change in the compensation or terms of such executive officers, or any employee stock option plan, equity incentive plan or any other material employee benefit plan
- Adoption or amendment of Oregon Electric's or PGE's [check definition of "Company"] annual operating and capital budgets as well as the three-year plan of each.
- Any public offering or private sale of equity securities or any change of control of Oregon Electric or any subsidiary.
- Any filing to obtain a material governmental permit or approval, any material filing in connection with a Company rate proceeding or any material change to the rates or other charges under any Company tariff, or any material amendment to any such filings.

Thus, it is obvious that TPG, as the primary equity investor, retains extensive control over PGE notwithstanding the fact that formally TPG will only hold five percent of the voting interest of Oregon Electric.

Q. How will the debt held by the holding company – Oregon Electric – be serviced?

A. It is anticipated that PGE stock will be the only investment of Oregon Electric. As such, all of the parent company debt servicing – including interest as well as mandatory principle repayment – is completely dependent upon a dividend stream from PGE. And since the primary source for PGE earnings and the related dividend stream are revenues received from Oregon jurisdictional customers, it is accurate to state and conclude that Oregon ratepayers will ultimately be providing the funds to service the parent company debt.

Q. Does the price being paid by Oregon Electric for all the common equity of PGE represent a "premium" over PGE's recorded or "book" equity?

A. Yes. According to the Company's response to CUB/OEUC Data Request No.72 which has been attached as CUB Exhibit No. 202, the anticipated purchase price of the common stock will exceed the book equity of PGE by approximately $121 million, or eleven percent (11.0%).

Q. Is it unusual for utilities to sell for prices above book value?

A. No. In recent years is has not been unusual for reasonably healthy energy utilities to sell at a premium – and sometimes a significant premium – above book value. However, generally speaking, absent the achievement and retention by the purchasing entity of merger synergies or other savings not achievable by the utility on a stand alone basis, or other compelling strategic benefits, one would not expect a purchaser to pay a large premium over the utility's book value.

Q. Does regulation tend to limit the valuation of utility businesses to a price tied to book value?

A. Yes. As this Commission is well aware, regulated utility rates are generally based upon *cost of service.* And since a utility's cost of service is generally determined to include all reasonable and prudently incurred operating expenses plus a reasonable return on the utility's *original* net depreciated investment, all other things held equal and constant, the purchaser would be expected to only be willing to pay an amount approximately equal to book value. Any payment above book value creates a risk to the buyer that the premium amount being paid may be difficult or impossible to recover.

Q. Does the Oregon Electric application anticipate any synergies or other costs savings that might be achieved and retained by Oregon Electric that serve to justify a purchase price above PGE's book equity value?

A. Since the business operations of PGE will not be merged with the operations of any other business, Applicants are not claiming any synergy savings. To the contrary, the removal of PGE from the Enron family is expected to create at least some degree of *diseconomies,* inasmuch as PGE must internalize certain shared corporate functions that have previously been undertaken by Enron. Applicants have stated intentions to review procedures and processes to determine whether expense or capital savings can be achieved. It is possible that the cost cutting measures being considered by the Applicants, and the Applicants' ability to retain the savings from such cost cutting efforts have influenced the purchase price ultimately reached. That stated, however, this is not the type of utility acquisition or merger that is being driven by the acquiring company anticipating the ability to retain all or some portion of significant forecasted synergy savings which is, in turn, justifying the payment of a price significantly above book value.

Q. Please expand upon what you mean when you state that the PGE extraction from Enron is expected to result in *diseconomies*of scale.

A. The Commission may recall, when Enron acquired PGE in 1997, Enron/PGE agreed that cost-of service savings would result from the acquisition by virtue of efficiencies stemming from combining similar corporate functions. Ultimately the parties agreed that Oregon customers should receive reduction in rates in the amount of $9.0 million per year for four years in the way of “merger credits.”

As a subsidiary of Enron, PGE receives from Enron, and pays Enron for, a number of corporate overhead and support functions.

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END CONFIDENTIAL MATERIAL

These functions and goods, which for a number of years have been provided or purchased by Enron, are items that must now be undertaken or procured by PGE on a stand alone basis and can be expected to result in *diseconomies of scale* While Applicants make repeated reference to the benefit of reducing risk and uncertainty which will result from PGE’s separation from Enron, they do not address the detriment of losing the economies of scale recognized by the parties at the time of Enron's acquisition of PGE.

Q. If Oregon Electric is not asserting synergy savings to justify the premium above book value for PGE equity, what is driving the purchase price of the PGE common equity above the book value?

A. The premium anticipated to be paid would appear to be primarily justified by the cost savings generated by retained parent debt financial leverage occurring at the Oregon Electric holding company level.

BEGIN CONFIDENTIAL MATERIAL

END CONFIDENTIAL MATERIAL

Q. Please explain.

A. Short term interest rates are currently at historic lows. As previously noted, Oregon Electric anticipates financing approximately $707 million (57%) of the purchase price with debt instruments that have relatively short maturities and, at least initially, floating or variable interest rates tied to published and recognized short term interest rates.

BEGIN CONFIDENTIAL MATERIAL

END CONFIDENTIAL MATERIAL

Q. If PGE were to earn the currently authorized return on equity of 10.5% on the PGE stand-alone equity balance, what return would TPG earn on its invested equity capital at the Oregon Electric holding company level?

A. BEGIN CONFIDENTIAL MATERIAL

END CONFIDENTIAL MATERIAL

Q. Doesn't the additional layer of parent debt at the Oregon Electric holding company level also increase the financial risk of the business prospectively?

A. Yes. The authorized return on equity ("ROE") for PGE is simply a *targeted* return which is not guaranteed. In fact, for recent years PGE has not earned its authorized ROE. Oregon Electric's interest obligation is real and must be paid regardless of the actual ROE earned by PGE. Further, as short term debt rates rise – as is now widely predicted – the interest cost of Oregon Electric's term loans will correspondingly rise, narrowing the anticipated as well as actual spread between PGE's ROE and the interest cost of its term loans (assuming this Commission does not correspondingly authorize a return on equity which rises approximately with short term interest rates).

OPUC CRITERIA FOR APPROVAL OF ACQUISITIONS AND MERGERS

Q. Please state your understanding of this Commission's precedent or criteria for approving acquisitions such as the Oregon Electric/PGE transaction.

A. In Order No. 97-196 this Commission approved a settlement between PGE/Enron, the OPUC Staff and numerous intervening parties which provided for Enron's acquisition of PGE stock subject to meeting a number of conditions. A reading of that order indicates that PGE/Enron were advocating that in order to meet the "public interest" test required by ORS 757.511 the acquisition or merger need only meet a "no harm" standard. Staff and other intervening parties were arguing that the Oregon "public interest" test demanded that PGE customers be better off with the merger than they would be without the merger, or in other words, the transaction must meet a "net benefit" standard. Because the settlement ultimately contained provisions to fairly immediately begin passing along anticipated synergy savings from the merger after its consummation, the parties and ultimately this Commission determined that the settlement would result in a net economic benefit to ratepayers – thus meeting the higher of the two argued standards. Because the settlement agreement met the "net benefits" standard this Commission did not, at that time, address whether the Oregon "public interest" test actually demanded only a "no harm" standard or the more stringent "net benefits" standard.

At the end of 1998 Scottish Power and PacifiCorp filed a joint application with this Commission seeking authority for Scottish Power to acquire all the outstanding stock of Pacificorp, resulting in PacifiCorp and Scottish Power UK becoming wholly owned subsidiaries of a newly organized parent holding company – Scottish Power plc. Like the previous PGE/Enron merger docket, Scottish Power/PacifiCorp argued that the Oregon "public interest" standard demanded only a "no harm" test while the OPUC Staff and other intervening parties argued for a "net benefit" standard. Like the PGE/Enron transaction, the parties to the Scottish Power/Pacificorp case ultimately reached an agreement that provided for "merger credits" to be passed onto PacifiCorp's Oregon customers that assured economic benefits would enure to Oregon ratepayers. Because the Scottish Power/Pacificorp settlement agreement met the higher "net benefits" standard argued for by Staff and other intervenors, this Commission was once again not required to ultimately interpret the requirements to meet Oregon's "public interest" standard.

Finally, in 2001 this Commission opened a generic investigation docket to study the legal question of the legislative intent of the "public interest" standard as set forth in ORS 757.511. In Order No. 01-778 issued in Docket No. UM 1011 this Commission found, in relevant part, that:

- [B]ased on a reading of the statute in question…the net benefit standard is the appropriate standard for merger approval. We do not believe that this standard is either rigid or arbitrary, as the opposing parties assert. We do not intend to reduce the net benefit standard to economic considerations as a matter of policy. We will consider the total set of concerns presented by each merger application in determining how to assess a net benefit.
- We cannot say in advance what showing a given utility must make to gain approval; such a determination would restrict the discretion the Legislature has given us. We will assess each merger on a case by case basis.
- [I]n addition to finding a net benefit to the utility's customers, we must also find that the proposed transaction will not impose a detriment on Oregon citizens as a whole. (Excerpts taken from page 11 of Order No. 01-778 issued on September 4, 2001 in Docket No. UM 1011)

Q. Does Oregon Electric's Application to acquire the common stock of PGE purport to meet this Commission's public interest tests as espoused in Order No. 01-778?

A. Yes. However, apparently because of difficulties in showing any economic benefits to ratepayers, Oregon Electric's Application emphasizes the "non-economic" or "non-monetary" benefits that its proposal purportedly brings to Oregon citizens. Specifically, it is significant to note the following claim set forth in Oregon Electric's Application:

> Importantly, the "net benefit" standard is not restricted to purely economic considerations, but incorporates the "total set of concerns" presented by a specific Applications. Similarly, a showing of "no harm" need not be reduced to monetary terms. In short, the Commission has stated that each transaction must be assessed on a case-by case basis and there is no requirement that benefits must come in monetary terms.

Q. What claimed benefits does Oregon Electric assert the proposed transaction with TPG ownership will produce for Oregon citizens?

A. Oregon Electric's Application and accompanying supportive testimony claim a number of benefits. First, at page 3 of the Application the following benefits arising from the acquisition are listed:

- Remove PGE from Enron's ownership and place it in the hands of unified ownership – ensuring certainty of ownership, stability, and strong shareholder support

- Re-establish local focus through significant Oregon representation on PGE's Board of Directors – ensuring accountability to customers and community concerns
- Recruit a first-class board, including experienced industry executives and national and local business leaders – ensuring that PGE management has the best advice on how to navigate the challenges ahead
- Re-invigorate board-level strategic direction and long-term planning – ensuring PGE's long term health
- Invest in the future of PGE through capital reinvestment – ensuring reliability and efficiency from existing assets, and the acquisition and development of new resources
- Reinforce management's efforts to achieve best-in-class performance across PGE's critical service metrics and to instill financial discipline throughout the business – ensuring that customers receive safe, reliable and efficient electric service.

At page 6 of its Application Oregon Electric goes on to state that PGE's name will not change, PGE headquarters is to remain in Portland, PGE's current management team will continue to operate the utility on a day-to-day basis, and Oregon Electric will appoint a new board of directors with considerable business expertise and prominent local representation. Finally, at page 24 of its Application Oregon Electric pledges to continue PGE's strong tradition of philanthropy. Thus, the Application emphasizes better governance and management without articulating any particular new strategies to achieve tangible benefits for ratepayers.

In direct testimony, Mr. Kelvin Davis appearing on behalf of the Applicants reiterates many of the non-specific pledges of better management performance and other benefits of the transaction, including:

- Certainty of ownership and unified shareholder support
- Accountability to customers and community
- PGE management will have the resources of a dedicated, first class board of directors to help it navigate the challenges ahead
- Thoughtful and skilled strategic leadership and long-term planning, ensuring PGE's long term health
- Enhanced reliability and efficiency from investment in utility assets and the acquisition and development of new resources
- Best-in-class safe, reliable and efficient electric service

Finally on pages 21 through 23 of his Supplemental Direct Testimony Mr. Kelvin Davis suggests certain additional "net benefits" not addressed in his original direct testimony or the Application:

- A commitment to reinforcing high-quality service while instilling financial discipline to ensure that customers receive safe, reliable and efficient electric service.
- Oregon Electric will be an Oregon taxpayer.
- Opportunity for customers to share some portion of profits from PGE's regulated business in excess of an actual return on equity of 10.5% (methodology to be agreed upon).
- 10-year extension of the commitment to service quality measures.
- Appointment of a manger within PGE with appropriate responsibility and authority to work with the advocacy groups for renewable energy sources, sustainability, energy efficiency, and environmental matters.

- Vigorous efforts to pursue a target of 10% of 1:2 peak capacity for load, whether contracted or owned, from renewable resources, by 2012, if economical.
- 10-year extension of PGE's cash and in-kind donations to Oregon HEAT and a doubling of the cash portion of the donations.
- Periodic access to PGE's Board of Directors for various customer and environmental advocacy groups.
- Commitment to work on additional program for low income assistance through a work group led by PGE.

Q. Do you believe that Oregon Electric's claims noted meet this Commission's "net benefits" test as established within Order No. 01-778?

A. No. Many of the benefits claimed will enure under any eventual new ownership of PGE stock. Other claimed benefits *should* accrue to ratepayers' regardless of PGE stock ownership.

Q. What claimed benefits will occur regardless of new PGE stock ownership?

A. The removal of PGE from the bankrupt Enron estate will eventually occur, even in the absence of the proposed acquisition by Oregon Electric/TPG. Thus, there will be eventual "certainty" and some greater level of "stability" outside the bankrupt Enron family even if this transaction is rejected or otherwise falls apart.

Q. Are you stating that all the other benefits claimed by Oregon Electric *should* accrue to Oregon ratepayers regardless of future ownership?

A. Most of the remaining claimed benefits should accrue to ratepayers' benefit simply as a result of utility ownership and management carrying out obligations pursuant to the "regulatory compact."

Q. Please explain.

A. The well established regulatory compact recognizes that there are certain rights as well as certain obligations that attach to regulated utility ownership and management that do not exist, or become mandated for, owners/management of unregulated businesses providing *non-essential* goods and services in a competitive environment. Specifically, the regulatory compact endorsed by all regulatory commissions that I am aware of recognizes that, in exchange for receiving a certificate that entitles a company exclusive rights to provide a utility service – generally deemed to be an *essential* service – in a specifically defined geographic territory free from other competitors, utility management must endeavor to provide safe, reliable and non-discriminatory utility service at the lowest long term cost achievable. In carrying out this obligation, utility ownership/management is expected to engage in business investment and management practices that reduce *overall* long term costs while still providing safe and reliable service.

Q. Are you then simply saying that, pursuant to the regulatory compact, utilities should strive to achieve and undertake many of the actions that Oregon Electric claims to be a "benefit" that its ownership structure will provide to PGE's ratepayers?

A. Yes. For example, utility ownership should always strive to "recruit a first class board." Typically this includes recruiting both "national and local" leaders with the intent of providing management with "the best advice on how to navigate the challenges ahead." Further, the utility Board of Directors needs to be vigilantly "invigorated" in providing strategic direction and long-term planning to ensure long term health as well as the ability to provide safe and reliable utility service. Long term utility planning necessarily requires the utility to periodically replace existing assets as well as acquire and develop new resources to meet anticipated future service territory growth. Finally, the regulatory compact requires utility ownership and management to strive to cut costs by reviewing modern technology options and modern business practices (such as best-in-class surveys/studies) without jeopardizing safety or reliability of service. In short and in sum, many of the items that Oregon Electric would have this Commission determine to be "benefits" of the transaction should be considered nothing more than reasonable expectations under any new PGE ownership group.

Q. What consideration should be given to Applicant's 10-year commitment to service quality measures and 10-year extension of PGE's cash and in-kind donations to Oregon HEAT?

A. The service and support programs or commitments are merely an "extension" of the status quo, not a discrete new benefit enabled by TPG ownership. In another portion of his Supplemental Direct Testimony Mr. Davis opines that the "net benefits" test should be based upon a comparison to the status quo – or a comparison to continued ownership by it bankrupt parent. Yet, at this point in his supplemental testimony he claims that continuation of programs or commitments made under current Enron ownership should be considered a "net benefit" of the proposed transaction.

Q. Is there ratepayer benefit in Mr. Davis' offer for customers to share in some portion of future profits from PGE's regulated business if such earnings exceed the currently authorized 10.5% return on equity?

A. Upon first impression this might appear to be a legitimate "net benefit" to ratepayers. During the context of the review of this Application, neither CUB nor Utilitech have undertaken a detailed review of PGE's current "normalized" earnings or its projected or anticipated future stand alone earnings. However, through discovery I have been made aware that PGE's actual return on equity for the last three years has been below the noted 10.5% "sharing point."

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It should also be remembered that when utilities earn in excess of commission-authorized or targeted rates of return that consumer groups or the OPUC Staff can instigate a complaint proceeding. Assuming a determination is made that then-current rates are resulting in excess earnings to the utility, rates would be reduced to the point that the utility would again only earn its authorized rate of return – without *any sharing* of earnings above the targeted or authorized return.

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Importantly, as I describe in a forthcoming section of testimony, the proposed transaction as structured is not without risks to Oregon ratepayers. Thus, the claimed "net benefit" of agreeing to share some portion of profits above a PGE stand-alone 10.5% return on equity must be considered in conjunction with the knowledge and understanding that 1) the sharing – if it is to happen at all – will only occur if Oregon Electric is achieving a significantly higher return on its equity capital, 2) any possible sharing of earnings above a noted return on equity threshold will only occur at the expense of exposing ratepayers to additional risks, and 3) there would be no sharing of excess earnings following a traditional show cause or complaint proceeding. In short, this claimed benefit does not match up to the risk that ratepayers are being asked to undertake with the proposed transaction.

Q. Returning to Applicant's list of benefits, how do you respond to Applicant's claim that the proposed transaction brings the added benefit of establishing local "Managing Members," holding 95% of Oregon Electric voting interest, who in turn bring "strong, local leadership and national relevant business expertise on the Board?" (Application page 15),

A. As previously noted, utilities are expected to provide strong and knowledgeable business experience. Further, meaning no disrespect for the Managing Members who have distinguished business, ownership and political achievements as well as impressive educational qualifications, it should nonetheless be noted that the Managing Members 1) have no relevant utility management experience, and 2) have extensive other business interests which suggests that their collective oversight of PGE operations may necessarily be on a very limited part-time basis.

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Finally, as described near the outset of my testimony, while the managing members nominally control 95% of the voting interest in Oregon Electric, *effective control* of Oregon Electric and PGE is retained by TPG through the consent rights and TPG's ability to handpick such Managing Members.

Q. Was Oregon Electric questioned regarding the unique actions or attributes which its ownership – and its ownership alone – could facilitate?

A. Yes. CUB's request number 78 to Oregon Electric the Applicant was asked:

> (Ref: Applicants' response to CUB/OEUC No. 19) For each future event that Applicants believe will cause PGE to "be more valuable in the future," describe the event and state whether it is believed to be caused as a result of unique actions that will only occur as a result of TPG/OEUC ownership *versus* events that will likely occur regardless of ownership. For each event that Applicants believe that they will facilitate by owning and controlling PGE, please discuss and describe in detail the unique attributes which they bring in the acquisition versus what could never be supplied under alternative owners.

In its response to CUB/OEUC No. 78, a complete copy of which is attached as CUB Exhibit 206, Oregon Electric lists a number of events that any new owner will automatically enjoy by virtue of PGE's split from the bankrupt Enron family or which any new owner would be expected to endeavor to achieve by simple adherence to the aforementioned regulatory compact. But the response concludes by stating:

> Applicants cannot speculate as to which of the unique attributes they bring to PGE "could never be supplied under alternative ownership."

Thus it is obvious that even Oregon Electric cannot point to claimed events that purportedly meet this Commission's "net benefits" test that alternative owners could never supply.

TRANSACTION RISKS AND COSTS

Q. Your testimony thus far concludes that there are no unique "net benefits" to ratepayers that can be expected if the transaction were to occur as proposed. Are there, in fact, risks or potential ratepayer detriments that could arise if the transaction goes forth?

A. Yes. First and foremost, the leveraged buyout increases financial risk. Specifically, the additional layer of debt financing at the Oregon Electric holding company level will add significant debt service cash flow requirements. Most of the Oregon Electric debt is of a short-to-medium term duration (i.e., five to nine years to maturity) with interest requirements tied to published short term floating rates. Short term rates are presently near all time lows, such that it is reasonable to expect prospective increases in such rates. Probable increasing interest rates in conjunction with obligations to repay principle on the short-to-medium term notes create the possibility of future cash flow pressure or credit rating deterioration.

Q. What are possible consequences to cash or credit crunches?

A. Access to debt capital may be limited, or alternatively, only achievable at rates that would be considered expensive or unreasonable when compared to safer debt securities of a similar duration issued in the same time frame. Further, such credit crunches can occur when the utility is most in need of capital – perhaps because of one or more adverse operational events.

Q. What adverse events could occur in the future to create financial stress to the utility and compromise utility access to capital on reasonable terms?

A. Uninsured or high-deductible casualty loss events at the utility's power plants can cause a sudden and significant need for capital, both for repairs as well as replacement power. Variable power supply costs to be recovered through jurisdictional rates are reestablished each year based upon forecasted load, prices, unit availability, etc. However, even with an annual adjustment, adverse low run off or below-average hydro conditions and/or unexpectedly high purchased power costs can still create financial stress for utilities such as PGE. Additionally, milder-than-normal weather conditions can also impact earnings for one or more years. Given that currently PGE is significantly short on capacity to meet its native load, exposure to higher-than-predicted purchased power prices could be dramatic. In short, there are no guarantees that PGE will recover its power supply costs in each and every year.

While the purchase agreement between Oregon Electric and Enron provides for broad and significant indemnification from Enron in the event of a number of adverse litigation rulings, PGE/Oregon Electric nonetheless remains exposed to at least some level of litigation risks. Finally, lower-than-projected load growth, higher-than-expected inflation or some combination of each can also cause Oregon Electric/PGE to experience financial stress

Q. What are possible, if not probable, ownership reactions to periods of financial stress and/or limited capital access?

A. Utility ownership and management may resort to conservation of cash by means of slashing, or at least not adequately increasing, operation and maintenance budgets and/or capital budgets. The adverse impact of such reactionary short term "remedies" is not always immediately detectable. The effects of utility resource restrictions can go undetected for a period of time inasmuch as delays or reductions in operation and maintenance expenses and/or capital expenditures may have little or only modest impacts over the short term. It is also possible that the utility may simply get "lucky" for a period of time – experiencing few operational problems notwithstanding a cutback in planned maintenance. However, the eventual required resumption of reasonable service quality or the required "catch up" maintenance and repairs may be difficult or expensive to achieve.

On this latter point, it is because the leverage buyout creates the noted risk and exposure to deterioration of service that service quality measures and requirements should be made a condition for approval of the transaction – assuming the transaction is approved in any respect. It is my understanding that a partial stipulation among at least some parties has been reached wherein service quality standards have been agreed to in hopes of protecting ratepayers in the face of the added risks that the leveraged buyout presents.

Q. Is the PGE acquisition expected to be a long term investment by Oregon Electric or the partners owning all of the Oregon Electric stock?

A. According to the direct testimony of Kelvin Davis appearing on behalf of the Applicants, TPG can only hold investments for up to twelve years. Realistically, the holding period could be much shorter than the maximum twelve years noted, and will likely be driven by the goal of maximizing TPG profits more than any other factors.

Q. Does the limited duration of Oregon Electric ownership of PGE have any implications to possible management strategies – particularly strategies responsive to financial stress?

A. As a potentially short term owner of PGE, Oregon Electric arguably has an even greater incentive to cut costs in the short run. Any short term reduction of costs serves potentially two purposes. First, as noted, in periods of financial stress, with its highly leveraged capital structure, Oregon Electric may be motivated if not required to preserve cash to meet its debt interest and repayment schedules. Second, and importantly, the exit valuation or sales price for the PGE business enterprise will likely be dependent in large part upon recently achieved earnings, interest coverages, as well as other cash flow coverage ratios. Thus, Oregon Electric has the added incentive to temporarily bolster earnings, conserve cash and enhance coverage ratios by constraining resource expenditures that, at least in the short run, could be viewed as "discretionary."

Q. You have alluded to *possible* reduction in operating, maintenance or construction expenditures. Are the *possible* reductions pure speculation on your part?

A. No. At page 14 of its Application, Applicants state:

> As part of its due diligence, TPG found that PGE is a fundamentally sound utility with talented and dedicated employees, a high-quality service territory, well-maintained generation assets, and a long track record of solid customer service. (Application Page 14)

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And while TPG has characterized these actions as part of its fresh new look and "re-invigorated" management direction, regulators must critically consider whether such cuts are simply realizing heretofore unrecognized efficiencies *or* excessively constraining near term expenditures that will not necessarily impair service quality in the short run but which will undoubtedly *eventually* result in a deterioration of service and/or "catch up" expenditures that will have to be made up by "the next"

PGE owner. Unfortunately, that distinction is not always easy to make in the near term – and may only be recognized in retrospect.

Q. You have also alluded to *possible* downratings to Oregon Electric and PGE's debt ratings. Are such references purely speculative on your part?

A. No. On March 10, 2004 Standard and Poor's Ratings Services ("S&P"), one of the three major rating services, placed PGE's rated debt instruments on CreditWatch "with negative implications following Oregon Electric Utility Co. (Oregon Electric) LLC's filing with the Oregon Public Utility Commission (OPUC) on March 8, 2004, to purchase 100% of PGE from Enron Corp. for about $2.35 billion, including the assumption of about $1.1 billion in debt and preferred stock."

In explaining its action S&P went on to state:

> The acquisition will result in a heavily leveraged consolidated balance sheet of PGE and Oregon Electric. Accordingly, Standard & Poor's expects that PGE's ratings will be downgraded. However, based upon the overall financing plan, Standard & Poor's expects that following the acquisition PGE will be able to maintain investment grade ratings. Key to this is Standard & Poor's expectation, and Oregon Electric's commitment, that all dividends from PGE will be used to service and pay down Oregon Electric's debt. Standard & Poor's does not expect Texas Pacific Group (TPG), to have any current income needs from the investment. This should result in over $250 million of debt reduction on a consolidated basis in the first five years following the transaction closing. Also important is the continued supportive regulatory regime in Oregon and the 48% equity layer requirement at PGE.

The complete March 10, 2004 release by S&P has been attached as CUB Exhibit 208.

Q. How did the other two major rating services react to the announcement of Oregon Electric's proposed acquisition of PGE?

A. Prior to the announcement Moody's Investors Service had placed PGE on negative outlook as a result of Enron filing for Chapter 11 bankruptcy. With Oregon Electric's planned acquisition announcement, Moody's changed its outlook from "negative" to "developing" to reflect the beneficial aspect of removing PGE from the bankrupt Enron empire. While noting the benefits to PGE's credit quality from the potential separation from Enron ownership, it nonetheless went on to state:

> There could be an adverse effect on credit quality in the event of a highly leveraged transaction in which Oregon Electric needs to excessively rely on PGE for dividends to service the new parent company's debt and provide a return for the equity investors. There are also uncertainties about the resolution of various contingent claims, and whether there will be any changes in regulatory requirements as part of obtaining the requisite approvals.

A complete copy of Moody's release from which the above excerpt was extracted has been attached as CUB Exhibit 209.

The third major rating service – Fitch Ratings – issued a release on November 20, 2003 wherein it stated that it "does not anticipate changes to Portland General Electric's (PGE) ratings or its Positive Rating Outlook until further details regarding the proposed sale of PGE by Enron Corp to Oregon Electric Utility Company, LLC (OE) are available and prospects for its completion become more certain." It went on to state that "Fitch believes the sale of PGE to OE would be a constructive development for PGE bond holders to the extent that it addresses concerns over ownership by a bankrupt parent." But it also stated that:

> Any change to ratings would be heavily dependent upon the capital structure implemented as part of any acquisition. Although financing details are unavailable at the moment, the potential upgrade of PGE's ratings could be constrained if a highly leveraged capital structure is adopted at OE.

The entire release issued by Fitch on November 20, 2003 has been attached as CUB Exhibit 210. Oregon Electric has not provided any more current updates from Fitch regarding the ratings of PGE securities as it relates to the proposed leveraged buyout.

To summarize, while all three rating agencies, on the one hand, acknowledge that PGE's separation from Enron will be a positive event, they all are concerned about the highly leveraged structure being proposed – with S&P placing PGE on "CreditWatch negative" in anticipation of the transaction.

Q. Much of Oregon Electric's Application addresses the benefits from previous, and need for continuing, ring fencing provisions established when PGE was acquired by Enron. Given the accolades for previous and proposed ring fencing requirements, why do you believe the rating agencies are very concerned about the highly leveraged consolidated capital structure of Oregon Electric?

A. In CUB's Request No. 79 (b) PGE was requested to "[i]dentify and describe Applicants' understanding regarding why regulatory 'ring fencing' is viewed by S&P as not sufficient to fully insulate PGE creditors from risks associated with parent/holding company debt." A complete copy of a commentary prepared by an analyst from Standard & Poor's was provided in response to the quoted data request and has been attached as CUB Exhibit 211. However, relevant excerpts from the noted response shown below highlight the reasons why the rating agencies do not conclude that even stringent ring fencing can fully protect a healthy subsidiary's bond holders:

> Standard & Poor's takes the general position that the rating of an otherwise financially healthy, wholly owned subsidiary is constrained by the rating of its weaker parent. The basis for this position is that a weak parent has both the ability and the incentive to siphon assets out of its financially healthy subsidiary and to burden it with liabilities during times of financial stress. The weak parent might also have an economic incentive to filing the subsidiary into bankruptcy – if the parent itself were forced into bankruptcy – regardless of the subsidiary's "stand alone" strength. Experience suggests that insolvent corporations will often jointly file with their subsidiaries – even those subsidiaries not themselves experiencing financial difficulty.

The commentary goes on to describe some of the devices that can be entered into in an attempt to protect or insulate the healthy subsidiary's bondholders from financial stress that might inflict the weaker parent. However, the commentary goes on to describe the eventual shortfalls which at least partially nullify the assurances sought to be achieved by such devices constructed or entered into. The commentary summarizes by stating:

> The evolution of structured finance techniques, and their adaptation by corporate credit structures, has expanded the methods by which the credit quality of a subsidiary might be rated higher than the credit quality of the consolidated entity. Of course, corporate affiliation can never be totally ignored, even where the parent has adopted a number of these structuring techniques. When business dependencies exist between subsidiary and parent, such techniques may not be respected by the courts.

Q. If debt financing becomes difficult or expensive, could Oregon Electric's investors simply infuse more equity capital?

A. Pursuant to the Oregon Electric Term Sheet attached as Exhibit 10 to the Application, Oregon Electric has the right, but no *obligation*, to make additional equity capital contributions. It should always be remembered, Oregon Electric is, at most, going to own PGE for twelve years. This relatively short holding period would likely influence the direction that Oregon Electric would take regarding a decision to infuse more equity capital into the ownership structure.

Q. Has TPG considered the convergence of negative events which could lead to deteriorating coverage ratios and tighter credit conditions?

A. Oregon Electric has considered numerous adverse as well as positive events that may eventually impact its future earnings stream and the attendant financial health of both PGE and Oregon Electric. Specifically, as previously noted, TPG ran 48 financial models for Oregon Electric and PGE which consider a combination of assumed future events such as various load growth rates, PGE-projected versus more restricted capital growth, construction of a Port Westward combined cycle generating unit in 2006 versus additional power purchases, as well as varying operating efficiencies (i.e., possible non-fuel operation and maintenance savings). Additionally, after considering the combination of possible events just noted, in two of the 48 model runs TPG also calculated additional coverage and capitalization ratios assuming Earnings Before Income Taxes ("EBIT") that were then reduced by 10% and 20%.

Q. What were the results of the Applicant's various financial forecast model runs?

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Q. Is anticipation of possible future events, and the financial modeling of such events, a precise science?

A. No. The future is always uncertain. The best laid plans, and diligent modeling efforts, do not assure that future conditions are being adequately considered. The financial forecasting business is an inherently judgmental process.

Q. After reviewing Applicant's financial projections, do you conclude that the transaction represents an acceptable level of risk from a financial health perspective for TPG, PGE and PGE's ratepayers?

A. Not necessarily. For one thing, I would note that the TPG model assumes complete and immediate recovery of net variable power costs through continuation of the Resource Valuation Mechanism ("RVM"). My understanding is that, while the RVM is reestablished annually to reflect forecasted variable power costs for a twelve month period, the difference between actual and forecasted variable power costs is not automatically deferred for later surcharging or crediting to ratepayers. To the contrary, only if PGE petitions and is granted authority to defer and later recover power cost shortfalls recover any of the shortfall between actual and forecasted variable power supply costs. Even in those instances the shortfall recovery has been limited to sharing some amount falling outside an established dead band. Thus, low hydro conditions and/or higher-than-predicted natural gas or purchased power costs can expose PGE to earnings and coverage ratio shortfalls. Further, a number of adverse financial events such as uninsured/underinsured property losses, higher-than-now predicted short term interest rates, as well as payment of Enron or PGE litigation claims not covered by indemnification provisions have not been explicitly modeled – and at most have only been *implicitly* modeled in two of the 48 runs vis-à-vis the 10% and 20% reductions to EBIT calculations contained within each of the 48 model runs.

I would also note that TPG does not appear to have modeled or considered any *incremental* costs that would logically occur as a result of *diseconomies of scale* stemming from the extraction from Enron. Finally, while I would not characterize TGP's modeling efforts as, overall, unduly optimistic, I believe a review of CUB

Exhibit No. 207 which summarizes the major input assumptions of the 48 scenarios reveals that Applicants have tended to model more *favorable* events – such as operating expense savings or capital cost savings – whenever it was also considering *unfavorable* events such as lower load growth scenarios. In other words, it would appear the Applicants avoided the combining of the more pessimistic events. Additionally, only two EBIT sensitivities appear to have been performed – and the model was not created to easily handle additional sensitivities to – lower EBIT achievements.

To summarize on the results of TPG's financial modeling efforts, clearly Applicants have not taken a strictly Pollyanna view of PGE's and Oregon Electric's probable plight. Indeed, as investors with expectations of return of capital as well as returns on invested capital, it is only prudent that they attempt to consider and handicap pessimistic as well as optimistic events. That said, I do not believe that TPG has necessarily modeled "worst case" scenarios. And unfortunately, if a worst-case scenario should arise, it is probable that TPG will react by either cutting prudent expenditures – at least in the short run – or alternatively, strenuously pursuing rate relief from this Commission even if the unexpected event would not normally be recoverable from ratepayers (i.e., unindemnified awards stemming from the Enron bankruptcy).

Q. Are there other adverse or detrimental events that may arise from the proposed transaction?

A. As previously noted, TPG will retain *effective* control by virtue of the consent right established as well as the exclusive right to select the Managing Members who will hold 95% of the voting interests. The Managing Members thus far selected have demonstrated business management and ownership achievements. However, as previously noted, the Managing Members as well the TPG representative who will sit on PGE's Board of Directors have no experience with regulated utilities. Thus, a truly independent board with significant energy utility experience that would have broad powers to make *long term* decisions in the best interest of PGE and its ratepayers has not been created through the proposed ownership structure

Further, the PGE Board management has the potential to be cumbersome. The Managing Members who will sit on PGE's Board, while astute local business men, do not have relevant energy experience, have other significant diverse business interests, and thus may not be in a position to devote significant time to PGE. The TPG owners expected to sit on PGE's Board are not local, and also have many diverse business interests.

Another event which could be viewed as detrimental to Oregon citizens is the proposed income tax structure.

Q. Please explain.

A. Oregon Electric will be filing federal and state income tax returns on an Oregon Electric/PGE consolidated basis. By so doing, Oregon Electric will be minimizing the tax liability of the two entities. Taxes will be minimized through avoidance of taxation on the dividend stream from PGE. In other words, if PGE were to file a separate or stand-alone basis, PGE's full equity return would be taxed. Additionally, if Oregon Electric were to file on a separate or stand alone basis, the dividend stream from PGE would be taxed. Thus, by filing a consolidated tax return, a "double taxation" of a portion of PGE's equity return can be avoided.

As previously noted, the Applicants' envision a double leveraged ownership structure that will have PGE common equity supported at the parent holding company level with a significant level of debt. While consolidated Oregon Electric will have a highly leveraged capital structure, the Applicants are proposing – indeed relying upon – regulation that will continue to set rates based upon PGE's conservatively leveraged stand alone capital structure (i.e., minimum 48% common equity ratio). In addition to assuming PGE's stand alone capital structure, Applicants are relying upon an assumption that Oregon regulation will continue to establish rates as if PGE were filing federal and state tax returns on a stand alone basis – separate from Oregon electric. More specifically, Applicants are counting upon this Commission ignoring the economic reality of the Oregon Electric consolidated tax election, and instead, determining that taxes calculated on a stand alone PGE basis that would ordinarily be paid to federal and state tax authorities instead be paid to parent Oregon Electric vis-à-vis the terms of an inter-company tax sharing agreement.

Thus, under Oregon Electric's ownership structure and anticipated regulatory plan, PGE customers will be paying a hypothetical level of federal and state income taxes that will not, in reality, be passed along to federal and state taxing authorities for the benefit of those governments' constituents. Or stated more succinctly, PGE rate payers will be paying through utility rates hypothetical Oregon state income taxes that will never be paid to the state of Oregon for the benefit of Oregon citizens.

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This, in my opinion, is a detriment of the transaction.

Q. When assessing any potential "net benefits" or perhaps "net detriments" expected from the transactions, should such calculations consider the status quo of continued ownership by PGE's bankrupt parent *or* a scenario of an assumed hypothetical new buyer?

A. That is an extremely difficult question to answer. First, the current *status quo* of ownership by bankrupt Enron is assuredly temporary. Thus, to consider the *status quo* that is known to be temporary appears to be illogical.

On the other hand, Mr. Kelvin Davis argues in Supplemental Direct Testimony that it is essentially impossible to credibly undertake a comparison of Oregon Electric's proposal to any other alternative disposition. Specifically, Mr. Davis states the following at page 24 of his Supplemental Direct Testimony regarding any analysis of a hypothetical alternative owner:

> First, in the event our proposal is not approved, there is no clear outcome for PGE's future. There are only infinite *possible* scenarios. Thus the identification of any particular alternative scenario would be guesswork. But even if a certain scenario could be considered likely, even if not certain, the risks and benefits of the alternative scenarios would be unknown and therefore comparison would have to be made against hypothetical risks and benefits. That is, one could only speculate as to the risks and benefits that would attach to any alternative disposition. Thus, the comparison of the Proposed Transaction to some alternative disposition of PGE would be of no value.

In my opinion there are three significant ironies, if not inconsistencies, in Applicant's position. First, Applicant insists that the "net benefits" test must be made by comparison to the status quo of continued ownership by bankrupt Enron – even though it is known with absolute certainty that Enron will *not* continue to own PGE. Second, many of Applicant's claimed benefits stem from PGE's extraction from the Enron empire – an event that will occur even if Oregon Electric does not acquire PGE. Further, if simple extraction from the Enron estate can credibly be claimed as a "net benefit" of this proposed transaction, surely it could be claimed as a "net benefit" by nearly any other purchaser under an alternative transaction – including distribution of PGE stock to creditors through the bankruptcy proceeding.

Third, synergies were claimed and at least partially agreed to by the parties at the time of Enron's acquisition of PGE in 1997. In fact, Oregon ratepayers were given reduced rates in the form of "merger credits" for a number of years following Enron's acquisition of PGE. *If* "net benefits" must be derived by comparison of continued ownership by Enron – as argued by Applicants – then it should logically and consistently follow that the *loss* of such synergies should be also be quantified and considered in the "net benefits" test. However, no such analysis or quantification has been suggested or undertaken by Applicants.

CONDITIONS TO CONSIDER IN AN ATTEMPT TO INSURE "NET BENEFITS" ACCRUE TO OREGON RATEPAYERS

Q. Thus far you are concluding that the proposed transaction does not meet this Commission's "net benefit" test, and further, the risks of the transaction outweigh any "benefits" being offered by Applicants. Are there requirements or conditions that could be imposed that would provide "net benefits" to ratepayers that are commensurate to the risks they are being asked to endure?

A. Yes. There are conditions that could be imposed that would better insulate ratepayers from the risks caused by the proposed transaction and/or which would help insure that benefits would be commensurate with risks being undertaken such that the transaction might meet this Commission's "net benefits" and "no harm" tests. While I will be mentioning certain concepts to be considered, Bob Jenks and Lowrey Brown will ultimately be presenting and sponsoring the precise conditions that CUB believes should be imposed before the transaction is approved.

Q. Please continue by describing some conditions that should be considered before approval of the transaction is approved.

A. First, I believe the Commission should require PGE to track all one-time costs incurred in the process of extracting itself from the Enron family. This would include without limitation any costs to instigate systems necessary to replace corporate governance and overhead functions now undertaken by Enron. This would be undertaken so that it can be ensured that such identified costs will never be passed on to ratepayers.

Second, I believe it would be reasonable for PGE to identify and track *incremental* costs incurred on an ongoing basis to replace the corporate governance and overhead functions now undertaken by Enron. Further, PGE should be required to produce and retain amounts paid by PGE to Enron for corporate services formerly provided by Enron which now must be provided on a stand alone PGE basis. With these accounting requirements the parties and this Commission should be able to determine what *diseconomies of scale* are resulting from the extraction of PGE from Enron. This process should also be undertaken to ensure that ratepayers enjoy the savings, at least for a period of time, that were envisioned with the acquisition by Enron.

Other conditions to be considered to ensure the transaction results in a “net benefit” to Oregon citizens would include some upfront rate concession to share in some of the saving envisioned from the double leveraged capital structure being established with the transaction. This could materialize in the form of recognition of Oregon Electric’s consolidated capital structure *for ratemaking purposes*, and recognition of the anticipated tax savings expected to be achieved at the Oregon Electric parent company level as a result of the parent's stand alone debt.

If some level of immediate rate relief is not recognized, in the alternative, and at a minimum, a rate moratorium period could be agreed to. On this latter point, I acknowledge that I am not an attorney, nor have I researched or inquired about this Commission's authority to "order" a stay out or rate moratorium period. If this Commission does not have such authority, such condition could, nonetheless, be agreed to by the parties – including Oregon Electric and PGE.

Q. Would the recognition of a consolidated capital structure, or the sharing of consolidated income tax savings, be in violation of the ring fencing condition which required PGE to retain at least a 48% common equity ratio put that was put in place by this Commission at the time that Enron acquired PGE in 1997?

A. No. This Commission can and should limit PGE's dividends to Oregon Electric to ensure that PGE retains a healthy level of equity capitalization, which should in turn, better ensure higher PGE stand alone debt ratings. The recognition of a consolidated capital structure, or the sharing of consolidated income tax savings, *for ratemaking purposes* does not prevent the continued requirement for PGE to retain a healthy stand alone balance sheet.

Q. Does that conclude your direct testimony?

A. Yes, it does.

STATEMENT OF QUALIFICATIONS

Q. Please state your educational background.

A. I graduated from the University of Missouri - Columbia, with a Bachelor of Science Degree in Business Administration, with an Accounting Major, in 1975. I hold a Certified Public Accountant Certificate in the State of Missouri. I am a member of the American Institute of Certified Public Accountants and the Missouri Society of Certified Public Accountants.

Q. Please summarize your professional experience.

A. Subsequent to graduation from the University of Missouri, I accepted a position as auditor for the Missouri Public Service Commission. In 1978, I was promoted to Accounting Manager of the Kansas City Office of the Commission Staff. In that position, I was responsible for all utility audits performed in the western third of the State of Missouri. During my service with the Missouri Public Service Commission, I was involved in the audits of numerous electric, gas, water and sewer utility companies. Additionally, I was involved in numerous fuel adjustment clause audits, and played an active part in the formulation and implementation of accounting staff policies with regard to rate case audits and accounting issue presentations in Missouri. In 1979, I left the Missouri Public Service Commission to start my own consulting business. From 1979 through 1985 I practiced as an independent regulatory utility consultant. In 1985, Dittmer, Brosch and Associates was organized. Dittmer, Brosch and Associates, Inc. changed its name to Utilitech, Inc in 1992.

My professional experience since leaving the Missouri Public Service Commission has consisted primarily of issues associated with utility rate, contract and acquisition matters. For the past twenty-five years, I have appeared on behalf of clients in utility rate proceedings before various federal and state regulatory agencies. In representing those clients, I performed revenue requirement studies for electric, gas, water and sewer utilities and testified as an expert witness on a variety of rate matters. As a consultant, I have filed testimony on behalf of industrial consumers, consumer groups, the Missouri Office of the Public Counsel, the Missouri Public Service Commission Staff, the Indiana Utility Consumer Counselor, the Mississippi Public Service Commission Staff, the Arizona Corporation Commission Staff, the Arizona Residential Utility Consumer Office, the Nevada Office of the Consumer Advocate, the Washington Attorney General's Office, the Hawaii Consumer Advocate's Staff, the Oklahoma Attorney General's Office, the West Virginia Public Service Commission Consumer Advocate's Staff, municipalities and the Federal government before regulatory agencies in the states of Arizona, Alaska, Maine, Michigan, Missouri, Oklahoma, Ohio, Florida, Colorado, Hawaii, Iowa, Kansas, Mississippi, New Mexico, Nevada, New York, West Virginia, Washington and Indiana, as well as the Federal Energy Regulatory Commission.

REQUEST CUB/OEUC 72:

Please provide the best estimate of the premium to be paid over net PGE book equity value anticipated at the time of closing the OEUC acquisition. Provide underlying calculations and assumptions supporting this estimate.

APPLICANTS' RESPONSE TO REQUEST CUB/OEUC 72:

As it relates to book equity value, if one compares the base purchase price of $1.25 billion to PGE's book equity account of $1.129 billion at the end of 2002 (per PGE's Form 10-K for the year ended December 31, 2002), the base purchase price represents an 11% premium over PGE's 2002 year end book equity account.

Oregon Electric is not buying the assets of PGE; rather Oregon Electric is acquiring the outstanding shares of PGE. Thus there is no premium as described in the question. PGE assets will be recorded and maintained on PGE's books at its then existing book value for ratemaking purposes.

REQUEST CUB/OEUC 78:

(Ref: Applicants' response to CUB/OEUC No. 19) For each future event that Applicants believe will cause PGE to "be more valuable in the future," describe the event and state whether it is believed to be caused as a result of unique actions that will only occur as a result of TPG/OEUC ownership *versus* events that will likely occur regardless of ownership. For each event that Applicants believe that they will facilitate by owning and controlling PGE, please discuss and describe in detail the unique attributes which they bring in the acquisition versus what could never be supplied under alternative owners.

APPLICANTS' RESPONSE TO REQUEST CUB/OEUC 78:

Applicants object to this request as vague, overly broad, unduly burdensome, and calling for speculation. Subject to and without waiving the foregoing objections, Applicants provide the following response:

In response to Request CUB/OEUC 19, Applicants stated as follows:

The Applicants believe that PGE will be more valuable in the future under Oregon Electric's responsible ownership because the following is expected to occur in the years to come:

[1] PGE will free itself from the distractions, uncertainty, and potential legal liabilities arising from its current owner.

[2] PGE's new Board of Directors will apply its fresh perspective, diverse expertise, local accountability, and deep experience to focus PGE on its business mission of providing electric service in a safe and reliable manner with excellent customer service at a cost-effective price.

[3] PGE's new Board of Directors, with access to TPG's resources and personnel, can draw on this expertise when needed to create effective financing plans and execute those plans successfully.

[4] PGE will maintain and enhance its generation, transmission, and distribution assets to meet its service quality measures, which in turn will ensure that these assets will represent ongoing value to PGE's shareholders.

[5] PGE will make long-term commitments and investments to address its short energy position, which will in turn provide increased rate stability.

[6] Oregon's economy should enjoy a period of renewed growth and expansion after the last few years of economic recession, and PGE will be a partner with the Oregon business community in harnessing these renewed growth opportunities.

[7] PGE's earnings will stabilize and improve as many "one-time" charges that have negatively impacted the company's results for the last few years cease to continue in the future (*e.g.*, write-offs and charges for the settlement of certain liabilities

related to the 2000/2001 energy crisis; OPUC disallowment of certain power contracts entered into during 2001).

Applicants believe that the combination of experienced and responsible ownership, local representation, and strong leadership promised by the Proposed Transaction makes it far more likely than not that the "events" described in items 1-5 above will occur "versus events that will occur regardless of ownership." In addition, while the expected economic recovery cited in item 6 will or will not occur regardless of PGE's ownership, Applicants believe that their leadership will assist PGE in partnering with the Oregon business community to harness renewed growth opportunities.

Applicants cannot speculate as to which of the unique attributes they bring to PGE "could never be supplied under alternative owners."

William Valach - Portland General Electric Placed on CreditWatch Negative After Acquisition Filing With OPUC

From: <SandPUtil@StandardAndPoors.Com>
To: <william_valach@pgn.com>
Date: 03/10/2004 1:43 PM
Subject: Portland General Electric Placed on CreditWatch Negative After Acquisition Filing With OPUC

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Portland General Electric Placed on CreditWatch Negative After Acquisition Filing With OPUC

Publication date: 10-Mar-2004

Analyst(s): Swami Venkataraman, CFA, San Francisco (1) 415-371-5071; Richard W Cortright, Jr., New York (1) 212-438-7665

Credit Rating: BBB+/Watch Neg/A-2

Rationale

Standard & Poor's Ratings Services today placed Portland General Electric Co.'s (PGE) 'BBB+' corporate credit rating and all issue ratings on CreditWatch with negative implications following Oregon Electric Utility Co. (Oregon Electric) LLC's filing with the Oregon

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Public Utility Commission (OPUC) on March 8, 2004, to purchase 100% of PGE from Enron Corp. (D/--/--) for about $2.35 billion, including the assumption of about $1.1 billion in debt and preferred stock. The final offer may be adjusted to reflect PGE's financial performance between Jan. 1, 2003 and the date of the sale's closing, which is expected during the second half of 2004. Based on filings with OPUC, Oregon Electric will need approximately $1.471 million to complete the transaction, which is expected to be funded through a combination of $525 million of equity, $707 million of debt, and a $240 million dividend from PGE at the time of closing.

The acquisition will result in a heavily leveraged consolidated balance sheet of PGE and Oregon Electric. Accordingly, Standard & Poor's expects that PGE's ratings will be downgraded. However, based upon the overall financing plan, Standard & Poor's expects that following the acquisition PGE will be able to maintain investment grade ratings. Key to this is Standard & Poor's expectation, and Oregon Electric's commitment, that all dividends from PGE will be used to service and pay down Oregon Electric's debt. Standard & Poor's does not expect Texas Pacific Group (TPG), to have any current income needs from the investment. This should result in over $250 million of debt reduction on a consolidated basis in the first five years following the transaction closing. Also important is the continued supportive regulatory regime in Oregon and the 48% equity layer requirement at PGE.

The Enron Bankruptcy Court approved the sale on Feb. 5, 2004, following the completion of an "overbid" process in which other potential buyers had the opportunity to submit superior bids; however, no other bids were made. The transaction will require approval of the OPUC, the Federal Energy Regulatory Commission, the Nuclear Regulatory Commission, and other regulatory agencies prior to closing.

Oregon Electric is an Oregon limited liability company backed by investment funds managed by TPG, a private equity investment firm with about $13 billion under management. The proposed transaction will be structured so as to avoid Oregon Electric from becoming subject to the Public Utility Holding Company Act (PUHCA). Accordingly, Oregon Electric will be composed of three groups: (1) "Local Applicants," consisting of three individuals, a former governor of the state, a prominent local businessman, and a civic leader, who will collectively own a 0.5% economic interest in Oregon Electric and 95% of the voting control; (2) "TPG Applicants," comprised of two investment funds managed by TPG, who will own a 79.9% economic interest in Oregon Electric and 5% of the voting control; and (3) Passive investors, who will own a 19.6% economic interest in Oregon Electric but have no voting control. The Local Applicants, who will collectively invest about $2.5 million, will serve a critical role on PGE's board of directors, with former Oregon Governor Neil Goldschmidt serving as chairman.

PGE's corporate credit rating reflects the supportive regulatory environment in Oregon, low-cost generation, and a strong financial

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profile. The resource valuation mechanism approved by OPUC allows for the annual reset of rates at the beginning of each year based on the company's forecast of net variable power costs for that year. PGE has 1,945 MW of efficient low-cost generation resources, comprised of a mix of hydro, coal, and gas-fired generation. PGE also benefits from cheap hydropower purchases from the Columbia River power system and Bonneville Power Administration. However, PGE must purchase a large amount, 35%, of its energy requirements from the wholesale market, which constitutes the utility's principal business risk. This risk is compounded by the predominance of hydroelectric power in its supply portfolio. PGE has filed an integrated resource plan (IRP) with OPUC, which details a plan to acquire long-term resources to cover the existing short position and includes a 300 MW gas-fired combined cycle power plant at Port Westward, Oregon.

PGE's financial performance has been sound, with unadjusted funds from operations coverage of interest at 5.0x for the nine months ended Sept. 30, 2003 and unadjusted total debt-to-capitalization at a comfortable 48%. As part of the IRP, PGE is expected to sign a number of long-term power purchase agreements (PPAs) to satisfy its short position. Standard & Poor's will make adjustments to PGE's financial profile by adding off-balance sheet debt obligations to reflect the fixed obligations incurred through the PPAs. The adjusted consolidated financial profile, which will reflect the impact of the PPAs and the debt issued by Oregon Electric to finance the purchase of PGE, will be a principal driver of the ratings on Oregon Electric and PGE. However, PGE's rating will benefit from the 48% minimum equity layer mandated by the OPUC and the strong, proactive regulatory history in Oregon.

The contract for the sale of PGE to Oregon Electric indemnifies Oregon Electric from any liabilities arising from the Enron bankruptcy to the extent of the purchase price ($1.25 billion). This includes matters such as income taxes, retiree health benefits and Enron pension plans. Oregon Electric is also indemnified with respect to FERC and California-related legal claims for up to $125 million.

Liquidity.

PGE has maintained access to the capital markets through the Enron bankruptcy. PGE has a $150 million, 364-day bank revolving line of credit, secured by first mortgage bonds, that matures in May 2004, of which $30 million was outstanding in the form of LOCs as of Sept. 30, 2003. As of Sept. 30, 2003, cash on hand totaled $148 million. Through the Enron bankruptcy, PGE has been required to maintain cash balances that are higher than historical levels. This is expected to come down once the transaction closes, particularly since PGE will dividend about $240 million to Oregon Electric. However, Standard & Poor's expects that PGE would maintain sufficient cash balances that, along with the bank line of credit, would provide sufficient liquidity for PGE's operations.

Ratings List

PGE 203965

Corporate Credit Rating:	BBB+/WatchNeg/A-2
Senior Secured:	BBB+/WatchNeg
Senior Unsecured:	BBB/WatchNeg
Subordinated:	BBB/WatchNeg
Preferred Stock:	BBB-/WatchNeg
Commercial Paper:	A-2/WatchNeg

Complete ratings information is available to subscribers of RatingsDirect, Standard & Poor's Web-based credit analysis system, at www.ratingsdirect.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com; under Credit Ratings in the left navigation bar, select Find Ratings, then Credit Ratings Search.

For a complete list of ratings, please click the hyperlink provided here http://www2.standardandpoors.com/NASApp/cs/ContentServer?pagename=sp/Page/FixedIncomeRatingActionsPg

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 CUB/209
Dittmer/1

Moody's Investors Service

Global Credit Research
Rating Action
20 NOV 2003

Rating Action: Portland General Electric Company

MOODY'S CONFIRMS DEBT RATINGS OF PORTLAND GENERAL ELECTRIC COMPANY (SR. SECURED AT Baa2); ALSO CHANGES RATING OUTLOOK TO DEVELOPING FROM NEGATIVE

Approximately US$1.1 Billion of Securities Affected

New York, November 20, 2003 -- Moody's Investors Service confirmed the debt ratings of Portland General Electric Company (PGE; Senior Secured at Baa2). In conjunction with confirming the ratings, Moody's changed the rating outlook to developing from negative.

The change in PGE's rating outlook reflects the announcement that Oregon Electric Utility Company, LLC, a newly-formed entity with financial backing from private equity firm Texas Pacific Group (TPG), has signed a definitive agreement to acquire PGE from Enron Corp. The developing outlook incorporates the benefit to PGE's credit quality from potential separation from Enron's ownership, and takes into account uncertainties about how the transaction will ultimately be structured and financed. There could be an adverse effect on credit quality in the event of a highly leveraged transaction in which Oregon Electric needs to excessively rely on PGE for dividends to service the new parent company's debt and provide a return for the equity investors. There are also uncertainties about the resolution of various contingent claims, and whether there will be any changes in regulatory requirements as part of obtaining the requisite approvals.

The announced transaction, which has been approved by Enron's Board of Directors and has the support of the Official Unsecured Creditors' Committee in the Enron bankruptcy proceeding, is valued at approximately $2.35 billion, including assumption of PGE's debt. The final transaction value, which would give Oregon Electric full control over PGE, is subject to determination based on PGE's performance between January 1, 2003 and closing. An "overbid" process is to be conducted by the Bankruptcy Court in order to foster competing bids. In the absence of a superior bid, the announced transaction is subject to approval by the Bankruptcy Court, as well as the Oregon Public Utility Commission and other federal regulatory agencies. Obtaining such approvals could take up to a year, if not longer.

Despite uncertainties, PGE's Baa2 senior secured rating continues to reflect the fact that it has been able to sustain fundamentally sound operations, including sustaining a solid common equity cushion in its capital structure and ample fixed charge coverage ratios, while carefully attending to its liquidity. There is a regulatory mandate from the Oregon PUC that PGE keep at least a 48% common equity ratio, and provide advance notice of dividends. A bankruptcy remote structure has helped to isolate PGE from the bankruptcy of its parent.

Portland General Electric Company ratings confirmed with a developing outlook include: Senior Secured Debt at Baa2; Senior Unsecured Debt and Issuer Ratings at Baa3; Subordinated debt at Ba1; Preferred Stock at Ba2; Shelf Registration for Senior Secured, Senior Unsecured and Subordinated Debt at (P)Baa2/(P)Baa3/(P)Ba1; and short-term debt rating for commercial paper at Prime-3.

Portland General Electric Company, a wholly-owned subsidiary of Enron Corp., is an electric utility company with headquarters in Portland, Oregon.

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PGE 203961

William Valach - FIFTCH: No changes - but recognizes that ratings can be higher as stand alone company

From: Marco Espinoza
To: All Exposure Reports Distribution List; Daily Credit Exposure Report
Date: 11/21/2003 9:39 AM
Subject: FIFTCH: No changes - but recognizes that ratings can be higher as stand alone company

Fitch Comments on Proposed Acquisition of Portland General Electric

20 Nov 2003 11:41 AM (EST)

Fitch Ratings-New York-November 20, 2003: Fitch Ratings does not anticipate changes to Portland General Electric's (PGE) ratings or its Positive Rating Outlook until further details regarding the proposed sale of PGE by Enron Corp, to Oregon Electric Utility Company, LLC (OE) are available and prospects for its completion become more certain. Fitch rates PGE's secured, unsecured debt and preferred securities 'BBB-', 'BB' and 'B+', respectively.

On Tuesday, November 18, 2003 Enron Corp. announced that it reached a definitive agreement to sell PGE to OE for $2.35 billion including the assumption of debt. Fitch believes the sale of PGE to OE would be a constructive development for PGE bond holders to the extent that it addresses concerns over ownership by a bankrupt parent. However, the proposed sale remains subject to execution risk. Two earlier proposals for the sale of PGE to Sierra Pacific Resources and Northwest Natural, respectively, failed. The current transaction is subject to bankruptcy court approval and an overbid process, in which other parties may put forward competing bids. In addition, regulatory approvals will be required from the OPUC, FERC, and SEC, a process that is likely to take approximately 12 months to complete.

Any change to ratings would be heavily dependent upon the capital structure implemented as part of any acquisition. Although financing details are unavailable at the moment, the potential upgrade of PGE's ratings could be constrained if a highly leveraged capital structure is adopted at OE. Under the terms of the proposed agreement, OE will pay approximately $1.25 billion for 100% of PGE's outstanding equity and will assume debt totaling $1.1 billion. Fitch regards it as unlikely that consummation of an acquisition will lead to a direct increase in debt at the PGE level, given existing ring-fencing measures.

Fitch notes that PGE's ratings remain below levels that would be justified on a stand alone basis due to contagion risk associated with its status as a subsidiary of a bankrupt parent, Enron. Recent positive developments include an improved liquidity position due to refinancing activity and settlement of FERC investigations related to wholesale power activities. The settlements require FERC approval, payment approximating $8.5 million and revocation market-based wholesale power tariffs for a twelve month period. Under the terms of the agreement, the settlement is not deemed to be an admission of fault or liability by PGE.

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PGE 203971

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STANDARD & POOR'S

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Commentary

Ring-Fencing a Subsidiary

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The evolution of structured finance techniques, and their adaptation by corporate credit structures, has expanded the methods by which the credit quality of a subsidiary might be rated higher than the credit quality of the consolidated entity. These methods, colloquially referred to as "ring-fencing," will be explored here.

Standard & Poor's takes the general position that the rating of an otherwise financially healthy, wholly owned subsidiary is constrained by the rating of its weaker parent. The basis for this position is that a weak parent has both the ability and the incentive to siphon assets out of its financially healthy subsidiary and to burden it with liabilities during times of financial stress. The weak parent might also have an economic incentive to filing the subsidiary into bankruptcy--if the parent itself were forced into bankruptcy--regardless of the subsidiary's "stand-alone" strength. Experience suggests that insolvent corporations will often jointly file with their subsidiaries--even those subsidiaries not themselves experiencing financial difficulty.

Before arriving at the rating of any particular subsidiary, Standard & Poor's assesses the credit quality of the consolidated entity of which the subsidiary is a part. No rating, per se, is assigned to the consolidated entity; rather, the credit-quality assessment is a pro forma measure of the consolidated entity's general ability to meet its obligations. (See "Consolidated Ratings Methodology" sidebar.)

Issuers and their advisors typically offer two particular devices to justify a ratings separation between the parent/group and the subsidiary: the protective covenant and the nonconsolidation opinion. The problem with these devices is that by themselves they do not go far enough in effectively insulating or "ring-fencing" the subsidiary from its parent.

The protective covenant is designed to restrict the shifting of assets and liabilities between parent and subsidiary. The covenant accomplishes this either by outright prohibition of asset transfers and dividend declarations or by subjecting such transfers and declarations to stringent tests. The parent may also offer a so-called "nonpetition" covenant, by which it undertakes not to file the subsidiary into bankruptcy.

Covenants are generally given little weight in the analysis of whether a subsidiary might be rated higher than its parent. Courts will rarely compel an entity to comply with or perform the terms of a covenant. They prefer instead to limit remedies to provable monetary damages in the event of breach of covenant and consequential loss. If a company breaches its financial covenants and thereafter goes into bankruptcy, any proven resulting damages would have to be recovered from the company's bankruptcy estate, most likely at a relatively low priority. It is, moreover, difficult to draft covenants that will cover every conceivable eventuality. Standard & Poor's assumes that

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management will, in keeping with its responsibilities to shareholders, attempt to devise ways to defeat covenants that are burdensome.

"Nonpetition" covenants are also problematic in that they are unenforceable as a matter of public policy. Although it views nonpetition covenants as an indication (at least, at the time given) of the parent's disinclination to filing a subsidiary into bankruptcy, Standard & Poor's measures the likelihood of the performance of any covenant (such as the obligation to pay timely debt service) by the level of the covenantor's own rating level. Standard & Poor's views compliance with nonpetition covenants as being, ultimately, more a question of willingness than of ability.

The second device is the offer of a "nonconsolidation" opinion by the parent. Nonconsolidation opinions are common in structured finance. The doctrine of substantive consolidation allows creditors of a bankrupt company to ignore the principles of the "corporate separateness" of parent and subsidiary if:

- The creditors can persuade the court that the parent was using the subsidiary to shelter the parent's assets; or
- The affairs of the parent and the subsidiary were so intertwined as to make the two entities essentially indistinguishable.

In appropriate circumstances, the court will "consolidate" the assets of the subsidiary with those of the bankrupt parent, thus allowing the parent's creditors access to the assets of the subsidiary. A nonconsolidation opinion addresses the degree of likelihood that a court will grant substantive consolidation based on the observance by parent and subsidiary of certain "separateness factors." Aside from the fact that they are fact-specific, limited in scope, and highly qualified, nonconsolidation opinions specifically do not address the likelihood of simultaneous bankruptcies of the parent and the subsidiary at the instigation of the parent. Even when a covenant package accompanies a nonconsolidation opinion, therefore, the potential still exists for a parent to act to the detriment of its subsidiary's creditors. Exceptions to the weak-parent/strong-subsidiary linkage have been made based on particular factual circumstances, such as transactions involving independent finance subsidiaries and regulated entities. Even in such instances, however, there typically remains some linkage. This linkage usually constrains the rating of an otherwise advantaged subsidiary to one full rating category (three "notches") above the credit quality of the consolidated entity. In cases where a regulated utility is the subsidiary, the three-notch, regulatory-based differential will not often be achieved, since it is only considered when the subsidiary is located in an actively regulated jurisdiction like Oregon, California, or Virginia. Similar examples of ratings that take serious regulatory oversight into account can be found in Australia and the United Kingdom.

See Sidebar

The evolution of structured finance techniques, and their adaptation by corporate credit structures, has expanded the methods by which the credit quality of a subsidiary might be rated higher than the credit quality of the consolidated entity. Of course, corporate affiliation can never be totally ignored, even where the parent has adopted a number of these structuring techniques. When business dependencies exist between subsidiary and parent, such techniques may not be respected by the courts. These methods, colloquially referred to as "ring-fencing," are cropping up in a variety of financing situations, including:

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- Acquisition financing (the incurring of debt by a newly formed entity for the purpose of acquiring an existing entity);
- Monetizing a subsidiary's dividend distributions (the formation by a low-rated parent of an intermediary subsidiary, interposed between the parent and its operating subsidiaries, for the purpose of borrowing funds, the debt service on such loans being derived from dividend streams received from the operating subsidiaries); and
- Corporate spinoffs (the formation by a single, low-rated parent of a new subsidiary, which then incurs debt for the purpose of acquiring a relatively profitable line of business, or assets, from the parent).

Exceptions to the Rule

Depending on the "stand-alone" strength of the subsidiary, a package of enhancements (including structural features, covenants, and a pledge of collateral) may be effective to raise the rating of the subsidiary a full rating category over the credit quality of the consolidated entity. (See "A Ratings Enhancement Package" sidebar.) If the subsidiary has multiple owners, one or more of which is capable of defending the subsidiary from the acts of a financially stressed or insolvent parent, an even wider rating differential may be merited. The basis for the rating differential is that the package may be viewed as reducing the means—as well as the incentive—of the parent to shift assets from and liabilities to the subsidiary, or to file it into bankruptcy. (The operational nature of the subsidiary's business distinguishes this approach from true securitizations in which differentials of three or more ratings categories can be achieved. Securitizations of statistically predictable pools of accounts receivable are, in the view of Standard & Poor's, fundamentally different from the business and financial issues characteristic of operating entities.)

Structure. As noted above, parent/subsidiary linkage is prompted, in part, by two concerns:

- That a healthy subsidiary's assets may be consolidated with those of its insolvent parent; and
- That the parent will have the ability to cause the subsidiary to file itself into bankruptcy, despite the fact that the subsidiary is not itself experiencing financial difficulty. Ensuring that the subsidiary is a limited-purpose operating entity, somewhat similar to the "special purpose entity" (SPE) found in a securitization, may mitigate this bankruptcy risk.

While the SPE is, strictly speaking, a creature of securitization, its operating asset analogues are found in the limited-purpose operating entities employed in industrial-based or project-financed transactions. In the context of a "ring-fenced" transaction, Standard & Poor's expects that such limited-purpose entity will:

- Be "single-purpose";
- Incur no additional debt (beyond that sized into the rating and necessary for routine business purposes, such as trade debt and ordinary working-capital facilities to prestated levels);
- Not merge or consolidate with a lower-rated entity;
- Not dissolve; and
- Have an "independent director."

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In the context of a "ring-fenced" transaction, the operative feature is the independent director.

Absent any stipulation to the contrary, a company's directors have a fiduciary duty to its shareholders. The fiduciary duties of the subsidiary's directors are understood to include the execution of the parent's instructions, including an order to file the subsidiary into bankruptcy voluntarily. (A financially healthy subsidiary should not properly be involuntarily filed by the parent, since the subsidiary would be able to pay its debts as they become due.)

To ensure that this duty is fulfilled properly, the charter documents of the SPE require the affirmative vote of the independent director, an individual with no tie or relationship to the parent, as a prerequisite to the SPE's voluntarily filing itself into bankruptcy. The charter documents of the SPE require the independent director to take into account the interests of the creditors of the subsidiary (including the holders of the rated debt), in addition to the interests of the shareholding parent, when deciding to file. The creditors of the subsidiary would almost certainly be prejudiced by such a filing.

As is the case in true securitizations, the SPE is most effective when paired with a nonconsolidation opinion. The combination of the SPE structure and the nonconsolidation opinion may provide some comfort that the parent and its potentially more highly rated subsidiary are adequately distanced from each other, thus justifying the existence of a rating differential between the credit quality of the subsidiary and the credit quality of the consolidated entity. Nevertheless, structural separation alone may simply elevate form over substance when the subsidiary has significant operating and business dependencies on the parent (and vice versa). Consequently, the advantages of structural separation may be lost if such dependencies exist.

An additional structural protection is the use by the subsidiary of a "lockbox" mechanism, whereby accounts receivable owed to the subsidiary are deposited by its customers directly into a bank account controlled by, and in the name of, the security trustee or collateral agent for the rated debt. The trustee or agent then allocates the cash according to a distribution mechanism designed to:

- Pay the costs of the subsidiary's operations;
- Settle administrative expenses; and
- Pay debt service while segregating cash from the direction and control of, and potential interference by, the lower-rated parent.

Covenants. Together with structural (or regulatory) and collateral provisions, a tightly drafted covenant package is important in preserving the financial well-being and autonomy of the subsidiary. These covenants may include (but are not limited to):

- Dividend tests;
- Negative pledges;
- Nonpetition covenants;
- Prohibitions against creating new entities; and
- Restrictions on asset transfer and intercompany advances.

In structures where the subsidiary has affiliates, covenants prohibiting any intercorporate dealings whatsoever (even when subject to "arm's-length" tests) may be desirable because of the potential for abuse.

Collateral. If the debt is fully secured by a pledge of all or substantially all of the assets of the subsidiary, the parent, in principle, has less freedom to deal with the assets of the subsidiary and, therefore, a reduced incentive to file the subsidiary into bankruptcy. The security usually takes the form of a subsidiary's general pledge of its assets to the collateral agent or security trustee, and a parent's pledge of its ownership interest, e.g., membership (LLC), partnership, (LP) or share (corporation interest) in the subsidiary as security for payment.

In support of the pledge, Standard & Poor's will request that the parent and the subsidiary provide evidence of the pledge, including, for example, in the case of real property, title insurance showing the interest of the collateral agent or security trustee and a legal opinion (addressed to Standard & Poor's) stating that the collateral agent or security trustee has a first perfected security interest in all other collateral in which a security interest can be perfected, either by possession or filing, or at common law. If the subsidiary is unwilling or unable to pledge its assets, reduced credit may be given for the parent's pledge of its ownership interest in the subsidiary.

Regulatory Supervision. Transactions involving electric, water, natural gas, and telephone utilities may be subject to regulatory supervision. In the context of the weak-parent/strong-subsidiary linkage, the utility usually represents the strong subsidiary. Regulatory approval, influence, or mandate may well have a positive effect on credit quality. The effect of regulation is felt minimally when the subsidiary must secure regulatory approval to sell debt or dividend cash to the parent. Depending on particular circumstances, the rating differential created by such regulatory environment may be compounded by a package of structure, covenants, and collateral.

Multiple Ownership. In circumstances where the subsidiary is controlled by at least two parents, or is the subject of a joint venture, the insolvency or financial difficulty of a particular venturer is less likely to have consequences for the credit quality of the subsidiary. The measure of control that a particular parent can exercise is usually related to the size of its ownership interest and the extent of its legal rights in the subsidiary. For this reason, the percentage of ownership is significant, but the identity and nature of any other owner is equally important in assessing its capabilities for effectively blocking an attempt by a co-owner to file the subsidiary. In general, where two or more parents are motivated and able to prevent each other from harming the credit quality of the subsidiary, the rating of the credit quality of the subsidiary may be higher than that of any parent's, if justified on a "stand-alone" basis. Moreover, the subsidiary may depend more heavily on one particular parent, in which case the subsidiary's rating may be affected by the dependency.

Conclusion

In the United States, there are a number of more or less traditional ways in which the credit quality of a subsidiary might be rated higher than the credit quality of its parent entity. In common-law jurisdictions such as the United Kingdom and Australia, there may be greater potential for differentiation. In all cases, the "package" of distancing mechanisms that serves as the basis for the rating differentiation should be an extensive one. Nevertheless, ratings benefits accruing to the subsidiary through the methods described above may come at a price: To the extent that the credit-quality rating of the subsidiary is elevated above the credit quality of the consolidated entity, the rating of the consolidated entity may be reduced. Finally, it cannot be overemphasized that the differentials achieved by true securitization will seldom be possible in a corporate transaction because of "single-asset" or enterprise risk, regardless of the structural and other features incorporated into the transaction.

See Sidebar

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Sidebar

Consolidated Ratings Methodology

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Before arriving at the rating of any particular subsidiary, Standard & Poor's analyzes the credit quality of each of the subsidiary's parents and affiliates in arriving at a view of the credit quality of the consolidated entity. No actual rating is assigned; rather, the credit-quality assessment is a pro forma measure of the consolidated entity's general ability to meet its obligations. The consolidated approach is prompted by the fact that corporate managements are presumed to allocate assets to achieve the best results for the shareholders of the overall corporation. For rating purposes, that a company actually moves cash around the organization may be less important than its having the ability and economic incentive to do so.

Economic incentive is the most important factor on which to base judgments about the degree of linkage that exists between a parent and subsidiary. Business managers have a primary obligation to serve the interest of their shareholders, and Standard & Poor's generally assumes that they will act accordingly. If this means infusing cash into a unit that management may once have termed a "stand-alone" subsidiary, or finding a way around covenants to get cash out of a "protected" subsidiary, then management can--on the basis of prior experience and economic incentive--be expected to follow these courses of action. Covenants, support agreements, management assertions, and legal opinions are of secondary importance compared with economic incentive.

Four consequences may result from the facts surrounding a particular parent/subsidiary relationship. If the subsidiary were sufficiently insulated from its parent, and would otherwise merit a higher rating were it a "stand-alone" entity, then the subsidiary's senior debt would be rated higher than that of the consolidated entity. Second, if the insulation were insufficient or the subsidiary's stand-alone rating were not sufficiently high, its credit quality could be considered equal to that of the consolidated entity's, if the subsidiary were of strategic importance to the parent. On the other hand, the credit of the subsidiary may be rated lower than that of the consolidated entity if the subsidiary is a noncore entity, whose parent has no presumptive or "moral"

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