BEFORE THE PUBLIC UTILITY 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	)
	)

DIRECT TESTIMONY OF

DONALD W. SCHOENBECK

ON BEHALF OF

THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES

REDACTED VERSION

(Confidential Information is Shaded)

July 21, 2004

Introduction and Summary

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Donald W. Schoenbeck. I am a member of Regulatory & Cogeneration Services, Inc. ("RCS"), a utility rate and economic consulting firm. My business address is 900 Washington Street, Suite 780, Vancouver, WA 98660.

Q. PLEASE DESCRIBE YOUR BACKGROUND AND EXPERIENCE.

A. I've been involved in the electric and gas utility industries for over 30 years. For the majority of this time, I have provided consulting services for large industrial customers addressing regulatory and contractual matters before numerous state commissions, public utility governing boards, governmental agencies, state and federal courts, the National Energy Board of Canada and the Federal Energy Regulatory Commission ("FERC"). A further description of my educational background and work experience is summarized in Exhibit ICNU/101.

Q. ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?

A. I am testifying on behalf of the Industrial Customers of Northwest Utilities ("ICNU"). ICNU is a non-profit trade association, whose members are large industrial customers served by electric utilities throughout the Pacific Northwest, including Portland General Electric ("PGE" or the "Company").

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I will address each of the alleged benefits of the transaction offered by Oregon Electric Utility Company, LLC ("Oregon Electric"), Texas Pacific Group ("TPG"), and the other Applicants (collectively, the "Applicants") to the Oregon ratepayers. In addition, I will address certain aspects of the proposed acquisition of PGE related to expected operational and capital expenditure efficiencies and the resulting financial implications for the owners of Oregon Electric. Testimony addressing the proposed capitalization structure and resulting tax implications will be presented by John Antonuk and Randy Vickroy on behalf of ICNU.

Q. PLEASE BRIEFLY SUMMARIZE YOUR TESTIMONY.

A. The application asserts that the proposed acquisition "offers significant, tangible benefits to PGE customers and the public at large." Re Oregon Electric *et al.*, OPUC Docket No. UM 1121, Application of Oregon Electric *et al.* to Acquire PGE at 23 (Mar. 8, 2004) ("Application"). In reality, the only tangible benefit TPG has offered is a $100,000 low income assistance contribution for a period of ten years. This represents just [redacted] of the net income provided to Oregon Electric under the transaction's structure and only 0.01% of PGE's retail revenue. This de minimis benefit to certain low income ratepayers does not satisfy the requirement that the transaction is in the public interest. Further, all the claimed additional benefits—local leadership, customer service and effective resource planning—are activities that a prudent, well-managed utility would already be providing to its customers.

Finally, TPG is relying upon achieving significant operation and maintenance ("O&M") savings in order to realize its targeted returns on investment in PGE. These savings amount to roughly [redacted] per year in O&M and [redacted] in capital expenditure reductions. When coupled with the proposed capital structure and tax treatment, the expected annual return on investment could approach [redacted], representing a potential gain of [redacted] million on an initial investment of $525-550 million in a relatively brief period of time, [redacted]. For all these reasons, ICNU urges the Oregon Public Utility Commission ("Commission") to deny the proposed takeover of PGE by Oregon Electric and TPG.

Ownership Structure

Q. PLEASE DESCRIBE THE PROPOSED OWNERSHIP STRUCTURE OF OREGON ELECTRIC.

A. The proposed acquisition of PGE's common stock is being orchestrated by TPG, a private equity investment firm. If TPG itself were to acquire PGE, TPG would become subject to the requirements of the Public Utility Holding Company Act ("PUHCA"). Accordingly, to circumvent the restrictions of the PUHCA, TPG is proposing to form Oregon Electric with an ownership governance structure composed of three entities: Managing Member LLC (whose owners are Mr. Kohler, Mr. Grinstein, and Mr. Walsh), TPG investment funds, and certain "passive" investors. The Managing Member LLC will have an economic investment of 0.7%, yet hold 95% of the voting rights. These voting rights, however, are subject to a host of negative consent rights held by TPG. The TPG investment fund will hold about 79.9% of the economic interest in Oregon Electric but have only 5% of the voting rights. The passive investors will have about 19.4% of the economic interest but no voting rights.

Q. HAS TPG'S SELECTION OF THE INDIVIDUALS COMPRISING MANAGING MEMBER LLC ALWAYS BEEN A CRITICAL ASPECT OF THE TRANSACTION?

A. Yes. Early in the evaluation process for acquiring PGE, an internal TPG memo dated April 21, 2003, which is attached as Confidential Exhibit ICNU/102, included an initial description of the governance structure and the managing or general partner:

[redacted]

Confidential Exhibit ICNU/102, Schoenbeck/6. The decision to go forward with the PGE acquisition was made by TPG's Investment Review Committee ("IRC") on September 15, 2003. Exhibit ICNU/103, Schoenbeck/1. The materials provided to the IRC for this meeting included a 57-page presentation addressing the transaction. Confidential Exhibit ICNU/104 (Excerpt of the Presentation). Page eight of this document, which is entitled [redacted] states:

[redacted]

[redacted]

Confidential Exhibit ICNU/104, Schoenbeck/6.

Benefits Proposed by the Applicants

Q. DO YOU AGREE THAT THE LOCAL BOARD REPRESENTATION OFFERED BY THE MANAGING MEMBER LLC AND OTHER INDIVIDUALS IS A TANGIBLE BENEFIT OF THE TPG ACQUISITION OF PGE?

A. No. The commitment to maintain at least five Oregonians on the ten to twelve-person PGE Board of Directors, including the Chair, is not a unique or unusual circumstance in the industry. Northwest Natural Gas Company has a Board of Directors consisting of eleven individuals, with all but one being local to the region. Similarly, Avista Corporation, which includes Avista Utilities serving the greater Spokane, Washington area, has an eleven-member Board including nine individuals from either Washington (6) or Idaho (3). Puget Sound Energy, which serves the outlying area of Seattle, has at least seven local area members out of a ten-person Board. Finally, even PacifiCorp's Board has about five individuals from within its large service territory. Thus, while the supplemental direct testimony of Mr. Davis states that there is "no assurance of local representation or leadership" on publicly held companies, it is still by far the norm and not the exception. Re Oregon Electric *et al.*, OPUC Docket No. UM 1121, Oregon Electric/Exhibit 22, Davis/16 (May 27, 2004). Consequently, TPG's commitment is nothing more than what would and should be expected to occur under any acquisition or public offering of PGE.

Q. DOES THE PROPOSED TRANSACTION CONTAIN THE NEGATIVE CONSENT RIGHTS REFERENCED IN CONFIDENTIAL EXHIBIT ICNU/102?

A. Yes. Oregon Electric/Exhibit 7 lists TPG's twenty-five consent rights, although important financial values for five of the rights (see numbers 4, 7, 8, 10, and 22) are left blank. These rights give TPG control of virtually all of PGE's fundamental business decisions, including the investment of capital (number 8), accounting practices (number 12), the hiring and firing of senior management positions within the company (number 15), the approval and any amendments to operating and capital budgets (number 17), and the submission or amendment of any jurisdictional filing, including permitting applications (number 21).

Q. WHAT WOULD OCCUR IF TPG EXERCISED ITS CONSENT RIGHTS ON AN ACTION ITEM THAT WAS OTHERWISE APPROVED BY THE BOARD?

A. Nothing would happen because the action item could not go forward. Under these circumstances, a compromise would have to be worked out or the item/activity simply would not occur. These negative consent rights present a risk that is not present in a typical utility board of directors because a single entity, TPG, would have veto power over such a wide range of management decisions. It would be very difficult, if not impossible, to assert that the existence of these negative consent rights are in the public interest.

Q. WILL RATEPAYERS OR THE COMMISSION BE AWARE THAT TPG HAS EXERCISED ITS CONSENT RIGHTS?

A. No. TPG has no intention of even maintaining records that it has exercised its negative consent rights nor does it intend to inform the Commission or any other regulatory authority when a right is exercised. Exhibit ICNU/105, Schoenbeck/1-2. This raises a concern over the sanitization process that will be applied to Board of Director meeting minutes. Typically, these documents are discoverable in a hearing such as a general rate case. At a minimum, these minutes should reflect a complete description of the activity with respect to which TPG exercised its veto right and the reasoning behind the decision.

Q. IN ADDITION TO LOCAL REPRESENTATION, WHAT OTHER BENEFITS DOES TPG CLAIM ARE ASSOCIATED WITH THE TRANSACTION?

A. In the initial application, TPG also emphasized ownership certainty and "thoughtful decisions about strategic direction, long-term resource planning, ongoing investment in the business." Application at 23. In the supplemental direct testimony provided by Mr. Davis of TPG, the Applicants claim benefits relating to the following: possibility of ratepayers receiving a rate credit, service quality standards, PGE Board access, renewable resources and low income assistance. Oregon Electric/Exhibit 22, Davis/8.

Q. DOES THE OWNERSHIP CERTAINTY ASSOCIATED WITH THE TRANSACTION PROVIDE A TANGIBLE BENEFIT TO RATEPAYERS?

A. No. TPG has no intention on holding of to PGE for a long period of time. Like any equity investment firm, TPG is interested in maximizing the return for their investors. TPG realizes that [redacted]. Confidential Exhibit ICNU/104, Schoenbeck/7. Consequently, even before entering into negotiations with Enron, TPG had [redacted] Id. at Schoenbeck/17-20. Similarly, the economic modeling of the transaction performed by TPG was most often based upon a sale or exit by the year [redacted] or [redacted], reflecting just [redacted] or [redacted] years of TPG ownership. Exhibit A to Applicants' Response to Request OEUC 1 (April 19, 2004). In fact, an ownership period of just [redacted] is a very brief period when measured by other events in the electric industry. For example, the re-licensing of an investor-owned hydroelectric plant can take well over six years. Similarly, the planning and construction of a single major resource addition can also easily take over five years. In no instance did the financial modeling go beyond the year [redacted]. These are certainly not the actions of an entity promoting ownership certainty as a real benefit to ratepayers.

Q. WILL THE ACQUISITION BY TPG PROVIDE TANGIBLE BENEFITS WITH REGARD TO STRATEGIC PLANNING, RESOURCE ACQUISITIONS, AND ONGOING CAPITAL EXPENDITURES?

A. I do not believe so for several reasons. First, this is the first electric utility that TPG has sought to acquire. With no utility experience, TPG must rely on outside consultants to provide the expertise to supplement the "in-house" experience of PGE's personnel, just as was done for much of the due diligence phase of this acquisition. Any entity can obtain consulting services from industry experts; hence, TPG ownership is not providing a unique perspective or planning direction. I am also concerned with PGE's level of ongoing maintenance expense and capital expenditures under TPG ownership. As I will present in greater detail later in this testimony, many of the financial model runs assumed a lower level of ongoing capital expenditures than PGE has planned. This obviously gives rise to reliability concerns, which are certainly not a benefit for Oregon ratepayers.

With regard to resource acquisitions, it is difficult to envision the possible direction or perspectives TPG will bring as a benefit to ratepayers. All statements addressing PGE's proposed acquisition of Port Westward have been redacted from all documents provided by TPG in response to data requests. This does not provide any confidence or assurance that TPG will have a positive influence on resource decisions. Finally, Oregon ratepayers should already be receiving thoughtful management attention and direction in all these areas. If this is not occurring, action should be taken to correct this deficiency with the existing management team irrespective of this proposed transaction.

Q. PLEASE EXPLAIN THE RATE CREDIT PROPOSED BY TPG IN ITS SUPPLEMENTAL TESTIMONY.

A. TPG's testimony offers a willingness to provide a rate credit to Oregon ratepayers triggered by PGE earning in excess of the currently authorized 10.5% return on common equity for a period of five years. TPG states that it would "share with customers some portion of the profits" but that the specific "methodology is to be agreed upon in the course of this proceeding." Oregon Electric/Exhibit 22, Davis/9. Most importantly, there is a critical footnote attached to this testimony that states: "Among the details of this methodology will be the need to accommodate the asymmetric impact of hydro variability." Id. at n.2.

Q. CAN THIS PROPOSAL BE CONSIDERED A TANGIBLE BENEFIT TO OREGON RATEPAYERS?

A. No, the proposal is so vague and poorly defined that it is essentially meaningless. TPG has not even specified if the "portion" to be credited to ratepayers is 1% or 100% of the over-earnings. Further, the additional caveat with regard to the need to incorporate hydro variability into the earnings determination suggests even further uncertainty and complexity. Unlike rate credits tied to efficiency improvements or cost savings, a rate credit tied to or incorporating hydro variability introduces an element that goes beyond the control of PGE or Oregon Electric. It appears to me that instead of offering a rate credit for Oregon ratepayers, TPG is actually asking for customers to accept some form of a five year power cost adjustment mechanism without an offsetting reduction in the cost of capital (and revenue requirement) for PGE. The paltry description of the possible rate credit mechanism in the supplemental testimony does not satisfy the requirement that the transaction is in the public interest, especially given that the rate credit must be agreed to by *all* parties.

Q. IS THE COMMITMENT TO EXTEND THE SERVICE QUALITY MEASURES AN ADDITIONAL 10 YEARS A TANGIBLE BENEFIT TO OREGON RATEPAYERS?

A. No. TPG is simply offering what Oregon ratepayers have been paying, and continue to pay for, under the existing quality of service measures. For example, PGE has made significant upgrades to its automated outage service reporting system. This system can handle thousands of calls an hour at less expense than talking to a customer service representative. The costs of systems that allow PGE to achieve the reliability benchmarks are part of PGE's revenue requirement and paid for by Oregon ratepayers. If TPG was not willing to extend these service measures, Oregon ratepayers should receive a rate reduction to reflect the cost difference from receiving a lower quality of service. Furthermore, the continuation of these measures should be a prerequisite for approval of a change in the ownership of PGE, not a basis upon which to conclude that customers will benefit from a change in ownership.

Q. ARE THE EXISTING QUALITY MEASURES ADEQUATE FOR THE TECHNOLOGY DRIVEN SOCIETY OF TODAY?

A. No. The reliability measures need to be re-examined given the very high reliance upon electronic devices in today's society. Momentary disruptions measured in cycles—not minutes or hours—can cause substantial restarts for industry. While the intent of the R-3 reliability measure is to account for these types of events, the first penalty does not occur until the average customer value is 5 occurrences. This is far too great for sensitive industrial applications. Maintaining the existing level of reliability standards is a necessary first step but more needs to be done to offer value to Oregon ratepayers.

Q. IS THE COMMITMENT TO PROVIDE CUSTOMERS ACCESS TO THE BOARD OF DIRECTORS A TANGIBLE BENEFIT FOR OREGON RATEPAYERS?

A. I do not believe the proposal represents a tangible benefit that satisfies the public interest standard of providing a net benefit to ratepayers. Like the proposed rate credit, the testimony addressing the concept is very superficial, consisting of a total of only eight lines. Oregon Electric/Exhibit 22, Davis/10-11, 22. The last sentence of the testimony addressing the topic states the gist of the proposal: "Accordingly, Oregon Electric is willing to commit that PGE will provide *periodic* access to the PGE Board for the *appropriate* advocacy groups." Id. at Davis/11 (emphasis added). Until the conditions, frequency, timeliness of the access, and the "appropriate" organizations are known, the proposal cannot be evaluated or cited as a tangible benefit for ratepayers. Even with further specificity, the benefits are nebulous.

Q. IS THE COMMITMENT TO PROVIDE A MANAGERIAL POSITION TO "FOLLOW-THROUGH" ON ISSUES AND WORK WITH CERTAIN RENEWABLE ADVOCACY GROUPS A TANGIBLE BENEFIT?

A. No. To the extent matters raised by these groups have "fallen through the cracks" in the past, establishing a dedicated position to work with these entities is not a demonstrable benefit brought by TPG. It is simply an action to correct past communication difficulties or shortcomings. In fact, the Bonneville Power Administration created such a position several years ago. From my perspective, this "benefit" should have already been addressed by PGE's management.

Q. IS THE COMMITMENT TO PROVIDE ADDITIONAL FUNDS FOR LOW INCOME ASSISTANCE A TANGIBLE BENEFIT?

A. Yes, for certain ratepayers. TPG has stated it will contribute an additional $100,000 per year for ten years for low income assistance. This is the only tangible benefit TPG has offered to date in this proceeding. Benevolent contributions such as this are greatly needed given the depressed Oregon economy. However, this represents just [redacted] of the net income provided to Oregon Electric under the transaction's structure and only 0.01% of PGE's retail revenue. Under the circumstances, although the contribution is appreciated, the needs and ability to provide such a donation are much greater.

Q. DO YOU HAVE ANY CONCERNS WITH THE PROPOSED ACQUISITON OF PGE BY TPG?

A. Yes. Virtually all the analytical work performed by TPG coupled with the due diligence work of the outside consultants have identified significant monetary sums for either O&M savings or capital savings from PGE budgeted levels. While ICNU believes PGE should be an efficiently run utility, concerns arise over the apparent premise of TPG that the cost savings must be achieved to realize the substantial rates of return targeted by TPG for this investment.

Q. PLEASE ILLUSTRATE THE EFFORTS UNDERTAKEN BY THE CONSULTANTS EMPLOYED BY TPG AND THEIR FINDINGS.

A. Early on in the process, TPG retained several outside consultants to perform various benchmarking analyses of PGE's O&M costs with those of other utilities.

These efforts resulted in preliminary reports indicating substantial cost savings could be achieved. I have included one such report as Confidential Exhibit ICNU/106, which is Revised Exhibit XX to Applicants' Response to Staff data request OEUC 68. [redacted] For example, Confidential Exhibit ICNU/107 is one such report regarding PGE's generating facilities. For the Boardman coal plant, the consultants' report noted the following with regard to potential cost savings:

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

Confidential Exhibit ICNU/107, Schoenbeck/2-3. [redacted]

[redacted]

[redacted]

[redacted] Addressing the hydroelectric facilities, the report concluded:

[redacted]

[redacted]

[redacted]

[redacted] These are illustrated by the following excerpts:

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

Confidential Exhibit ICNU/108, Schoenbeck/2. The findings from all these reports were succinctly summarized in a brief update memo to the TPG IRC dated August 25, 2003, which is included as Confidential Exhibit ICNU/109:

[redacted]

Confidential Exhibit ICNU/109, Schoenbeck/1.

Q. DO YOU BELIEVE THE CONSULTANTS DID A THOROUGH INVESTIGATION IN IDENTIFYING COST SAVINGS?

A. I cannot say. I am not sure if I have examined all of the consultants work product, nor do I know the specific hours devoted to this particular task. However, I will note that TPG has paid in aggregate over [redacted] to these consultants to date related to the entire transaction. Confidential Exhibit ICNU/110, Schoenbeck/1. This obviously is a substantial sum.

Q. WERE COST SAVINGS INCLUDED IN THE FINANCIAL EVALUATIONS PRESENTED TO THE IRC AT THE SEPTEMBER 15, 2003 MEETING?

A. Yes. Confidential Exhibit ICNU/104 contains numerous references or notes to cost savings ranging from [redacted] million per year. A few examples are:

[redacted]

In my view, critical pages in Confidential Exhibit ICNU/104 are Schoenbeck/8, 10, 11, 12, 14, and 22, which present numerous sensitivities with virtually all assuming some level of cost savings. These pages set forth the various expected rates of return on the TPG investment under various assumptions. You will note that a substantial number of these cases result in annual returns in excess of [redacted] at typical industry multiples and even approach [redacted] per year. Assuming more attractive multiples, the returns can exceed [redacted] per year. These substantial returns are driven in part by the assumption that TPG retains or captures all of these cost savings.

Q. WERE COST SAVINGS INCLUDED IN TPG'S PRESENTATION TO RATING AGENCIES IN EXPLAINING THE PROPOSED ACQUISITION?

A. Yes. Confidential Exhibit ICNU/111 is a TPG presentation to Standard & Poor's dated November 10, 2003. This document presents two scenarios. [redacted] The following table presents critical differences in assumptions between the two cases.

[redacted]

[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]

Q. WHAT IMPACT DOES THE LOAD GROWTH ASSUMPTION HAVE BETWEEN THE TWO SCENARIOS?

A. [redacted]

Q. WHAT IMPACT DOES THE BUILDING OF PORT WESTWARD HAVE ON THE FINANCIAL ANALYSIS PERFORMED BY TPG?

A. [redacted]

Q. PLEASE EXPLAIN THE IMPLICATIONS OF THE DIFFERING O&M ESCALATION RATES.

A. The difference in the assumption for the O&M escalation rate between the two cases is [redacted] per year. Based upon a 2003 O&M amount of [redacted] million, a substantial savings of O&M over the ownership period occur between the two cases as shown by the following table.

[redacted]

For the period of 2005 through 2008, the O&M savings total almost [redacted]. Similarly, for the period of 2005 through 2010, the O&M savings are almost [redacted]. Without an offsetting reduction in rate levels, these cost savings represent a substantial overpayment by ratepayers for the service being provided by PGE. Put another way, without the rate reduction, these cost savings increase the rate of return for TPG by over [redacted].

I recognize that TPG has been attempting to distance themselves from these assumed cost cuts in this proceeding by introducing the Business Review Process. However, it is difficult to believe major operational savings or improvements will not be implemented because of the heavy reliance upon these projections during all phases of the due diligence process.

Q. DID TPG ASSUME SIMILAR SAVINGS IN THE CAPITAL EXPENDITURE LEVELS FOR PGE?

A. Yes. The following table compares the capital expenditures assumed in the two cases.

[redacted]

Even with excluding the Port Westward capital requirement, TPG's presentation to the rating agencies suggests the possibility of reducing the capital investment in PGE by [redacted] per year. The savings associated with limiting the capital investment increases the rate of return by about [redacted].

Q. WHY HAS TPG WORKED SO HARD TO IDENTIFY O&M COST SAVINGS AND REDUCED CAPITAL REQUIREMENTS?

A. Being able to achieve savings such as these results in a dramatic increase in TPG's return on investment, as long as there is not a corresponding rate reduction or credit for ratepayers. [redacted] Taken together, the cost savings associated with both the O&M and capital cuts increase the rate of return [redacted].

Q. WHAT DOES THE PROPOSED ACQUISITION OF PGE BY TPG MEAN FOR OREGON RATEPAYERS?

A. TPG is attempting to exploit an unintended benefit of ring fencing and planning to implement substantial cost reductions while not reducing any retail rate charges or provide meaningful rate credits. The substantial return on the equity investment that TPG is attempting to achieve through the proposed acquisition of PGE should not be paid for by Oregon ratepayers. This transaction is not in the public interest of Oregon and should not be authorized by the Commission.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

QUALIFICATIONS AND BACKGROUND OF DONALD W. SCHOENBECK

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. Donald W. Schoenbeck, 900 Washington Street, Suite 780, Vancouver, Washington 98660.

Q. PLEASE STATE YOUR OCCUPATION.

A. I am a consultant in the field of public utility regulation and I am a member of Regulatory & Cogeneration Services, Inc. ("RCS").

Q. PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.

A. I have a Bachelor of Science Degree in Electrical Engineering from the University of Kansas and a Master of Science Degree in Engineering Management from the University of Missouri.

From June of 1972 until June of 1980, I was employed by Union Electric Company in the Transmission and Distribution, Rates, and Corporate Planning functions. In the Transmission and Distribution function, I had various areas of responsibility, including load management, budget proposals and special studies. While in the Rates function, I worked on rate design studies, filings and exhibits for several regulatory jurisdictions. In Corporate Planning, I was responsible for the development and maintenance of computer models used to simulate the Company's financial and economic operations.

In June of 1980, I joined the national consulting firm of Drazen-Brubaker & Associates, Inc. Since that time, I have participated in the analysis of various utilities for power cost forecasts, avoided cost pricing, contract negotiations for gas and electric services, siting and licensing proceedings, and rate case purposes including revenue requirement determination, class cost-of-service and rate design.

In April 1988, I formed RCS. RCS provides consulting services in the field of public utility regulation to many clients, including large industrial and institutional customers. We also assist in the negotiation of contracts for utility services for large users. In general, we are engaged in regulatory consulting, rate work, feasibility, economic and cost-of-service studies, design of rates for utility service and contract negotiations.

Q. IN WHICH JURISDICTIONS HAVE YOU TESTIFIED AS AN EXPERT WITNESS REGARDING UTILITY COST AND RATE MATTERS?

A. I have testified as an expert witness in rate proceedings before commissions in the states of Alaska, Arizona, California, Delaware, Idaho, Illinois, Montana, Nevada, North Carolina, Ohio, Oregon, Washington, Wisconsin and Wyoming. In addition, I have presented testimony before the Bonneville Power Administration, the National Energy Board of Canada, the Federal Energy Regulatory Commission, publicly-owned utility boards and in court proceedings in the states of Washington, Oregon and California.

CONFIDENTIAL
PURSUANT TO
PROTECTIVE ORDER IN
OPUC DOCKET NO. UM 1121

Schoenbeck Exhibits:

ICNU/102

REQUEST ICNU/OEUC 5.31:

(a) Please provide the date upon which the TPG Investment Review Committee or any other governing body formally approved the transaction to acquire PGE. If such approval has not been formally granted, please provide the date upon which TPG will seek approval of the acquisition from the IRC or other governing body.

(b) Please provide a copy of all documents that refer or relate to approval of the acquisition by the IRC or other governing body.

APPLICANTS' RESPONSE TO REQUEST ICNU/OEUC 5.31:

(a) Please see Applicants' Response to Request Staff/OEUC 22, describing the Investment Review Committee ("IRC"). The IRC approved the transaction on September 15, 2003.

(b) Please also see the following previously produced exhibits listed in Appendix B: Staff/OEUC 24A-I.

ATER WYNNE LLP
222 SW COLUMBIA, SUITE 1800
PORTLAND, OR 97201-6618
(503) 226-1191

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Schoenbeck Exhibits:

ICNU/104

REQUEST PORTLAND/OEUC 12:

Regarding the negative consent rights vested in TPG as described in the testimony at OEUC Ex. 3/Davis/9, and as set forth in OEUC Exhibit 7:

a. Please describe the types of decisions over which OEUC *and the PGE Board of Directors* will have sole and unrestricted discretion. Please provide specific examples that will illustrate the breadth and scope of OEUC's *and the PGE Board of Directors'* unfettered discretion. Please provide specific examples that illustrate any limits upon OEUC's *or PGE Board of Directors'* discretion.

b. Please describe the process which will be used by TPG in exercising its negative consent rights. Please identify whether: OEUC *and/or the PGE Board* will be notified that TPG will exercise, or has exercised its consent rights; whether the notice will specify what authority is being or has been exercised; whether records of the exercise of TPG's consent rights will be maintained for public review; and, whether any regulatory agencies will be notified when TPG's consent rights have been exercised.

Note: Text in italics has been inserted to clarify questions in accordance with a teleconference with Ben Walters on April 29, 2004.

APPLICANTS' RESPONSE TO REQUEST PORTLAND/OEUC 12:

Applicants object to this question on the grounds that it is vague, overly broad, and unduly burdensome. Subject to and without waiving the foregoing objections, Applicants provide the following response:

a. The types of decisions over which the Oregon Electric and PGE Boards of Directors will have sole and unrestricted discretion are set forth in Applicants' Responses to Request CUB/OEUC 2 (describing the authority and discretion of the PGE Board relative to TPG Applicants' consent rights) (provided under separate cover dated May 7, 2004), Request Staff/OEUC 75 (describing the powers of PGE's Board of Directors) (attached hereto as Exhibit A to Applicants' Response to Request Portland/OEUC 12), and Request Staff/OEUC 76 (describing the powers of the Oregon Electric Board) (attached hereto as Exhibit B to Applicants' Response to Request Portland/OEUC 12). Specific examples that illustrate limits on Oregon Electric's discretion are set out in detail in Exhibit 7 to the Application.

b. The process that TPG Applicants will follow in exercising their consent rights has not been established, but will be established prior to closing. TPG Applicants would exercise those rights only after the PGE Board has undertaken a full discussion of the relevant issues and has passed a resolution approving a matter requiring consent. It is expected that during PGE Board discussions on any matter requiring consideration and approval by the Board, each Board member will have had an opportunity to express his or her views and reach an independent conclusion on how to vote.

Applicants do not expect to maintain records of the exercise of consent rights for public review, nor do Applicants expect to report such exercise to any regulatory agency.

Applicants are not aware of any regulatory requirement that would require them to maintain public records regarding the exercise of TPG Applicants' consent rights or to notify any regulatory body of the exercise of those consent rights.

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Schoenbeck Exhibits:

ICNU/106

ICNU/107

ICNU/108

ICNU/109

ICNU/110

ICNU/111

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DIRECT TESTIMONY OF

JOHN ANTONUK AND RANDALL VICKROY

ON BEHALF OF

THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES

REDACTED VERSION

(Confidential Information is shaded)

July 21, 2004

Introduction and Qualifications

Q. MR. ANTONUK, PLEASE STATE YOUR NAME, OCCUPATION AND BUSINESS ADDRESS.

A. My name is John Antonuk. I am the President of The Liberty Consulting Group. My business address is 65 Main Street, Box 237, Quentin, PA 17083.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND PROFESSIONAL EXPERIENCE.

A. I graduated in 1973 from Dickinson College, earning a bachelors degree with honors. I graduated in 1976 from the Dickinson School of Law, earning a juris doctor degree with honors. I began my career in 1975 as an investigator for the litigation section of the Pennsylvania Attorney General's office. I then spent several years as assistant counsel to the Pennsylvania Public Utility Commission, for which I conducted administrative and civil litigation involving a wide variety of case types in the electricity, natural gas, telecommunications, water, and transportation industries. I also served in a number of capacities on a variety of matters involving commission administration and operations.

I then served as the head of the service and facilities section of Pennsylvania Power & Light ("PP&L") Company's regulatory-affairs department. I left PP&L to begin consulting in the utility industry in 1982. I managed the litigation-services practice of Management Analysis Company, a consulting firm that specialized in the electric-utility industry.

I am one of the founders of Liberty, which was established 17 years ago. I have held management or lead roles on over 150 projects over the 22 years that I have been consulting in the utility industries.

Q. HAVE YOU PARTICIPATED PREVIOUSLY IN STATE COMMISSION PROCEEDINGS?

A. Yes. I have been engaged in many state utility regulatory proceedings in the electric, natural gas, and telecommunications industries in my time as a utility consultant. Much but not all of it has been on behalf of commissions or their staffs. I have served as a staff witness, an independent witness appearing on a commission's behalf, a contracted administrative law judge, a facilitator, an arbitrator, and a commission advisor. Appendix A to this testimony describes my roles in such proceedings in more detail.

Q. PLEASE DESCRIBE THE BUSINESS OF THE LIBERTY CONSULTING GROUP.

A. Liberty is a management-consulting firm that has been serving regulators and managers in the utility industries for 17 years. Liberty has performed over 250 utility industry engagements. Liberty's experience includes work involving energy and telecommunications utilities across the country. Liberty has performed or is performing substantial engagements for utility regulatory authorities in about two thirds of the states. These states include:

Arizona	Hawaii	Minnesota	New York	Tennessee
Arkansas	Idaho	Mississippi	North Dakota	Utah
Colorado	Illinois	Montana	Ohio	Vermont
Connecticut	Iowa	Nebraska	Oklahoma	Virginia
Delaware	Kentucky	New Hampshire	Oregon	Washington
District of Columbia	Maine	New Jersey	Pennsylvania	Wyoming
Georgia	Maryland	New Mexico	South Dakota	

Q. WHAT WORK HAS LIBERTY PERFORMED REGARDING THE REGULATORY ASPECTS OF UTILITY FINANCE, SERVICE RELIABILITY, HOLDING COMPANIES, AND CHANGES IN UTILITY OWNERSHIP AND CONTROL?

A. Our recent work on these subjects includes evaluating the proposed leveraged buyout ("LBO") of UniSource by private investors in Arizona, examining the causes and effects of financial distress at NUI Corporation on its New Jersey utility operations, examining the impacts of bankruptcy on the Montana utility operations of NorthWestern Energy, addressing the Consolidated Edison/Northeast Utilities merger, and auditing Commonwealth Edison's reliability problems in the Chicago metropolitan area. Appendix B to this testimony describes these engagements in more detail.

Q. MR. VICKROY, PLEASE STATE YOUR NAME, OCCUPATION AND BUSINESS ADDRESS.

A. My name is Randall E. Vickroy, I am Liberty's principal consultant for utility financial matters, and my Liberty business address is 65 Main Street, Box 237, Quentin, PA 17083.

Q. MR. VICKROY, WHAT ROLE HAVE YOU PLAYED IN THESE PROCEEDINGS?

A. I led Liberty's review of the discovery and testimony on financial issues associated with the transaction, and participated jointly with John Antonuk in forming the observations, conclusions and recommendations addressed in this testimony. We drafted this testimony together.

Q. MR. VICKROY, PLEASE SUMMARIZE YOUR BACKGROUND.

A. I received a Bachelor of Arts from Monmouth College in 1976 with a major in business administration. I received a Masters of Business Administration degree from the University of Denver with an emphasis in finance in 1978. In April 1979, I was hired by Public Service Company of Colorado, an electric and gas utility, as a financial analyst in the corporate finance and planning department. For the next twelve years I was employed as a financial analyst, financial supervisor, director of analysis, business development manager, and assistant to the chief financial officer. My responsibilities included financial planning, capital acquisition, capital spending analysis and allocation, treasury operations, securitization financing, project financing, mergers and acquisitions, cash management, and investor relations.

In 1991, I began consulting on corporate finance issues in the electricity, natural gas, and telecommunications industries. During the past thirteen years I have provided consulting services to utility commissions and to companies in over 25 states and in two foreign countries. From 1991 through 1998, I was a senior consultant with the Liberty Consulting Group. From 1999 until 2001, I was a project manager on major utility consulting engagements for Deloitte Consulting. From 2001 until the present, I have again consulted almost exclusively for Liberty Consulting.

I have been involved with utility corporate finance, treasury, and credit issues as both a utility practitioner and a utility management consultant for over 25 years. My consulting experience includes numerous utility consulting projects with Liberty Consulting Group in over 20 states, in which I had responsibility for financial issues. I have been Liberty's lead financial consultant on almost all of those projects that have relevance to the issues in this case.

<u>Purpose and Summary of Testimony</u>

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS CASE?

A. This testimony sets forth our views on the financial issues raised by the acquisition of Portland General Electric Company ("PGE" or "the Company") by Oregon Electric Utility Company ("OEUC" or "Oregon Electric"), Texas Pacific Group ("TPG"), and the other applicants (collectively, the "Applicants").

Q. PLEASE SUMMARIZE YOUR POSITION ON THE TRANSACTION AS PROPOSED BY THE APPLICANTS.

A. We do not believe the transaction as currently proposed provides net benefits to customers. We believe that the transaction as structured will create a substantially increased risk of impairment of the utility's financial status, and of preventing the utility from providing safe, reasonable, and adequate service. Its use of double leveraging (*i.e.*, significant debt levels at both the utility and parent levels) would substantially increase debt as a percentage of consolidated capitalization. The resulting reduction in equity as a percentage of total capitalization would diminish PGE's ability to withstand adverse future financial conditions. The risks of this substantially greater leverage will be increased in the event that floating rate debt is chosen by the Applicants, who have not yet made final financing arrangements. The transaction also creates risk by failing to provide sufficient protection against inclusion of the utility entity in a possible bankruptcy of the parent. There is already substantial evidence that the transaction would reduce credit quality.

The transaction's risks to service reliability and quality arise from a failure to provide sufficient assurances against a decline in service quality and reliability both during and after the period of ownership by the Applicants. The service quality standards agreed to in the Partial Stipulation that is expected to be filed soon in this Docket provide a baseline for measuring service quality. However, relying solely upon lagging service quality measures is insufficient to prevent undue cost reduction steps that may have consequences only after an extended period of time. That time may come after the period during which Applicants would be likely to own PGE. The expected exit strategy for such an ownership structure creates a strong potential for a fairly short period of ownership. This potential requires measures for assuring that there would not be a failure to continue a long-term approach and commitment to maintaining service quality.

We, therefore, do not believe that the Oregon Public Utility Commission ("OPUC" or the "Commission") should approve the transaction as proposed by the Applicants. We believe that a number of risks will arise from a transfer of ownership and control like that proposed here. Against those risks, we do not see either compensating or greater positive benefits for customers or substantial benefit to the public interest. Generalized, superficial, and inadequately supported projections of improvement should not be taken as convincing proof of future benefits. Claims of no net harm or even of marginal benefit to customers should meet substantial disfavor where there is reason to believe that a transfer of control will create new or increased risks of disruption to the economic well-being of the utility. The imposition of conditions can serve to mitigate, but not to eliminate, those risks. Therefore, the absence of significant positive benefits to counter the risks this change of control would bring remains troubling, even were the Commission to add conditions to mitigate financial risk.

Q. PLEASE SUMMARIZE YOUR REASONS FOR TAKING THIS POSITION.

A. **First**, this transaction would result in a very large increase in leverage at the consolidated level, despite maintenance of healthy equity levels as a percentage of total capitalization at the PGE level. This increase would considerably diminish the ability of PGE to withstand financial stress imposed by market or operating conditions. The transaction would produce a strong need for PGE to make utility cash flow available to support parent debt payments. That need would create a corresponding concern about assuring that future utility cash flows remain dedicated to debt payment. Moreover, in the event that financial circumstances worsen in the future, there will exist pressure to increase those cash flows, to the potential detriment of the utility.

Second, there is the pressure for LBOs to be followed by strong actions to cut costs. This pressure has a substantial likelihood of producing too short-term a focus on service quality issues. The transaction as proposed does not contain enough objective, enforceable protections against reductions that would threaten long-term maintenance of safe, reliable, and adequate service. This is not to say that no efficiency gains should be expected or promoted. Rather, the concern is in assuring that any such gains not come at the expense of future degradations in service quality or reliability. The Applicants propose to continue the performance standards agreed to by the Company in the Enron transaction. Assuring this commitment is appropriate and constructive; however, such standards at best focus on lagging indicators. The transaction as proposed presents an inappropriately increased risk of service quality degradation. A more effective method for ensuring continued service quality after a change in control would have been to provide for a focused, independent, post-transaction review of management and operations after a period of operations under new ownership.

Q. DO YOU HAVE A POSITION ON THE QUESTION OF WHETHER THIS TRANSACTION SHOULD BE APPROVED COMMISSION?

A. Yes. There is a failure to provide conditions sufficient to mitigate the risks that the transaction will cause harm or risk of harm, and there has not been a demonstration that this change in ownership will serve the public interest by creating discernible net positive benefits sufficient to balance the risks. We recognize the difficulty in eliminating risks entirely. Substantial commitments, limitations, and protections nevertheless remain necessary to assure that the public will eventually see benefits from the acquisition that is at issue here. Specifically, there is a need for a substantially revised financial structure that will significantly reduce consolidated leverage. There is also inadequate mitigation of the potential for parent lenders to cause the utility to be included in any bankruptcy or receivership occasioned by a failure of an affiliate, or the holding company, to pay their debts as they become due. Finally, there is a lack of sufficient protection against undue reductions in expenditures necessary for assuring that service reliability and quality remain adequate over the period during which the Applicants may be expected to control utility operations and the period immediately thereafter.

A failure to make substantial structural changes and to impose conditions addressing these matters means that this transaction, as proposed, would create undue risk of:

- Financial harm in the form of difficulty or undue expense in securing capital efficiently and economically;
- Adverse consequences to utility operations from a failure to insulate utility finances from those of an affiliate or the holding company; and
- Decline in service quality, reliability, and adequacy due to reductions in utility capital and operation and maintenance ("O&M") expenditures.

Q. WHY DO YOU FOCUS ON RISKS, AS OPPOSED TO ACTUAL RESULTS?

A. Experience shows that even apparently stable, well-structured utility operations can become troubled. Sometimes difficulties arise from unforeseen circumstances in the utility sector; more frequently, however, problems outside the utility produce adverse consequences for utility operations. Weakness or stress at the holding company level or within affiliates should not be permitted to entangle utility operations. The central issue is whether the transaction as structured increases risks. If it does, the next question becomes whether the Commission should accept that risk, should impose conditions to mitigate it, or should simply disapprove the transaction as structured by those seeking its approval.

Standards for Reviewing the Proposed Transaction

Q. HOW DOES THIS TRANSACTION COMPARE WITH THOSE THAT OTHER COMMISSIONS HAVE EXAMINED RECENTLY?

A. There are few closely comparable transactions. This is not a traditional reorganization, *i.e.*, one involving a merger of existing utilities or of utility holding companies. The proposed reorganization involves the acquisition of PGE by private investors. The most recent similar transaction is the proposed acquisition of UniSource, the parent of Tucson Electric Power, by a group of private investors. I (John Antonuk) testified in that proceeding before the Arizona Commerce Commission in June of this year on behalf of the Arizona Commission Staff. In recent years, Texas-New Mexico Power and MidAmerican Energy were both acquired by private investors. And, of course, the Oregon Commission has already dealt with non-traditional transactions, *i.e.*, Enron's acquisition of PGE and ScottishPower's acquisition of PacifiCorp.

Q. ON WHAT FINANCIAL AREAS HAVE OTHER COMMISSIONS FOCUSED IN REVIEWING TRANSACTIONS?

A. Each case has been different; applicable laws in each state have guided public service commission examinations of proposed reorganizations and utility acquisitions. Nevertheless, the commissions examining them have typically considered, among other factors, whether the transaction would negatively affect the following:

- Customer and the public interest, including rates;
- The utility's ability to attract capital on reasonable terms and to maintain a reasonable capital structure; and

- Continuation of activities and expenditures needed to provide safe, reasonable, and adequate service.

Q. WHAT STANDARDS HAVE YOU APPLIED IN REVIEWING THE PROPOSED TRANSACTION?

A. We have examined whether this transaction is in the public interest. Oregon law provides that the Commission should determine whether approval would "serve the public utility's customers in the public interest." ORS § 757.511. The OPUC has found that this standard requires a showing of "net benefit[s]." Re Legal Standard for Approval of Mergers, OPUC Docket No. UM 1011, Order No. 01-778 at 11 (Sept. 4, 2001).

We believe that benefits need to be discernible and reasonably likely to occur. An opportunity for significantly higher returns to investors (through, for example, the effects of double leveraging) can add risks to the detriment of customers. Absent a positive demonstration of net customer benefits, it is our position that the uncertainties associated with making a change support a conclusion that the applicable standard has not been met.

Q. HAVE THE APPLICANTS MAINTAINED THAT THERE ARE NET BENEFITS TO THE TRANSACTION?

A. They have; however, we do not believe that these purported benefits are significant enough to counteract the increased risk. The Applicants have listed the following benefits:

- Unified, certain, and stable management
- Local participation on the board
- Experience of investors in helping companies through transitions

- Long-term planning to secure resources on a cost-effective basis
- Reinvestment in the business
- Simplicity and transparency

Re Oregon Electric *et al.*, OPUC Docket No. UM 1121, Application of Oregon Electric *et al.* to Acquire PGE at 23-25 (Mar. 8, 2004) ("Application"). These "benefits" really do little more than restate what are fundamental, baseline obligations of utilities. They represent the minimum that officials responsible for regulating prices and service should expect, whoever owns and operates a public utility. It is difficult for us to comprehend how offering what this Commission has the full authority to demand of any ownership, existing or not, can be construed as providing customers with some level of incremental benefit. As discussed more extensively in Exhibit ICNU/100, the testimony of ICNU witness Donald Schoenbeck, we do not find these benefits particularly positive or compelling.

The transaction as proposed does not offer protection for PGE from the high leverage of the parent, nor does it offer protection against possible, future parent-creditor efforts to involve the utility in bankruptcy or receivership proceedings. The net effect will be even further reduced ratings of PGE, and a possible negative impact on the utility's ability to access capital markets. Further reduction of PGE's credit ratings would lead to higher financing costs and upward pressure on rates.

Q. WILL THE NEW HOLDING COMPANY AND PGE HAVE THE BENEFIT OF REDUCED COSTS THAT PROPONENTS OF MERGERS OFTEN PROJECT?

A. If the utility has been run with reasonable efficiency, there should not be areas of significant, potential cost reduction. This acquisition would not likely represent a combination of separate entities performing like activities. Although there are few, if any, operating synergies, many of TPG's financial model runs indicate operating cost and capital reductions. We are concerned that such reductions may harm PGE's operations. For a utility that has been operated well, a significant reduction in costs would create a material added risk of a reduction in service quality and reliability

Financial Issues

Q. PLEASE EXPLAIN PGE'S CURRENT FINANCIAL STANDING AND CREDIT RATINGS?

A. PGE is currently rated "BBB+" by Standard and Poor's Rating Services ("S&P") and Baa3 by Moody's. Confidential Exhibit ICNU/201, Antonuk-Vickroy/1, 6. S&P provided an update of PGE's current corporate credit rating of "BBB+" as of January 2004, in conjunction with consideration of the TPG transaction. Confidential Exhibit ICNU/202 (Excerpt of the January 2004 Update). PGE is now rated by S&P based primarily on its stand-alone credit quality. PGE's current credit rating takes into account PGE's low-cost generation and the utility's currently strong financial profile and financial coverage ratios. PGE's adjusted equity to capitalization in January 2004 was at 54%, which is comparatively strong for the industry. The current PGE rating also recognizes, however, the business risk associated with the purchase of 35% of PGE energy requirements from the wholesale electric market. In addition, it recognizes that PGE could become liable for a portion of an IRS claim for income taxes against Enron, for further refunds on prior power sales in California, and for a portion of Enron's pension and healthcare plans. Id. at Antonuk-Vickroy/5-8.

Q. HAVE THE OPUC'S RING FENCING MEASURES, AS ORDERED IN THE 1997 ENRON MERGER DOCKET, EFFECTIVELY PROTECTED PGE FROM ENRON'S PROBLEMS?

A. For the most part, except as described below. PGE has now met S&P's ring fencing criteria for providing financial separation between a utility subsidiary and its affiliates and holding company parent. The establishment of financial and structural ring fencing through the OPUC order in the 1997 Enron merger docket established the foundation for credit separation from Enron. In addition to the 1997 OPUC ring fencing conditions, PGE has received a non-consolidation legal opinion to the effect that PGE would not substantively be consolidated into the Enron bankruptcy estate.

PGE has also issued a special class of junior preferred stock, whose vote could block a voluntary bankruptcy petition. The use of this "golden share" approach to protect against voluntary filings is beneficial and important. It should be continued, but it does not address the equally important question of mitigating the potential for parent creditors to involve the utility subsidiary in a bankruptcy or receivership of the parent.

The ring fencing measures now in place have prevented Enron from gaining undue access to PGE's equity capital, pledging PGE assets as collateral, and selling PGE's assets to pay Enron's creditors. Most importantly, ring fencing has prevented the utility's consolidation into Enron's bankruptcy estate. These measures have also caused a large separation in credit ratings from Enron's "D", or default, status to PGE's investment grade rating.

Q. WHY HAS PGE'S CREDIT RATING DECREASED FROM A3 IN 2001 TO "Baa3" CURRENTLY?

A. PGE's credit rating from Moody's was downgraded by three credit rating levels starting in late 2001, due to liquidity challenges from the Western energy crisis and from the ownership and liability uncertainty related to Enron. The Pacific Northwest electric utilities faced liquidity problems caused by the California energy crisis, drought conditions, spikes in natural gas prices, and maintenance outages. These factors created extremely volatile and increased pricing on the wholesale power market. The utilities' inability to pass increased costs to customers immediately caused liquidity problems at several utilities, including PGE. Moody's Investor Service, Special Comment, Improving Liquidity for Pacific Northwest Utilities at 2, 4-5 (Dec. 2002).

PGE also faced uncertainty in its struggle to remain insulated from the bankruptcy proceedings of Enron, and needed to clarify uncertainties about federal investigations into its role in Western power markets. Uncertainty about the future ownership structure for PGE was also a factor in PGE's ratings reductions. Id.

Q. WHAT DO YOU ANTICIPATE TO BE THE OVERALL CREDIT IMPACT OF THE TPG TRANSACTION ON PGE?

A. The impact of the proposed TPG transaction on the financial standing and credit rating of PGE is negative, due to the increased levels of debt leverage that would exist in the consolidated Oregon Electric capital structure. S&P took this point of view in placing PGE on CreditWatch with negative implications on March 10, 2004, following Oregon Electric's filing with the OPUC requesting approval of the transaction. Exhibit ICNU/201, Antonuk-Vickroy/1-2.

S&P noted that Oregon Electric will need about $1.47 billion to complete the transaction. The acquirers expect to fund this amount through a combination of $525 million of TPG equity capital, $707 million of debt, and a $240 million dividend from PGE at the time of closing. S&P has specifically noted that:

> The acquisition will result in a heavily leveraged consolidated balance sheet of PGE and Oregon Electric. Accordingly, Standard and Poor's expects that PGE's ratings will be downgraded.

Id. at Antonuk-Vickroy/2. S&P considers the high degree of leverage included in the TPG transaction to have a strong negative impact on PGE's credit quality, but has indicated that it does not expect PGE to fall below an investment grade level. Id. Positive transaction features, according to S&P, include Oregon Electric's commitment that all dividends from PGE to Oregon Electric will be used to service and pay down Oregon Electric's debt, and an OPUC requirement for maintaining a 48% minimum equity capital layer at PGE. Id. However, the negative effect of the high levels of leverage overrides the positive features.

Q. WHY WILL THE TPG TRANSACTION PRODUCE LESS FAVORABLE FINANCIAL CIRCUMSTANCES THAN EXIST CURRENTLY FOR PGE?

A. The greatly increased amounts of debt and percentages of leverage within the proposed Oregon Electric consolidated family would cause consolidated equity capital and cash flow measures to decline markedly. This conclusion is explicitly supported by [redacted] Exhibit A to Applicants' Response to Request OEUC 3 at OE 100022 (Apr. 2, 2004); Confidential Exhibit ICNU/111, Schoenbeck/4. [redacted]

S&P provided its conclusions to TPG in January 2004. See Confidential Exhibit ICNU/202, Antonuk-Vickroy/1-16. [redacted] Id. at Antonuk-Vickroy/4. [redacted] Id. [redacted] Id.

S&P made two important observations about the credit weaknesses of the post-transaction consolidated company: [redacted] Id. at Antonuk-Vickroy/10, 15. [redacted] Id. at Antonuk-Vickroy/15. [redacted]

Id. at Antonuk-Vickroy/10.

Q. DOES THE TPG TRANSACTION PROVIDE AN IMPROVEMENT TO PGE'S FINANCIAL CONDITION BY RESCUING THE UTILITY FROM ENRON'S BANKRUPTCY AND LIABILITIES?

A. No. In the Application, Oregon Electric and TPG represent that a benefit of the proposed transaction to PGE and its customers is that the utility is removed from the Enron bankruptcy and its potential liabilities. In fact, the financial standing and credit ratings of PGE would not be improved, but would worsen, due to the added leverage that the acquisition would produce. As we have previously noted, the high levels of leverage proposed to finance the purchase of PGE from Enron will cause increased financial risk to PGE. [redacted] Exhibit A to Applicants' Response to Request OEUC 3 at OE 100037, OE 100044 (Apr. 2, 2004); Confidential Exhibit ICNU/111, Schoenbeck/19, 26. [redacted] Id. [redacted]

The increased financial risk due to the double leverage overrides the benefits of PGE's removal from Enron. S&P's indicative conclusion that the overall effect of the TPG transaction calls for a decrease in PGE's credit rating clearly supports this view. Rather than improving PGE's current financial standing, the TPG transaction as proposed would cause harm and deterioration in PGE's financial standing as compared to ownership by Enron.

Q. WHY ARE THE CREDIT RATINGS AN IMPORTANT INDICATOR OF THE RISK TO AND FINANCIAL IMPACT ON PGE CUSTOMERS?

A. Credit ratings are a critical measure of the financial risk of an entity that issues debt securities, such as PGE and other utilities. The primary audience for credit ratings includes creditors and investors in a utility's debt securities. The credit risk of a utility can become the problem of utility customers and of utility regulators if financial difficulty is experienced. Utility rates have been raised as a last resort to improve the financial status of a failing utility. The cost of raising capital for future utility investments will also increase for companies with declining financial health. Most importantly, utility financial stress can cause a loss of access to the capital markets and can induce vendors, such as wholesale power producers and marketers, to demand prepayments or onerous credit or collateral terms. The loss of credit and ready access to capital markets are inappropriate in the utility industry, where the service quality provided is critical to customers.

Q. WHAT DOES THE TERM "DOUBLE LEVERAGE" MEAN IN A REGULATED UTILITY CONTEXT?

A. The term "double leverage" in the utility industry describes the use of debt financing by a parent or holding company to finance the acquisition or continued ownership of a utility's equity capital. Investor-owned utility companies have traditionally been self-contained entities providing monopoly utility services in a franchised territory, with rates regulated by state public service commissions. The capital-intensive nature of the business and the relatively stable customer base and cash flow have allowed utility financing to include significant levels of debt capital. The prudent use of debt reduces a utility's cost of capital, and allows lower costs than would be possible without the use of leverage.

Over the last several decades, the optimal capitalization of a utility company has generally been accepted to be in a range of 40 to 55% equity, with the remainder in debt capital. Utilities are not homogenous; therefore, the optimal percentage can vary. PGE currently has about 52% equity capital.

Utility holding companies have been formed to hold the operations of several utilities and to house non-utility affiliates. For the most part, utility holding companies have owned all of the equity capital of their subsidiaries, with minimal debt at the holding company level.

Double leverage occurs when the holding company uses substantial amounts of debt at the holding company level to finance the ownership of a utility subsidiary's equity capital. The utility subsidiary is already leveraged; in the case of PGE, the utility carries 48% leverage currently. The acquisition of PGE's 52% equity capital with 25% equity capital and 75% debt would create a second layer of debt capital at the holding company level. The result would be equity capital that has been "double leveraged," once at the utility level, and a second time at the holding company level.

Q. DISCUSS MORE SPECIFICALLY HOW THE TPG TRANSACTION USES DOUBLE LEVERAGE.

A. As we have noted, TPG would acquire PGE's equity capital with $525 million of TPG equity capital, $707 million of debt, and $240 million of PGE's cash. Only $525 million of equity capital would therefore remain in the Oregon Electric consolidated holding company. Consolidated equity capital would be leveraged once at the utility level with the utility's $1.0 billion in debt, and a second time at the holding company with $707 million of debt. The credit rating agencies incorporate these two levels of debt into their credit analysis by recognizing the consolidated capital structure and financial ratios in their analysis of PGE.

Q. DO THE HIGH LEVELS OF LEVERAGE PROPOSED CREATE ANY OTHER RISKS AS THIS TRANSACTION HAS BEEN STRUCTURED?

A. Yes. TPG's leveraged structure could also increase variable interest rate risk within the new Oregon Electric holding company. The proposed transaction calls for debt to finance a large portion of PGE's purchase price. [redacted] These commitments include detailed term sheets outlining the expected terms of the debt financings. Revised Exhibit C to Applicants' Response to Request OEUC 24 at OE 105317 (April 2, 2004). However, TPG has not yet secured commitments for debt financing on these or any other specific terms.

Without specific, committed financings in place, there must be concern about the risk of variable interest rate exposure associated with the LBO debt. If TPG chooses to finance the debt portion of PGE's purchase price with variable rate debt, an additional level of financial risk will be introduced at the holding company. The risk is that a rise in interest rates will increase the payments required to service and pay down holding-company debt. The principal source of debt payments will be utility dividends; therefore, a rise in interest rates under variable rate debt will put direct and increased upward pressure on the revenue stream needed from the utility. Existing ring fencing protections for PGE against the Enron parent are strong, but the utility cannot be completely insulated against variable rate interest risk at the parent company.

Accordingly, we believe that the failure to rule out variable rate instruments as a source of funding the debt portion of the purchase price is problematic. [redacted]. Confidential Exhibit ICNU/203, Antonuk-Vickroy/13.

TPG's proposed LBO structure would also increase variable rate interest risk within PGE. PGE has accumulated approximately $240 million in cash by not paying a dividend to Enron in recent years. The portion of utility cash resources deemed by the Applicants to exceed utility needs would be used to finance a portion of the purchase price. PGE's current revolving line of credit of $150 million would be replaced by a $250 million line of credit arranged as part of the TPG transaction. As a result, PGE would be replacing the existing cash resources with the new revolving line of credit to meet its future working capital needs. Revolving lines of credit generally call for variable interest rates based on a spread over an index rate. This change in working capital financing should not have an immediate impact on customer rates, but would expose PGE and its customers to greater financial risk as a result of increased exposure to rising interest rates. This change could lead to higher costs for PGE and potentially higher rates for its customers.

Q. HAS TPG COMMITTED TO USING FIXED-RATE DEBT OR SWAPPING VARIABLE RATE DEBT FOR FIXED-RATE DEBT TO MITIGATE VARIABLE-RATE EXPOSURE?

A. No. TPG may intend to fix the interest rates on its LBO debt by making swaps or issuing fixed-rate debt; however, no commitment to do so has been made. As a result, the potential for variable interest rate exposure for Oregon Electric and in turn PGE currently remains. Mitigating this risk is especially important in light of the general economic expectation that interest rates will rise in the future from their current, historically low levels.

[redacted]

Q. EARLIER YOU MENTIONED BANKRUPTCY/RECEIVERSHIP RISKS INVOLVING PARENT LENDERS. PLEASE DISCUSS THAT RISK IN MORE DETAIL.

A. A key goal of ring fencing is to keep utility resources out of the hands of creditors of the parent and affiliates should those entities become unable to pay their debts as they come due. If things work out as well as the Applicants project, parent insolvency would not likely become a problem, however, things do not always work as planned. We have only just finished working on a matter for the New Jersey Board of Public Utilities, where the lack of utility separation nearly brought a financially and operationally healthy utility to financial catastrophe. We are now working on issues in the NorthWestern bankruptcy, where the Montana Public Service Commission has to deal with how it can effectively regulate a utility that has been dragged into bankruptcy proceedings by poor non-utility performance.

The income stream from utility operations is the paramount source of Oregon Electric's debt repayment. Should that stream prove insufficient to meet the obligations of the parent, creditors will clearly look to increasing that stream or to getting at utility assets to secure repayment of their loans. Bankruptcy or receivership provide the principal means for gaining that access. Should access be gained, the benefits of ring fencing the utility will be undone. It is prudent to protect against this possibility in normal circumstances; it becomes even more important to do so in such a highly leveraged parent. The reason is that the parent in such a case has much less ability to withstand adverse conditions, because it has proportionately much less equity.

The kinds of protections that are necessary, but that have not been provided here, should be in the form of the following four specific representations or covenants, each of which should apply to existing and future indebtedness:

- That the utility is being operated as a corporate and legal entity separate from all affiliates;

- That lenders to the parent and affiliates in agreeing to make loans have relied solely on the creditworthiness of the parent and affiliates, based on the assets and equity interests owned by the parent and affiliates;
- That the repayment of parent and affiliate indebtedness will be made solely from the assets of the parent and affiliate, and not from any assets or pledge of assets of the utility; and
- That no lenders will take any steps to procure the appointment of a receiver or to institute any bankruptcy, reorganization, insolvency, wind up, liquidation, or like proceeding that includes the utility or any of its assets.

Without these representations and covenants, which are not present in the transaction as proposed, there remains an inappropriate level of risk that parent creditors will seek to break down the ring fencing imposed to protect the utility.

Q. WHAT KEY FINANCIAL ASPECTS DRIVE THE PROPOSED TRANSACTION, AND HOW DOES TPG EXPECT TO MAKE A RETURN FOR ITS INVESTORS?

A. A leveraged buyout such as that proposed by TPG generally relies on two fundamental components to provide an attractive return to private equity investors. The first component is a significant appreciation in value between the purchase price and the expected sale (or "exit") price at some point in the future. The second key component is the use of significant levels of debt leverage to finance the purchase. The use of leverage, especially at lower interest rate levels, results in sizeable increases in the returns to investors, when compared to returns without the use of leverage.

[redacted]

[redacted] Confidential Exhibit ICNU/204, Antonuk-Vickroy/2. [redacted]

The other fundamental driver of returns for TPG's investors arises from the use of high levels of debt to finance the purchase. We have previously discussed why TPG's LBO structure increases the financial risk to PGE and its customers. From the investor's point of view, the use of extensive leverage to finance the purchase substantially increases the expected return above what a utility typically can earn on equity. This increase in return for investors comes from two factors: the relatively low cost of debt capital in a low interest rate environment and the tax deductibility of interest expense. The leverage impact significantly increases the return on equity of the utility investment to the TPG investors.

Q. WHAT WILL BE THE IMPACT OF TPG'S PURCHASE AND PROFITABLE SALE OF PGE ON THE COMPANY AND ITS CUSTOMERS?

A. TPG has represented that no acquisition adjustment will be claimed by PGE for ratemaking purposes. As a result, TPG's purchase of PGE from Enron should not cause any near-term rate changes that result from purchase-price considerations. However, the exit sale of PGE does raise the issue of a future acquisition adjustment claim. TPG hopes eventually to sell PGE at a substantial premium to PGE's book value. A sale of PGE at a premium may require the future acquirer to seek an acquisition adjustment to provide an opportunity for acceptable returns on the amount invested; *i.e.*, an amount significantly in excess of rate base. Requests for recovery of such a premium are often offset by claimed operating savings.

The economic and regulatory impacts of any future sale will be considered at that point in time; they should not have a near-term impact. However, it is important to note the likelihood of a TPG exit plan to be executed in the relatively near future, and to observe further that increases in asset value do have the potential to make the next sale of this utility an occasion for addressing acquisition premium issues.

Q. ARE THERE OTHER IMPORTANT FACTORS THAT WILL INFLUENCE THE RATE OF RETURN FOR TPG AND ITS INVESTORS?

A. Yes. Key drivers of financial results for PGE will also affect the rate of return for TPG investors. The most important of these financial drivers are PGE load growth, utility operating expense levels and growth rates, annual utility capital expenditure levels, and the Port Westward electric generation project. TPG analyzed each of these key drivers extensively in its confidential internal correspondence.

[redacted]. Confidential Exhibit ICNU/203, Antonuk-Vickroy/2, 14.

Other critical variables for utility financial performance are operating expense levels and growth rates. [redacted]

[redacted]. Id. at Antonuk-Vickroy/6. As noted later in our testimony, we are concerned that reductions in base-level capital and operating expenditures may cause system reliability problems—problems that may not have apparent consequences for several years. In fact, TPG may well have sold PGE by the time any reductions in utility spending cause reliability problems.

[redacted]

Q. HOW HAS TPG PROPOSED TO MITIGATE THE RISKS ASSOCIATED WITH THE PROPOSED LBO STRUCTURE?

A. TPG's presentation of the transaction to S&P assumed that the OPUC regulatory ring fencing conditions currently in place for PGE will continue to apply. TPG has also negotiated with Enron certain indemnification provisions to protect against outstanding PGE legal matters that arose during Enron's ownership. This indemnification offers a constructive limitation on future utility liabilities. TPG has also proposed that Oregon Electric use all of PGE's dividends to the holding company to pay down principal on the debt after the payment of interest on the LBO debt. This proposal also is constructive, because it will reduce holding company leverage (with which we have significant concern) over time.

We observe, however, that, while indicating that the OPUC ring fencing will be applied to the TPG transaction and that the LBO debt will be paid down, TPG has not, to our knowledge, made specific commitments that will ensure these actions.

Q. DO YOU BELIEVE THAT THE PROPOSED TPG LBO STRUCTURE CAN BE MODIFIED SO THAT PGE AND ITS CUSTOMERS ARE NOT EXPOSED TO INCREASED RISKS DUE TO THE TRANSACTION?

A. We find it unlikely that there can be modifications that TPG would find acceptable. S&P has assumed that PGE's existing ring fencing would apply to the TPG transaction. Current OPUC ring fencing, combined with subsequent bankruptcy-proofing measures enacted by PGE, provide comparatively strong utility protections when compared with those in place elsewhere in the country. The TPG transaction also removes PGE from the Enron bankruptcy, and limits future liabilities from the Enron ownership period, which, when viewed alone, is a positive development for PGE.

All that considered, however, the proposed levels of holding company leverage would call for a reduction in PGE's credit rating. The risks of the high degree of leverage of this deal simply overwhelm other positive aspects of the change in ownership. While even more stringent utility protections could probably be structured, our preferred solution to protecting the utility from the risks of LBO leverage is to reduce the levels of post-transaction leverage. The proposed LBO would increase the consolidated leverage of the entities in question here by around 32 percentage points. Consolidated leverage would reach 77 or 78% of total capitalization. Consolidated financial coverage ratios would decline for the first few years after the transaction. Using significantly less leverage in the transaction would produce a positive effect on PGE's financial standing, not the negative one that can be expected under the current financial design.

The use of less leverage by TPG would provide mitigation of financial risk for PGE and its customers; however, it would also reduce the return on investment to the TPG investors. We do not know the investors' tolerance for reduced returns due to reductions in leverage, but we doubt their willingness to accept the lower returns that would result from decreasing leverage substantially. This in turn leads us to pessimism about the ability to agree on an appropriate level of debt in the consolidated, post-transaction financial structure.

Reliability Issues

Q. HOW COMMON ARE SERVICE QUALITY AND RELIABILITY COMMITMENTS BY UTILITIES IN CONNECTION WITH REORGANIZATIONS OR MERGERS?

A. They are often made. In a number of cases these conditions have been extensive and detailed. Commissions have recognized that one way for acquiring companies to increase cash flow from their utility subsidiaries after a merger is to cut utility O&M expenditures and capital investments. Commissions have used reliability and service quality commitments as a way to ensure that new owners do not allow service quality and network performance to degrade as a result of post-merger cost cutting to secure projected synergies or return levels.

In the Enron merger stipulation, for example, PGE agreed to implement a service quality performance program. Re Enron Corp., OPUC Docket No. UM 814, Order No. 97-196 at 7 (June 4, 1997). PGE became subject to penalties should it not meet certain performance targets. Id. In the Scottish Power acquisition of PacifiCorp, the applicants agreed to adopt certain network-performance standards and to extend existing service quality measurements. Re Scottish Power and PacifiCorp, OPUC Docket No. UM 918, Order No. 99-616 at 5-6, 14 (Oct. 6, 1999). The agreement provided for revenue-requirements reductions for poor performance. Id.

Q. DESCRIBE THE PRESSURES THAT UTILITIES FACE TO REDUCE O&M AND CAPITAL EXPENDITURES.

A. Most utilities feel such pressures. In the case of this proposed transaction, concerns are heightened by the financial structure that the new owners will be using to make the acquisition. Our work has uncovered a number of cases of reduced attention to public service infrastructure in the recent past. Utilities across the country have been experiencing strong pressures for controlling costs. These pressures spring partly from a general awareness of the need to promote efficiency in all sectors of the American economy. In the utility industry, the rate "freezes," "moratoria," and other similar arrangements that have resulted from restructuring have precluded rate cases as a means of recovering cost increases, thereby heightening interest in finding ways to cut costs. Moreover, long-term declines in rates of inflation, financing costs, and the like have provided extra opportunity for cost-conscious companies to increase profitability while staying out of rate cases. Finally, a wave of consolidation in the industry has, we believe, led some to increase their attractiveness to potential suitors by increasing profitability short term through reducing expenditures on infrastructure.

A thinned consolidated capital structure caused by taking on a layer of LBO debt, with the associated interest expense, compounded by a need to provide healthy returns to sophisticated private equity investors, can only increase the pressures. A desire to make added future investments in other businesses would tend to have the same effect.

Even experienced utility leadership can be deceived into thinking that cutting capital and operating expenditures is a low-risk way to improve cash flow and profitability. The reason is that the consequences of those cuts can be delayed. Such a delay can produce an illusion that what has been cut is not really necessary to preserving the reliability, safety, and efficiency of service. Short-term cuts then become long-term, institutionalized ones, and adverse effects eventually follow.

The problem is that measures of service quality are lagging indicators. That is, the degree to which a utility is able to meet or exceed standards or otherwise keep its service quality at sufficient levels is a function of past expenditures. The effects of near-term cuts in O&M and capital may not manifest themselves for a number of years.

Q. WHAT COMMITMENTS HAVE THE INVESTORS MADE ABOUT MAINTAINING THE QUALITY OF THE SERVICE THAT THE UTILITY WILL PROVIDE?

A. As with financial conditions, the Applicants have agreed to adopt the service quality conditions of the Enron transaction. In that case, PGE agreed that it would implement service quality performance measures, as outlined in Commission Staff's Proposed Stipulations for Service Quality Measures, to ensure that then-current levels of service quality would be maintained or improved with revenue requirements reductions for non-attainment.

The Applicants also pledged to maintain and enhance PGE's record of system operations and investment. They stated that PGE has consistently exceeded the T&D safety and service quality benchmarks set by the Commission as part of the Enron merger approval in 1997. The Company also indicated that its record in service restoration, service quality, and generating plant performance is very good, and that it has continued to invest in its system, upgrading both generation plants and the T&D network.

Q. DO YOU BELIEVE THAT THE INVESTORS HAVE MADE SUFFICIENT COMMITMENTS ABOUT MAINTAINING THE UTILTY'S QUALITY OF SERVICE AFTER THE ACQUISITION?

A. No. We believe that the Applicants' pledge about service quality and the utility's recent performance are encouraging; however, there should be more in the way of commitments. We agree that the service reliability conditions the Commission applied in the Enron merger should be continued for Oregon Electric. These conditions are useful in providing a penalty if PGE's performance slips in certain areas.

Q. WHAT THEN ARE YOUR CONCERNS?

A. We have already discussed the pressure to generate maximum cash flows in order to reduce the extraordinary leverage created by buyouts of the type at issue here. Our concern is that Oregon Electric will implement considerable reductions in O&M and capital expenditures after completing the transaction. Such reductions may have a significant impact on service quality and reliability that may not be immediately discernable in existing service quality performance measures.

In the base case economic model runs that TPG prepared while considering their investment, they assumed [redacted]

PGE is also facing an important capital decision in the near future regarding additional sources of generation. If the holding company should place pressure on PGE to provide maximum dividends to pay down Oregon Electric debt, decisions about which investments PGE needs to make may not be made independently of concerns about Oregon Electric's finances.

The relatively short investment horizon to be expected here is also of concern. The Applicants have made general statements about maintaining the quality of service, implying that they will make necessary investments to ensure that quality. Given the fact that short-changing the network often does not produce customer-discernible impacts until years later, we believe the

Commission should specifically address the concern that the Applicants could forgo capital investments and maintenance expenses in order to maximize cash flow from the utility over the short term. If TPG only holds this investment for five years, for example, then the impacts of cost cuts may not be seen until after the utility is sold.

Q. HOW CAN COMMISSIONS MINIMIZE THE RISKS OF REDUCTIONS IN SERVICE QUALITY AND NEGATIVE EFFECTS ON RATES FROM CAPITAL DECISIONS?

A. There are a few options. The first is to establish, as some commissions have done in similar circumstances, quantitative measures of service quality against which the utility's performance would be judged. The second is to bind the utility to maintaining capital and O&M expenditures at minimum levels. The third is to expose utility management and operations to outside review conducted on behalf of the Commission.

Q. DISCUSS THESE APPROACHES.

A. Many utilities now have service quality measures by which they and their regulators and customers judge their performance. These quantitative measures are typically those that customers can directly perceive, including how quickly telephone calls are answered, the length and frequency of interruptions of (electric and telephone) service, and a utility's speed in installing new service. Some utilities pay customers when their performance falls below a standard.

Commitments to specified levels of expenditures are less common. Their advantage over the first approach is that they deal with the most likely cause of inadequate performance, while the first approach deals only with effects. The focus on inputs as opposed to outputs can allow the root causes of problems to be observed and addressed before customers discern their effects. One of the options that could be used in a case like this is to require utilities to maintain capital and O&M expenditures at some rate, *e.g.*, at inflation-adjusted levels corresponding to those of a defined historical period, or at currently forecasted levels.

The third approach is actually a variation on the second, insofar as it addresses inputs rather than outputs. It recognizes that pre-set minimum expenditure requirements may not be flexible enough to address emerging circumstances and needs. Even the best forecasters in the utility business are far from perfect. One must always expect plans to require adjustment, even if there are no major unforeseen events. When circumstances diverge from expectations, such adjustments may need to be extreme. In those events, judging performance against pre-set limits can give impetus to conduct that ultimately disserves customer interests. Simply maintaining the current level of expenditures actually may effectively mean reducing them, for example.

Q. WHAT DO YOU RECOMMEND THE COMMISSION CHOOSE AS A CONDITION OF ITS APPROVAL OF THIS TRANSACTION?

A. We recommend an outside examination, in addition to the service quality performance measures already in place. The issue here is assuring that a new ownership group that is strongly motivated to increase the cash produced by its utility continues to make the capital and O&M expenditures that are needed to provide safe, efficient, and reliable service, both during and after its expected period of ownership. Should the transaction close and should the new owners in fact decide to reduce expenditures, the effects may not be observable for some time. Further, in this scenario, if reductions are made and service suffers, it will take some time to recover from the lack of spending. This would create a situation requiring customers and the Commission to invest extra time, effort, and expenditures to overcome problems after they become evident. It may also require customers to suffer lingering service quality problems for an extended "recovery" period.

Q. WHY DO YOU NOT RECOMMEND THE SECOND OPTION, DEALING WITH EXPENDITURE LEVELS?

A. This option would require the utility to commit to quantified levels of capital and O&M expenditures that give some assurance that there will not be degradation in the reliability, safety, and efficiency of service and operations. This approach would require some analysis of what the utility has been spending and projections of what it will need to spend in the future. The latter aspect is the one that introduces the complexity to setting the parameters of such an approach. For instance, if a utility has just finished a major capital project or several projects, then future capital expenditures could be lower, and the recently-invested capital might produce O&M savings. In that scenario, a utility might legitimately have lower expenditures, but still violate a commitment.

Q. DO YOU BELIEVE THAT EVERY REDUCTION IN O&M SPENDING SIGNALS AN INCREASED RISK OF SERVICE QUALITY DEGRADATION?

A. Not necessarily. We are simply not in the position at this time to discern what the appropriate level of O&M cost and capital spending consistent with reliable service should be, which is why the audit is important. There may be opportunities for removing operating inefficiencies in a manner that will have no impact on service reliability or quality. We believe this is another reason why an audit is desirable. If the new owners can effectuate significant cost savings of this type, quantifying them and sharing them with customers become an important regulatory focus.

Q. PLEASE DESCRIBE MORE SPECIFICALLY THE DIMENSIONS OF SUCH AN AUDIT.

A. We would envision a utility-funded, commission-sponsored management and operations audit commencing up to 24 months after an ownership transition, to be conducted by Staff and a firm selected by the Commission, with utility funding in an amount not less than $400,000. Generally in such audits, the Commission Staff prepares a scope of work, and identifies the firms capable of performing the work with the required levels of expertise, experience, and independence. Many commissions across the country have already established useful scope documents and lists of firms that meet such criteria. The Commission then generally issues a request for proposals ("RFP") to a list of firms that Staff approves. What follows in most states thereafter is a three-party contract involving the selected consultant, the Company, and the Commission, or a two-party, Commission-drafted and approved contract between the selected consultant and the Company. Either contract type generally provides that a Commission Staff designee is responsible for managing and controlling the work of the consultant, and provides that the utility is responsible for cooperation in making people, work sites, and documents available and for paying for the audit in accordance with the agreed-upon terms.

Such audits generally work toward a fixed deadline and specify defined deliverables. The work scope is usually addressed in terms of specific areas of focus, which here should include governance, affiliate transactions and costs, and a number of areas as they relate to utility cost of service, including, without limitation, areas such as:

- Strategic and operational planning
- Budgeting
- Capital expenditures
- O&M expenditures
- Measures of work planned and performed
- Maintenance planning, performance, and backlogs
- Performance measurement
- Comparative and trended expenditures and work performance

Income Tax Benefits to Oregon Electric

Q. HOW WILL INCOME TAX CONSOLIDATION BENEFIT THE OWNERS, SHOULD THIS TRANSACTION BE APPROVED?

A. We understand that the policy in Oregon is to compute income taxes for ratemaking purposes on a stand-alone basis. In other words, revenue requirements assume the amount that the utility would have paid in income taxes absent consolidation with any affiliates. The holding company here would not engage in any other businesses, but would issue substantial debt amounts.

Consolidation for income tax purposes would allow the utility's positive income to be offset by deductions for interest payments at the parent level, thus producing lower consolidated taxable income for the family of entities, which would file one federal tax return. The net impact is that the utility would be presumed for ratemaking purposes to be paying taxes as if the holding company were not there.

The utility would then make payments to the parent of the amount it would have paid to the IRS on a "stand-alone" basis. The parent would make payments to the IRS on a consolidated basis, which means it would receive more from the utility than it must in turn pay to the IRS. Therefore, the combination of income tax consolidation and stand-alone utility tax calculations for ratemaking purposes would serve to increase returns at the holding company level due to the deductibility of interest expense on the holding company tax returns. Based on TPG's confidential financial projections, we estimate this tax shield benefit to be about [redacted] per year for 2005 through 2008.

Q. IS THE OREGON METHOD FOR COMPUTING INCOME TAXES FOR RATEMAKING PURPOSES ATYPICAL?

A. No.

Q. ARE THERE FACTORS HERE THAT MAY LEAD THIS COMMISSION TO EXAMINE THE MERITS OF APPLYING ITS TYPICAL RULE ABOUT TAX CONSOLIDATION?

A. Yes. In particular, as this testimony emphasizes, the acquisition proposed here will substantially increase debt leverage. That increase will expose customers to increased risk. As that increased leverage represents a material detriment to customers, it produces an opportunity for significantly increased economic benefit to the new owners. We believe that the Commission should require significant mitigation of the risks of this leverage to customers. Such increased leverage is not generally typical of utility acquisitions. Allowing revenue requirements to be calculated on the basis of stand-alone liability has therefore not generally been done in circumstances of this type.

Should significantly increased debt leverage remain a feature of this acquisition despite our recommendations to reduce it, we believe that it would then be appropriate to consider requiring compensating benefits to customers. The failure to make some accommodation for increased leverage would allow the new owners significantly greater returns by exposing customers to increased financial risk.

Q. PLEASE SUMMARIZE YOUR POSITION ON THE TRANSACTION.

A. We believe that the transaction as proposed imposes substantial risks due to increased leverage, the lack of protection against involving the utility in a parent/affiliate bankruptcy, and the lack of adequate means for assuring that service reliability and quality remain at acceptable levels. We believe that the Applicants have failed to offer necessary and appropriate means for addressing these concerns. These issues have caused problems for other states, principally because future realities often make current, optimistic projections of the future inapplicable. It is important now, while there is an ability to craft adequate protections against risks, to do precisely that. Apart from its failure to offer adequate protections against material risks, the transaction offers no apparent benefits beyond repeating baseline expectations that regulators can and should require apart from any change in ownership. Therefore, we believe that this transaction should not be approved as proposed by the Applicants.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

APPENDIX A: PRIOR REGULATORY PROCEEDINGS IN WHICH MR. ANTONUK AND MR. VICKROY PARTICIPATED

1. The Arizona Commerce Commission (ACC) regarding the proposed acquisition of UniSource by a group of private investors. On behalf of Staff, John Antonuk provided testimony that summarized the treatment of similar transactions by other utility regulatory commissions, addressed standards for review, and discussed the shortcomings and risks in the original application. Liberty's testimony proposed conditions on the transaction in the areas of (a) utility financial segregation and protection, (b) service quality and reliability assurance, (c) affiliate transactions and costs, (d) governance, (e) regulatory oversight and access to records, (f) community presence, and (g) non-recoverability of merger-related costs (DOCKET NO. E-04230A-03-0933). [Antonuk/Vickroy]
2. The New Jersey Board of Public Utilities (BPU) as part of its investigation of NUI's finances, governance, affiliate transactions, controls, and compliance with the conditions established by the BPU in allowing the formation of a holding company. Mr. Antonuk's role there was to manage a focused audit to address the matters listed above and to advise the BPU on interim actions necessary to assure that significant financial difficulties at the holding company did not cause a failure of Elizabethtown Gas to continue to deliver safe, reliable, and adequate service to its many retail customers in Northern New Jersey. Mr. Vickroy led the review of financial issues. [Antonuk/Vickroy]

3. The New Hampshire Public Utilities Commission regarding the agreement that settled the restructuring of Public Service Company of New Hampshire (DR 99-099). [Antonuk/Vickroy]
4. The New Hampshire Public Utilities Commission regarding the merger of NU and CEI (DE 00-009). [Antonuk]
5. The Pennsylvania Public Utility Commission regarding test-year expense adjustments for various findings, conclusions, and recommendations from Liberty's management and operations audit of West Penn Power Company. [Antonuk]
6. The Tennessee Public Service Commission regarding the rate-case implications of various findings, conclusions, and recommendations from Liberty's management and operations audit of United Cities Gas Company. [Antonuk/Vickroy]
7. The Maryland Public Service Commission regarding the rate-case implications of Liberty's audit of the affiliate relationships and transactions of C&P Telephone Company of Maryland (now Verizon Maryland). [Antonuk]
8. The Maryland Public Service Commission regarding the rules of conduct that should apply to relationships between Baltimore Gas & Electric Company and its affiliates in the energy business. [Antonuk]
9. The Virginia State Corporation Commission regarding a variety of matters at issue in arbitrations between major competitive local exchange service providers (including AT&T, MCI, and Sprint) and Bell Atlantic. [Antonuk]
10. The Illinois Commerce Commission on the fuel-procurement practices and decisions of Central Illinois Public Service Company. [Antonuk]

11. The Massachusetts Department of Telecommunications and Energy regarding competitive, market, and affiliate-relationship issues concerning Boston Edison's entry into non-traditional businesses, including energy marketing and services and telecommunications, as a consultant to Boston Edison. [Antonuk]
12. The Public Utilities Commission of Ohio, regarding the findings and conclusions reached by Liberty in its audit of Ameritech retail service performance quality and performance quality measurement. [Antonuk]
13. Wyoming Public Service Commission regarding the gas procurement and transportation practices of K N Energy. [Antonuk]
14. The Colorado, Wyoming, and Utah public service commissions regarding the status of a performance measures audit and performance data reconciliation related to Qwest 271 OSS testing. [Antonuk]
15. Maryland Public Service Commission, regarding the Code of Conduct adopted as part of the BG&E/PEPCO merger. [Antonuk]
16. The Virginia Corporation Commission concerning separate arbitrations involving five CLECS and Bell Atlantic and GTE. [Antonuk]
17. Service as an arbitrator, facilitator, or administrative law judge on a contract basis in the following state commission proceedings under the Telecommunications Act of 1996:
    - AT&T/USWest interconnection agreement arbitration agreement: Idaho Public Utilities Commission
    - AT&T/GTE interconnection agreement arbitration agreement: Idaho Public Utilities Commission

- Interconnection agreement arbitrations involving two small CLECs and Qwest: Idaho Public Utilities Commission
- AT&T/Bell South interconnection agreement arbitration: Mississippi Public Service Commission
- Qwest Section 271 Checklist Compliance, Separate Affiliate, Public Interest, and Existence of Local Competition Issues: Idaho, Iowa, Montana, New Mexico, North Dakota, Utah, and Wyoming public service commissions
- Sufficiency of Qwest Performance Assurance Plan related to Section 271 entry: Idaho, Iowa, Montana, New Mexico, Nebraska, North Dakota, Washington, and Wyoming public service commissions
- Small CLEC issues forum in connection with state review of Qwest 271 petition: Montana Public Service Commission
- Billing complaints by three paging companies against Qwest: Idaho Public Utilities Commission.

[Antonuk]

18. Service as an advisor to commissioners, administrative law judges, and arbitrators in a number of other state proceedings related to the Telecommunications Act of 1996:

- Global settlement of interconnection, universal service funding, and related issues involving all ILECs and CLECs: Pennsylvania Public Utility Commission
- Three separate ILEC interconnection agreement arbitrations with Bell Atlantic: New Jersey Board of Public Utilities

- Bell Atlantic SGAT and UNE price and access proceedings: Virginia Corporation Commission
- Nine separate arbitrations over seven years, involving Bell Atlantic: Delaware Public Service Commission
- Bell Atlantic Collocation proceedings: Delaware Public Service Commission
- Verizon 271 entry: Delaware Public Service Commission
- Verizon 271 entry: District of Columbia Public Service Commission.

[Antonuk]

APPENDIX B: LIBERTY WORK DESCRIPTIONS

1. UniSource

For the Staff of the Arizona Commerce Commission (ACC), Mr. Antonuk testified regarding the shortcomings and potential risks in the proposed acquisition UniSource by a private investor group. That testimony discussed conditions that other commissions have applied in similar transactions, the ways in which the application failed to meet the public interest standard and other requirements, and proposed conditions on the transaction in the areas of (a) utility financial segregation and protection, (b) service quality and reliability assurance, (c) affiliate transactions and costs, (d) governance, (e) regulatory oversight and access to records, (f) community presence, and (g) non-recoverability of merger-related costs. [Mr. Vickroy participated in this project.]

2. NUI

For the New Jersey Board of Public Utilities (BPU), Mr. Antonuk managed a focused audit of NUI Corporation and its operating utility companies. This audit included detailed examinations of the:

- Company’s compliance with the conditions of the BPU order that allowed formation of a holding company
- Sufficiency of those conditions to protect the public interest in light of the conduct and activities of the holding company, its non-utility affiliates, and its utility operations
- Reasons why utility credit ratings fell to substantially below investment grade
- Impact of weakened financial condition on capital costs

- Need and means for insulating utility credit and financial strength from that of the parent and the non-utility affiliates
- Kinds of ring fencing of utility finances warranted in light of the parent's financial condition
- Use of common cash pools by utility and non-utility operations
- Direct and indirect use of utility financial strength to support non-utility capital acquisition
- Financial, accounting, payroll, receivables, and payables controls
- Affiliate transactions
- Corporate structure, governance, and compensation at the executive and director levels
- Arms'-length nature of energy trading operations involving utility operations and the non-utility energy brokering operation of an affiliate.

[Mr. Vickroy participated in this project.]

3. Consolidated Edison/Northeast Utilities merger.

For the Governor of the State of New Hampshire, Mr. Antonuk testified about the public interest and potential harm issues arising from the proposed merger of Northeast Utilities and Consolidated Edison. That testimony addressed the kinds of risks that the merger created and it addressed the conditions appropriate to mitigation of those risks sufficiently to support a finding that the proposed merger was in the public interest.

4. Competitive Services of New Jersey Electric Utilities

Mr. Antonuk managed Liberty's audits of the competitive services of the four major New Jersey electric utilities (including one of the country's largest retail electricity suppliers, PSE&G, which also serves as a local distribution gas utility). This audit addressed code-of-conduct issues, use of customer information by affiliates, affiliate transactions, cost allocations and assignment, commingling of financial resources and credit, and a number of other issues associated with utility operations within a holding company structure. Three New Jersey retail electric utilities operate as part of multi-state holding company operations, which include:

- Consolidated Edison, which serves over 3.3 million electric customers and more than 1.2 million gas customers in New York, Pennsylvania, and New Jersey
- First Energy, which serves 4.4 million electric customers through seven operating companies in Ohio, Pennsylvania, and New Jersey
- Pepco Holdings, which distributes electricity and natural gas to some 1.8 million customers in the Mid-Atlantic region, from New Jersey to Virginia.

[Mr. Vickroy participated in this project.]

5. Commonwealth Edison Service Quality and Reliability

Mr. Antonuk led an extensive review for the Illinois Commerce Commission of the costs of a massive capital and O&M “catch-up” spending program adopted by Commonwealth Edison to respond to a major series of service disruptions in the City of Chicago. This review included:

- Detailed analyses of capital and operating expenditure trends within the company and in comparison to those of its peers
- Extensive reviews of service quality drivers, such as numbers of open maintenance items and productivity over an extended period

- Impacts of externally caused financial constraints on transmission, distribution, and customer service programs and expenditures
- Capital project and maintenance program design, planning, and execution.

[Mr. Vickroy participated in this project.]

6. Public Service Electric & Gas.

About a decade ago Liberty performed one of the country's first detailed examinations of holding-company operations for a state utility regulatory commission. This focused audit of PSE&G for the New Jersey Board of Public Utilities:

- Addressed performance of utility and non-utility affiliates after holding company formation
- Examined the effects of poor non-utility affiliate performance on utility finances and financial health
- Included a detailed review of affiliate transactions, which included competitive energy supply businesses, costs, allocations, provision of central services, executive management and governance.

[Mr. Vickroy participated in this project.]

7. Dominion Resources and Virginia Power.

Mr. Antonuk managed Liberty's examination, for the Virginia State Corporation Commission of the circumstances underlying the open and notorious dispute between the board and executive management of the Commonwealth's largest electricity supplier, Virginia Power, and its counterparts at Dominion Resources, which owned the utility. This examination included executive and board structure and operations, the degree to which utility independence of operation (vis-à-vis the holding company) was necessary to promote the public interest, affiliate transactions, and financial, capital, and operational planning, budgeting, and execution. [Mr. Vickroy also participated in this project.]

8. Management and Operations Audits and Affiliate Examinations

Mr. Antonuk has managed many Liberty management and operations audits for the commissions of Pennsylvania, New York, Connecticut, Tennessee, Kentucky, and New Hampshire. These major engagements have examined a number of multi-state holding company or utility operations, Verizon, GTE, Northeast Utilities, and United Cities Gas, a multi-state gas distribution utility later acquired by Atmos. These audits have also included a number of then stand-alone utilities, examples of which include New York State Electric & Gas, Central Hudson Gas & Electric, Yankee Gas, Southern Connecticut Gas, and Connecticut Natural Gas. These engagements typically have included reviews of governance, executive management, planning and budgeting, operations, finance, and affiliate costs, which are among the issues I address in this testimony. [Mr. Vickroy also participated in these projects.]

9. NorthWestern Corporation

Mr. Vickroy reviewed the reliability of NorthWestern's Montana transmission and distribution system, historical and projected capital and operating and maintenance expenditures, and benchmarking and cost information.

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

From: <SandPUtil@StandardAndPoors.Com>
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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

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 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

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

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Moody's Investors Service

Global Credit Research

Credit Opinion

31 MAR 2004

Credit Opinion: Portland General Electric Company

Portland General Electric Company

Portland, Oregon, United States

Ratings

Category	Moody's Rating
Outlook	Developing
Issuer Rating	Baa3
First Mortgage Bonds	Baa2
Senior Secured	Baa2
Senior Unsecured	Baa3
Jr Subordinate	Ba1
Preferred Stock	Ba2
Commercial Paper	P-3

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Key Indicators

Portland General Electric Company

	LTM Q3 03	2002	2001	2000
Adjusted Funds from Operations / Adjusted Debt [1][2]	22%	20%	18%	32%
Adjusted Retained Cash Flow / Adjusted Debt [2][3]	22%	20%	15%	24%
Common Dividends / Net Income Available for Common	0%	0%	125%	58%
Adjusted Funds from Operations + Adjusted Interest / Adjusted Interest [1][4]	3.9	3.8	3.8	5.0
Adjusted Debt / Adjusted Capitalization [2][5]	49%	50%	53%	49%
Net Income Available for Common / Common Equity	3%	6%	3%	13%

[1] Adjusted FFO adjusted for preferred dividends [2] Adj. debt includes adjustments for certain preferred securities and operating leases [3] Adjusted RCF includes Adjusted FFO less common dividends [4] Adjusted interest includes all payments for preferred securities and an adjustment for operating leases [5] Adjusted capitalization includes adjusted debt, equity, preferred stock, and minority interest, but excludes deferred taxes

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Credit Strengths

Credit strengths for Portland General Electric (PGE) are:

PGE 200898

- Fundamentally sound operations

- Solid common equity and fixed charge coverage ratios

- Careful attention to liquidity

- Reasonably good support of Oregon regulators

- Remaining insulated from Enron's bankruptcy

Credit Challenges

Credit challenges of PGE are:

- Lingering uncertainty about future ownership of PGE

- Combating financial effects of below normal hydro conditions, unfavorable weather and a slow economy in the region

- Gaining regulatory support for integrated resource plan to reduce dependence on more volatile spot energy market

Rating Rationale

PGE's Baa2 senior secured rating reflects lingering uncertainty about the future ownership of PGE, as a private equity firm, Texas Pacific Group (TPG), pursues regulatory approvals to acquire PGE from Enron. The rating also reflects that PGE has avoided becoming part of Enron's bankruptcy, helped in part by a bankruptcy remote structure created by PGE. Also, the regulatory and contractual protections that restrict Enron's access to PGE's assets are valid insulation for PGE's creditors.

Despite disappointing financial results in 2003, PGE remains fundamentally sound. We expect PGE to sustain solid common equity (minimum 48%) and fixed charge coverage ratios (above 4x), while carefully attending to liquidity. The latter benefited from long-term financings in 2002 and 2003. Proceeds were used to repay short-term debt, refinance maturing obligations, and redeem higher coupon debt early, thereby reducing future interest costs. PGE has very modest current maturities of long-term debt over the next several years, has recently been maintaining cash balances in excess of $100MM, and we do not expect near-term drawdowns under the company's secured $150MM 364-day bank credit facility to meet liquidity requirements. The facility expires in May 2004 and we expect PGE to renew the facility in advance of its expiration date.

The Oregon regulatory mandate that PGE keep at least a 48% common equity ratio is intact, as is dividend notification requirements to the regulators. The slow pace of deregulation per Oregon law has been neutral to PGE's credit and regulators continue to support recovery of PGE's remaining deferred energy costs incurred while power cost adjustment mechanisms were in place during 2001 and 2002.

Rating Outlook

PGE's developing rating outlook reflects efforts by Oregon Electric Utility Company, LLC, a newly-formed entity with financial backing from TPG, 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 the possibility that the currently contemplated level of debt and legal structure for the transaction could materially change during the state regulatory approval process. 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.

What Could Change the Rating - UP

Separation from Enron's ownership under a structure that avoids undue demands on PGE's cash flow and satisfactorily resolves various contingencies.

What Could Change the Rating - DOWN

A change in ownership structure through a highly leveraged transaction that compromises currently solid common equity and coverage ratios by creating excessive demands on PGE's cash flow. Any unexpected shift toward less regulatory support than historically demonstrated by Oregon regulators.

Recent Developments

In March, Oregon Electric filed an application with the Oregon Public Utility Commission (OPUC) requesting approval to acquire 100% of PGE from Enron in a $2.35 billion transaction, including assumption of PGE's debt. The final transaction value is subject to determination based on PGE's performance between 1/1/03 and closing. Obtaining OPUC and other federal regulatory approvals could still take up to a year, if not longer. A distribution of PGE's stock owned by Enron to creditors over time would still be possible if requisite approvals are not obtained. Meanwhile, PGE is working with the OPUC to identify a long-term solution to hydroelectric volatility. As part of these efforts, PGE is seeking OPUC acknowledgement of its integrated resource plans, which includes adding gas-fired generating capacity to utility rate base. Success with regard to these efforts would be considered a favorable credit development.

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