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3 **BEFORE THE PUBLIC UTILITY COMMISSION**
4 **OF OREGON**
5 **UM 1121**
6
7 In the Matter of
8 OREGON ELECTRIC UTILITY COMPANY, LLC, et al.,
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10 Application for Authorization to Acquire Portland General Electric Company
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14 **SUR-SURREBUTTAL TESTIMONY**
15 **OF**
16 **KELVIN L. DAVIS**
17 **ON BEHALF OF OREGON ELECTRIC**
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21 **October 11, 2004**
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1 ## I. INTRODUCTION

2 **Q. Please state your name.**

3 A. My name is Kelvin L. Davis. I previously offered direct, supplemental direct, and
4 rebuttal testimony in this proceeding.

5 **Q. What is the purpose of your testimony?**

6 A. The purpose of my testimony is to respond to the surrebuttal testimony filed by the Staff
7 ("Staff") of the Public Utility Commission of Oregon ("Commission") and various
8 intervenors on September 22, 2004.

9 **Q. Please provide an overview of your sur-surrebuttal testimony.**

10 A. My sur-surrebuttal testimony, along with the sur-surrebuttal testimony of others offered
11 in support of Oregon Electric,[1] presents a comprehensive proposal[2] for the future of
12 Portland General Electric Company ("PGE"). Oregon Electric's proposal includes
13 revised conditions that provide additional concrete benefits to PGE and its customers.
14 Specifically, we are proposing that:

15 - PGE's customers will receive a guaranteed rate credit in the amount of $43
16 million; and
17 - PGE will receive the benefit of contractual indemnifications from Enron
18 against potentially significant liabilities in an amount up to $94 million.

19 These quantitative benefits will provide real economic value to PGE and its
20 customers.

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24 [1] Throughout this testimony, I will use "Oregon Electric" to refer to Oregon Electric Utility Company, LLC, or to all Applicants, as the context may imply.

25 [2] Attached as Oregon Electric/501, Davis/1-9 is a complete list of conditions to which Oregon Electric is prepared to agree. These conditions are interrelated and intended to be considered as a package.

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1 In addition, Oregon Electric agrees to enhance several previously offered
2 protective conditions. These conditions include:

3 • Enhanced ring-fencing and other conditions designed to protect PGE's
4 financial health; and
5 • Conditions that grant the Commission additional regulatory tools to oversee
6 PGE and to audit its activities.

7 In our view, these conditions, which improve upon measures that already have been
8 lauded as the best in the nation, are more than adequate to address all reasonable potential
9 harms of our leveraged financial structure and ownership arrangements and will
10 effectively protect PGE and its customers.

11 Finally, it is worth noting that these benefits will not exist in the absence of the
12 Proposed Transaction. Thus, Oregon Electric is confident that its proposal presents
13 PGE's customers with a net benefit and serves the public interest.

14 **Q. Do you address any additional issues in your sur-surrebuttal testimony?**

15 A. Yes. I respond to various concerns expressed by Staff and some of the intervenors
16 regarding the potential for imprudent management of PGE and rebut claims presented by
17 Citizens' Utility Board ("CUB") regarding certain employee reductions at other
18 companies in which Texas Pacific Group ("TPG") has invested. I also address
19 transparency, exit considerations, service quality measures, affiliated interests, and the
20 Master Services Agreement.

21 **Q. Are others filing rebuttal testimony in support of Oregon Electric?**

22 A. Yes. My testimony is submitted in conjunction with that of the following witnesses, all
23 of whom are providing testimony in support of Oregon Electric's Application:

24 • Carrie Wheeler, TPG Principal, who will discuss ring-fencing generally,
25 explain why some of the financial conditions proposed by Staff are not

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1 necessary to protect PGE, and why Oregon Electric's proposed alternative
2 conditions should meet the Commission's objectives;

- 3 Dr. Karl McDermott, economist and former member of the Illinois Commerce
4 Commission, who will address the adequacy of the regulatory structure, in
5 conjunction with our proposed conditions of approval, to protect customers
6 and mitigate the risks of the Proposed Transaction;
- 7 Daniel Bussel, professor of law and bankruptcy expert, who will testify that
8 there is no material risk of the substantive consolidation of Oregon Electric
9 and PGE in the highly remote event that Oregon Electric were to declare
10 bankruptcy;
- 11 Richard Schifter, TPG Principal, who will update the parties regarding
12 proceedings at the SEC;
- 13 Jim Piro, Chief Financial Officer of PGE, who will explain that certain
14 financial conditions proposed by Staff are unnecessary to protect customers,
15 and will respond to various concerns raised by the parties regarding the effect
16 of the Proposed Transaction on PGE's financial health; and
- 17 Robert Bingham of Enron, who will clarify that the indemnification
18 provisions of the Stock Purchase Agreement are unique to the Proposed
19 Transaction and, with the possible exception of the indemnities for the control
20 group liabilities, are unlikely to be offered in the absence of this transaction.[3]

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25 [3] Enron/3, Bingham/1-2.

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II. OREGON ELECTRIC'S INVESTMENT IN PGE'S FUTURE

Q. Staff and intervenors have expressed ongoing concerns regarding possible cuts in O&M and capital expenditures at PGE.[4] Can you summarize the parties' positions?

A. Yes. As a preliminary matter, I am pleased to see that Staff seems satisfied that Oregon Electric is not planning to implement cost-cutting measures without first conducting a thorough review of PGE's operations after closing.[5] I am also pleased that Oregon Electric's commitment to the integrated resources planning process in general, and Port Westward in particular, has ameliorated Staff's concerns regarding Oregon Electric's "commitment to investing in PGE's utility infrastructure and future growth."[6]

That said, I understand that Staff is still somewhat concerned that Oregon Electric has not yet identified potential efficiency enhancements at PGE.[7] Although Staff is apparently satisfied that Oregon Electric is not planning to implement cost savings based upon TPG's consultants' due diligence reports,[8] it appears that Staff is still not entirely convinced that the Commission will have adequate regulatory tools to ensure that safety and reliability will not be impacted by a failure to adequately invest in PGE.[9] CUB witnesses Jenks and Brown also argue that the regulatory structure is inadequate to protect against "aggressive" cost cutting.[10]

Q. What is your response?

A. I disagree that the parties have cause for concern. As I explained in my rebuttal testimony, Oregon Electric has every incentive to prudently invest in PGE. Moreover,

[4] Staff/1000, Durrenberger/2-6; CUB/300, Jenks-Brown/6; ICNU/400; Antonuk-Vickroy/18.

[5] Staff/1000, Durrenberger/2-5.

[6] Staff/1000, Durrenberger/6.

[7] Staff/1000, Durrenberger/2-5.

[8] *See* Oregon Electric/100, Davis/14-18.

[9] Staff/1000, Durrenberger/4.

[10] CUB/300, Jenks-Brown/8.

the Commission has adequate tools to protect against imprudent cost cutting or inadequate capital expenditures. Finally, Oregon Electric is agreeing to conditions of approval that supplement these tools.[11]

Q. Will Oregon Electric agree to additional conditions of approval designed to allay the parties' concerns?

A. Yes. In addition to the tools already available to the Commission, including the conditions to which Oregon Electric has previously agreed, Oregon Electric is willing to agree to the following specific conditions of approval. These conditions are designed to further augment the Commission's ability to monitor PGE's ongoing investment in its infrastructure and operations and maintenance ("O&M").

> *22. Oregon Electric and PGE agree to submit a final "transition plan" to the Commission within one year of closing.*

Oregon Electric is committed to engaging in a thorough review of PGE's operations after the closing of the Proposed Transaction pursuant to the Initial Review Process Plan set forth in my supplemental direct testimony.[12] This process will result in the creation of a Transition Plan for PGE. This Transition Plan will set forth Oregon Electric's goals for PGE and will include an initial set of priorities to guide Oregon Electric's and PGE's implementation of these goals. The Transition Plan will also include the identification of potential productivity and operational efficiencies, including estimates of the cost impacts, if any, of such efficiencies.

[11] For a detailed discussion of these regulatory tools, *see* Oregon Electric/400, McDermott/5-7 and Oregon Electric/700, McDermott/*.

[12] Oregon Electric/22, Davis/3-8.

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23. PGE agrees to the following with respect to its non-fuel operation and maintenance (O&M) expenses and capital expenditures:

a. PGE shall file with its Results of Operations report an O&M expense and capital expenditure update report (OMCE Update). Using individual FERC accounts for O&M (i.e., FERC Accounts 500 through 598 and 901 through 923), and Construction Work-in-Progress (CWIP) costs by functional area, the OMCE Update will compare the actual O&M and capital expenditures for the most recent past year with (a) the current year's budgeted O&M and capital expenditures, and (b) the average of the preceding three calendar years' actual O&M and capital expenditures. The OMCE Update will also compare actual O&M costs by functional area for the most recent past year to the last approved test year revenue requirement. The OMCE Update will include a written narrative description of the reasons for major variances between the compared accounts, including accounting changes and the most recent organization chart for PGE. If requested, PGE shall present the major findings of the OMCE Update at a Commission meeting.

b. After completing and presenting its third OMCE Update, PGE may petition the Commission to terminate this condition. The Commission shall provide PGE and other interested parties an opportunity to be heard with respect to the termination.

In accordance with this condition, PGE will file and present an annual report that will provide detailed information regarding the level of O&M and capital expenditures at PGE. This information will allow the Commission and other interested parties to monitor the level of investment in PGE and any variations between budgeted and actual expenditures.

24. Within the first seven years after closing, but no sooner than 2007, PGE agrees, if directed by the Commission, to conduct an audit, using an independent auditor approved by the Commission, to review the company's O&M and/or capital construction plans and expenditures. The shareholders will bear the expense of the audit up to $400,000.

This condition allows the Commission to require PGE to conduct an audit of its operations at shareholders' expense (up to $400,000) within the first 7 years after closing of the Proposed Transaction. Under this condition, this audit could not be conducted

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before 2007. There are two reasons for the delay: (1) Oregon Electric and PGE will be developing and submitting the Transition Plan during the first year of Oregon Electric's ownership, which will provide details regarding current and future expenditures; and (2) PGE anticipates filing a rate case at the end of 2005 or early 2006. Because these two processes will provide a significant level of information regarding PGE's current and planned O&M and capital expenditures, an audit should not be necessary until after 2007, after the rate case has been concluded.

Q. Staff witness Durrenberger has asked TPG to respond to concerns raised by two press releases issued by the FAA regarding fines imposed against America West for alleged maintenance and operations violations.[13] Can you do so?

A. Yes. First, although it is true that America West was fined for specific maintenance and operations violations, the FAA never asserted that the alleged violations were the result of cost cutting directed by TPG. Second, it is important to note that passenger safety was never compromised in any way. America West has an excellent safety record, consistently outperforming other carriers in key safety metrics.

America West is an excellent example of TPG's commitment to encouraging its portfolio companies to create and maintain positive relationships with regulators, and to work with regulators to correct any problems. America West worked with the FAA to develop and implement an Operations Improvement Plan that included significant investment in infrastructure and preventative maintenance. As a result of the Improvement Plan and other service enhancements, America West's flight cancellations improved by 70 percent, on-time performance improved by 16 percent, load factors (the percentage of seats occupied per flight) began to consistently exceed industry average,

[13] Staff/1000, Durrenberger/4-5; Staff/1001, Durrenberger/1-2.

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1 and consumer complaints recorded by the Department of Transportation decreased by 55
2 percent.[14]

3 It is important to note that, during the course of TPG's investment in America
4 West,[15] the airline made enormous strides in customer service, reliability, and overall
5 performance. Attached as Oregon Electric/503, Davis 1-7, is a series of press releases
6 that demonstrate how the company has significantly improved in key performance areas:

7 - In February 2002, America West ranked first in on-time performance among
8 all major carriers, improving 30 percent from 2001.
9 - By February 2002, America West performed below the industry average in
10 flight cancellations, decreasing the number of cancelled flights by more than
11 90 percent as compared to February 2001.
12 - By 2002, America West had posted a 34 percent improvement in baggage
13 handling, ranking the airline second best among major airlines.
14 - Customer complaints at the Department of Transportation declined by more
15 than 75 percent between October 2001 and October 2002, giving the airline its
16 lowest complaint levels since 1996.
17 - In 2002, America West's Senior Vice President of Technical Operations
18 received a Maintenance, Repair & Overhaul safety award for his outstanding
19 commitment to safety.
20 - In 2003 and 2004, America West's FlightFund frequent flyer program won the
21 "Freddie Award" for best Elite-Level program in the United States, Canada,
22 and Latin America, becoming the first low-fare airline to win the prestigious
23 award.

24

25 [14] Oregon Electric/502, Davis/1.

[15] TPG invested in America West in 1994 and continues to hold an investment.

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- By 2004, America West ranked second among the major airlines in three out of four categories of operational performance (on-time performance, customer complaints, and baggage handling) as reported in the Department of Transportation's *Air Travel Consumer Report* for December 2003.
- In 2004, customer complaints reached an eight-year low, decreasing 67 percent from 2003.
- In 2003 and 2004, America West was voted "Best Major Airline" by *Entrepreneur* magazine.

America West demonstrates TPG's commitment to providing its portfolio companies with the support, both financial and managerial, to allow these companies to achieve the highest levels of customer satisfaction, safety, and reliability.

Q. Staff witness Thomas Morgan mentioned that, although Oregon Electric has testified that it is committed to the integrated resources planning process and the building of a gas-fired generation facility, Oregon Electric has not committed specifically to constructing Port Westward.[16] Can you address Staff's concerns?

A. Yes. On September 2, 2004, Oregon Electric officially consented to PGE undertaking construction of Port Westward.

Q. Despite your explanations to the contrary, CUB witnesses Jenks and Brown continue to argue that TPG is likely to implement "aggressive" cost cutting at PGE based upon TPG's alleged "management style at other companies it has purchased."[17] Is this accurate?

A. No. In support of this assertion, CUB relies upon allegations of "aggressive" cost cutting at four of the companies in which TPG has invested: Continental Airlines, J.Crew,

[16] Staff/900, Morgan/28.

[17] CUB/300, Jenks-Brown/3.

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Seagate Technology, and MEMC Electronic Materials.[18] As discussed in detail below, CUB's statements regarding cost reductions at these companies are misleading.

At the outset, it bears repeating that TPG frequently invests in companies confronting financial hardship or industry challenges. Identifying inefficiencies and implementing cost reductions are often required to improve these companies' financial health and competitiveness. To the extent that CUB is implying that TPG makes significant cost cuts that *negatively* impact the stability, long-term financial health, quality, and service of the companies in which it invests, its allegations are unfounded. I have been a partner at Texas Pacific Group since 2000. During that time, TPG has invested in 30 companies. TPG's ultimate goal with all of its investments is to improve product quality, customer service, and reliability while operating each company as efficiently as possible. Although the appropriate approach to achieving this goal varies for each investment, the process often involves identifying inefficiencies and implementing product and productivity enhancements. However, TPG does not encourage cost savings at the expense of the long-term financial health of the company or of service and product quality. TPG understands that it is impossible to be successful by imposing imprudent cost cuts that degrade the long-term financial health and stability of a company or impair service or product quality. Neither are such imprudent actions likely to result in an increase in the short-term value of the investment, as thoroughly discussed in my rebuttal testimony.[19]

[18] CUB/300, Jenks-Brown/3-4.

[19] Oregon Electric/100, Davis/6-18.

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Q. As mentioned above, CUB cites four examples as support for its assertion that significant cost cuts are a part of TPG's management style. How do you respond?

A. In my rebuttal testimony, I discussed five examples of companies that have significantly increased capital expenditures during the course of TPG's ownership. In response, CUB does not dispute my point regarding the level of capital expenditures, but rather points out that cost cuts were made at four of those companies: Continental Airlines, J.Crew, Seagate Technology, and MEMC.[20]

Q. Can you explain the reasons for the cost reductions at Continental, J.Crew, Seagate Technology, and MEMC Electronic Materials?

A. Yes. As discussed above, management strategies aimed at strengthening a company's competitiveness, reducing product pricing, and/or addressing poor financial performance may result in prudent cost reductions. In each example cited by CUB, the company was facing financial or industry turmoil at the time of TPG's investment and in some cases had already begun implementing cost reductions before TPG's involvement. Importantly, CUB fails to view the facts in context, or to look beyond a single point in time to examine the profile of company performance and overall level of cost reductions throughout TPG's investment. In order to assess the impact of the cost reductions cited by CUB, it is essential to look at the surrounding circumstances and the ultimate outcome in each case.

Continental Airlines: In 1993, Continental was widely thought of as a poorly run airline, as evidenced by its results. Continental ranked last out of the ten largest U.S. airlines in all key customer service areas as measured by the Department of Transportation ("DOT"). It ranked last in on-time arrivals, baggage handling, customer

[20] CUB/300, Jenks-Brown/3-5.

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complaints, and involuntarily denied boardings. The company had not posted a profit since 1978.

In 1993, the principals of TPG, in conjunction with Air Canada as their partner, led a $6 billion reorganization of Continental under Chapter 11 of the Bankruptcy Code. Ultimately, the transaction infused $450 million in capital into the airline and resulted in one of the largest bankruptcy emergences in U.S. history at that time.

Once Continental emerged from bankruptcy, it was still unprofitable, and significant changes needed to be made. Ultimately, the company made dramatic improvements in all areas, including customer service, reliability, and profitability.[21] This turnaround involved four key elements. *First,* TPG recruited an exceptional new management team to help lead the turnaround. *Second,* a new business strategy was implemented: the carrier's route and hub structure was redesigned, which involved the divestiture of certain second-tier hubs, including Denver, while rapidly expanding and investing in promising locations, primarily Newark.[22] *Third,* management took actions to improve the efficiency and financial footing of the airline. These actions included investing $5.5 billion in a new fleet of aircraft, rationalizing lease structures, and restructuring long-term indebtedness. *Fourth*, and probably most importantly, the company's culture was revolutionized to change the way the company and its employees approached the business. Management instituted a series of incentives that were designed to reward employees for meeting certain DOT targets each month—as

[21] Attached as Oregon Electric/504, Davis/1-18, is a series of press releases detailing many of the significant improvements during TPG's ownership.

[22] CUB notes that "most of [Continental's] flights out of Denver and throughout the western United States were cut." CUB/300, Jenks & Brown/4. At the time, Continental was losing substantial amounts of money per year by operating out of its Denver hub and needed to exit the hub and reduce the number of flights that were operated significantly below capacity in order to improve the company's financial position. As the company has become financially stronger, Continental has added routes in the western United States. *See, e.g.,* Oregon Electric/505, Davis/1-19.

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1 Continental's customers benefited from greater on-time departures and fewer lost bags,
2 so did Continental's employees.

3 CUB states that Continental cut 4,000 jobs after TPG acquired the company in
4 1994.[23] Although that is correct, Continental began *increasing* the number of employees
5 in 1995 as the company's overall performance began to improve. By the time TPG sold
6 its interest in Continental in 1998, over 11,600 employees had been added—a net
7 increase of 7,600 employees during TPG's tenure. Continental also increased employee
8 wages, which were the lowest in the industry before TPG invested in the company. By
9 1998, Continental was ranked among the top 100 best companies to work for in
10 America.[24] In addition, the institutional changes implemented at Continental during
11 TPG's ownership have been the foundation for improvements in customer service,
12 reliability, and profitability that have continued to this day.[25]

13 Over the course of TPG's investment, management successfully remade the
14 airline. Continental dramatically improved its customer service and performance, as
15 evidenced by its rise from tenth to third in on-time performance and sixth to third in
16 complaint ranking in just three years. From a net operating loss of $174 million in 1994,
17 Continental's net income grew to $215 million in 1995 and to $387 million in 1998.
18 TPG sold its interest in Continental in 1998.

19 *J.Crew*: TPG invested in J.Crew in 1997. At the time, J.Crew had two
20 subsidiaries operating catalog companies (Popular Club Plan and Clifford & Wills). It
21 was management's view that the company would benefit from focusing on its core
22 business of producing quality apparel at reasonable prices. For that reason, J.Crew sold
23

24 [23] CUB/300, Jenks & Brown/3-4.

[24] Oregon Electric/506, Davis/1.

25 [25] Attached as Oregon Electric/507, Davis/1-29, is a series of press releases detailing many of the improvements that continued after TPG sold its interest in Continental.

these two subsidiaries, which is the primary reason for the reduction in the number of employees cited by CUB.

In addition, although J.Crew had a strong brand name and quality products, the company was rapidly falling behind historic earnings levels. It was necessary for the company to identify and eliminate inefficiencies to address the problem. TPG and J.Crew worked together to identify areas where efficiencies could be achieved without negatively impacting product quality or customer service. For example, J.Crew was the only company in the industry to have three different departments for production, design, and merchandising. J.Crew consolidated the merchandising and production departments and, as a result, reduced the number of employees. J.Crew invested over $40 million in upgrading information technology systems, which among other benefits, automated much of its finance department and allowed for reduced staffing.

As a result of this prudent implementation of efficiency enhancements and productivity improvements, J.Crew was able to fund increased levels of capital expenditures, which included tripling the number of retail stores. The core employee base of the J.Crew brand has grown by over 2,000 during TPG's ownership. Today, J.Crew is profitable and is one of the fastest growing retailers in America, producing high-quality products and maintaining excellent customer service while operating as efficiently as possible.

Seagate Technology: When TPG invested in Seagate Technology in November 2000, the company was in the process of implementing a transition plan that was partially aimed at reducing manufacturing costs by consolidating manufacturing sites. The cost cuts cited by CUB as evidence of TPG's "management style" were actually planned and largely implemented before TPG invested in the company. CUB states that Seagate reduced the number of employees by 17,000 in three years following TPG's investment

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(between 2000 and 2003). To put this number in perspective, it is important to note that, before TPG invested in Seagate, the company eliminated 51,000 jobs as part of a plan implemented in January 1998.

Seagate is engaged in a highly competitive business. At the time that the transition plan was implemented, Seagate's competitors were actively cutting costs. If Seagate had not acted to increase the efficiency of its operations and reduce costs, the company would have quickly become non-competitive and would have ultimately failed.

MEMC Electronic Materials: As a preliminary matter, I would like to point out that CUB's testimony regarding MEMC is inaccurate. CUB states that MEMC "had 6,600 full-time and 370 temporary workers in December 31, 2000, just before TPG's acquisition. Two years later, after TPG's acquisition, the company had reduced its workforce to 4,600 full-time and 100 temporary workers…."[26] While the numbers that CUB cites are correct, their statements regarding the timing of TPG's acquisition and the responsibility for the workforce reductions are not. TPG did not acquire MEMC until *November 13, 2001*. The vast majority of the workforce reductions were implemented between December 2000 and November 2001 (from approximately 6,900 full-time and temporary workers to approximately 4,800 full-time and temporary workers), *before TPG invested in the company*. Since TPG's investment, the number of employees has *increased* to approximately 4,900 (as of December 2003).

At the time of TPG's investment, MEMC was on the brink of bankruptcy as the company faced the worst downturn in the history of the semiconductor industry. Immediately following the investment, management – with TPG's support – undertook a series of operational initiatives to contain costs, rationalize order fulfillment processes, and reinvigorate core customer relationships through direct sales visits. These actions

[26] CUB/300, Jenks-Brown/4.

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1 accelerated with the TPG-led recruitment of a new CEO and a new Board that included
2 former semiconductor industry executives. Together with new management, TPG helped
3 lead a restructuring of the business that brought gross margins from negative 8 percent in
4 fourth quarter 2001 to positive 25 percent in fourth quarter 2002. Cash flow from
5 operations improved from negative $18 million in fourth quarter 2001 to positive $43
6 million in fourth quarter 2002, in spite of continued softness in the company's end
7 markets. Rather than having to pursue a bankruptcy process, MEMC was able to
8 recapitalize its balance sheet while maintaining its headquarters and jobs in St. Louis.

9 **Q. CUB witnesses Jenks and Brown testify that TPG was unable to provide them with**
10 **a 10-K filing for the year after it acquired PETCO and, as a result, they have no**
11 **independent or publicly available data with which to determine whether TPG cut**
12 **costs at that company.[27] Is this correct?**

13 A. No. Although PETCO did not file a 10-K in 2001, PETCO did file 10-Ks in 2000, 2002,
14 2003, and 2004, all of which provide publicly available data about the company after
15 TPG's investment in 2000. Looking at changes in workforce levels as one indication of
16 cost cutting (consistent with CUB's approach), these documents clearly show that, after
17 TPG invested in PETCO, the number of company employees steadily *increased* from
18 10,200 in 2000 to 15,300 in 2004.[28]
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23 [27] CUB/300, Jenks/Brown/4.

24 [28] All of the information cited above about the number of employees at PETCO, Continental, MEMC, Seagate,
and J.Crew is available in the 10-Ks that were provided to CUB on September 14, 2004 in response to CUB data
25 request 131. Attached as Oregon Electric/508, Davis/1-32 are excerpts from these 10-Ks.

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1 **Q. CUB dismisses your previous testimony as arguing that the Commission and other**
2 **interested parties should "simply trust TPG not to cut costs to a level that could**
3 **impact customers."[29] Is this an accurate depiction of Oregon Electric's testimony?**
4 A. Absolutely not. In my rebuttal testimony, I discuss Oregon Electric's financial
5 incentives for ensuring adequate investment in PGE and responsible stewardship of the
6 company.[30] CUB attempts to dismiss these incentives as an argument simply to "trust
7 TPG." But these incentives are powerful motivators for any business. CUB's real
8 dispute with my rebuttal testimony is not whether Oregon Electric's financial incentives
9 are powerful motivational tools. CUB's dispute is over the impact of those financial
10 incentives on how Oregon Electric will choose to manage PGE. CUB believes that the
11 financial incentives will cause Oregon Electric to drastically cut costs while
12 simultaneously limiting capital expenditures to the detriment of PGE and its customers.
13 But these incentives actually have the opposite effect, as thoroughly discussed in my
14 rebuttal testimony.[31] In addition, such an approach is simply inconsistent with how TPG
15 seeks to influence the companies in which it invests.
16 **Q. CUB also argues that a "subsequent buyer's due diligence will not protect**
17 **customers."[32] How do you respond?**
18 A. In my rebuttal testimony, I discussed a variety of reasons why it would make no financial
19 sense for Oregon Electric to fail to invest in PGE, including the fact that a subsequent
20 buyer's due diligence will reveal the results of imprudent cost cutting and lack of
21 adequate capital expenditures, thereby reducing the value of the company to that buyer.
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[29] CUB/300, Jenks & Brown/6.

[30] I also discuss the role of regulatory oversight in protecting PGE and its customers from inadequate capital expenditures and imprudent cost cutting, but this subject is more thoroughly addressed by Dr. McDermott in his rebuttal testimony. *See* Oregon Electric/400, McDermott/5-7.

[31] Oregon Electric/100, Davis/6-23.

[32] CUB/300, Jenks-Brown/5.

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CUB argues that the inherent limitations of due diligence render it virtually meaningless and it should therefore not be relied upon to protect customers from imprudent management and inadequate investment in the utility. In making this argument, CUB relies on my own statements about the limitations of due diligence. But CUB's argument misses the point. My testimony addressed the inherent limitations of due diligence *as the basis for operational plans* at a company, not the limitations of due diligence *as an investigative tool for potential buyers*.[33] Due diligence investigations are standard practice when acquiring a company and are very effective *for the purposes they are designed to serve* (*i.e.*, informing a potential acquirer's decision to buy a company, including information about the company's condition and appropriate valuation).

It is important to note that, contrary to CUB's assertions, I did not argue that PGE customers' "primary protection" against imprudent cost cutting and inadequate capital expenditures is a subsequent buyer's due diligence. Rather, a subsequent buyer's due diligence is simply an additional but significant incentive for Oregon Electric to prudently manage and invest in PGE.

III. INDEMNIFICATION PROVISIONS OF THE STOCK PURCHASE AGREEMENT

Q. Staff witness Thomas Morgan would like assurances that the potential liabilities facing PGE "due to its ownership by Enron will not erode PGE's financial integrity" and that the indemnification provisions of the Stock Purchase Agreement will directly benefit PGE.[34] Can you comment?

A. Yes. As a preliminary matter, I would like to clarify that the only liabilities currently facing PGE that can appropriately be considered as "due to [PGE's] ownership by

[33] *See* Oregon Electric's response to CUB's data request number 127, attached as Oregon Electric/509, Davis/1.

[34] Staff/900, Morgan/6.

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1 Enron" are the "control group" liabilities.[35] Under the Stock Purchase Agreement, Enron
2 agreed to indemnify PGE and Oregon Electric for 100 percent of the post-tax-effected
3 losses related to these liabilities, subject to a cap at the purchase price (approximately
4 $1.25 billion).[36]

5 Moreover, Oregon Electric has already provided concrete assurance that the
6 indemnification provisions related to the control group liabilities will directly benefit
7 PGE. In my rebuttal testimony, Oregon Electric agreed that, to the extent PGE incurs a
8 loss from any of the control group liabilities, the benefits of the indemnification
9 protections embodied in the Stock Purchase Agreement will be realized solely by PGE.[37]
10 This condition significantly protects PGE's financial integrity from any negative impact
11 that could result from the Enron-related liabilities.

12 **Q. Do the indemnifications contained in the Stock Purchase Agreement provide any**
13 **additional benefits to PGE?**

14 A. Yes. The Stock Purchase Agreement also provides assurance that Oregon Electric and
15 PGE will be protected from up to $94 million of losses incurred as a result of certain
16 additional liabilities facing PGE.[38] These liabilities are not the result of Enron's
17 ownership and are currently borne solely by PGE. Absent the Proposed Transaction,
18 Enron is under no obligation to indemnify PGE for any of these matters and has
19

20 [35] Oregon Electric/100, Davis/36. The control group liabilities consist of: (1) certain tax liabilities relating to the period when PGE was a member of the Enron consolidated tax group; and (2) certain liabilities relating to Enron's
21 benefits plans. *Id.*

22 [36] A copy of the Stock Purchase Agreement is attached as Exhibit 6 to the Application. The indemnification provisions are found in sections 9.2, 10.8, and 10.9. For a detailed summary of the indemnification provisions, *see* Oregon Electric/108, Davis/4-10.
23

[37] Oregon Electric/100, Davis/38-39; Oregon Electric/107, Davis/5 (Condition No. 21).

24 [38] The indemnification provisions of the Stock Purchase Agreement apply to four different categories of liabilities. *See* Oregon Electric/100, Davis/34-36 for a description of the various categories of indemnification. A chart
25 listing the known liabilities or losses currently facing PGE and describing PGE's and Oregon Electric's rights to indemnification under the Stock Purchase Agreement can be found at Oregon Electric/102, Davis/1-4.

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1 indicated that it does not anticipate providing any such indemnification to PGE.[39] It is
2 also important to note that the $94 million will be set aside in an escrow account at
3 closing from cash that would otherwise be paid to Enron.

4 **Q. Staff also appears concerned that the indemnification provisions will not directly**
5 **benefit PGE. Did Staff propose a solution to remedy Staff's concerns?**

6 A. Yes. Staff witness Morgan stated that Staff's concerns would be alleviated if Oregon
7 Electric agreed to a condition of approval that provided that the benefits of the
8 indemnification provisions in the Stock Purchase Agreement would be paid directly to
9 PGE.[40]

10 **Q. Is Oregon Electric willing to agree to such a condition?**

11 A. Yes. Although Oregon Electric believes that the existing indemnification provisions
12 provide a substantial benefit, Oregon Electric is willing to provide an even greater
13 benefit by agreeing to the following condition of approval:

14 *21. To the extent that PGE incurs or suffers a loss that is subject to*
15 *indemnification under the Stock Purchase Agreement, Oregon Electric will direct Enron to pay the benefit of such indemnity directly to PGE.*

16 Without this condition, Oregon Electric and PGE have equal rights to
17 indemnification under the Stock Purchase Agreement. With this condition, Oregon
18 Electric is guaranteeing that, if PGE incurs a loss that is subject to a right to
19 indemnification under the Stock Purchase Agreement, Oregon Electric will direct Enron
20 to pay the benefit of the indemnification directly to PGE. Thus, the indemnification
21 provisions provide a direct contribution to PGE's financial health.

22

23

24 [39] Enron/2, Bingham/3-4; Enron/3, Bingham/1-2.
25 [40] *Id.*

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Q. Staff has expressed concern that the amount of potential liabilities facing PGE exceeds the value of the indemnification.[41] How do you respond?

A. The indemnification provisions contained in the final Stock Purchase Agreement were the subject of intense negotiations between Enron and Oregon Electric. Oregon Electric believes that the amounts of indemnification protection will appropriately protect PGE and Oregon Electric if potentially significant liabilities were to befall PGE. Although it is possible that the liabilities could exceed the indemnification caps, it is unlikely. In addition, it is important to realize that the indemnification provisions provide significant monetary protection to PGE even if a worst-case scenario were to occur. For example, in the absence of this transaction, if PGE were to incur a liability that exceeded the $94 million indemnification cap, PGE would bear the full amount of the loss. If the Proposed Transaction closes, *Enron will indemnify PGE for up to $94 million*, and PGE will bear only the loss in excess of the amount paid by Enron.

IV. RATE CREDIT

Q. Oregon Electric has previously agreed to guarantee $15 million in rate credits to customers. Is Oregon Electric prepared to increase the amount of guaranteed rate credits at this time?

A. Yes. Oregon Electric is prepared to increase the amount of guaranteed rate credits to $43 million over 5 years beginning in 2007.

Q. Why is Oregon Electric proposing to increase the amount of guaranteed rate credits?

A. As we have said before, Oregon Electric is optimistic that PGE's earnings will increase as the Oregon economy improves, as certain and stable ownership returns to the company, and as Oregon Electric and new Board leadership assist the company in

[41] Staff/900, Morgan/5-6.

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1 becoming more efficient, productive, and effective.[42] Oregon Electric has previously
2 agreed to share the benefits of this anticipated increase in earnings through a $15 million
3 guaranteed rate credit. However, we have heard the parties' concerns that this amount is
4 insufficient. Accordingly, Oregon Electric is willing to agree to increase the amount of
5 the guaranteed rate credits to $43 million. Our revised proposal places a guarantee
6 behind what we believe at this point may be an achievable level of savings in the next
7 general rate case. We may achieve more. But even if we achieve less than the $8.6
8 million in savings per year, customers will receive the guaranteed amount.

9 These rate credits do not begin until 2007 because, until that time, it is extremely
10 unlikely that PGE can earn its allowed rate of return. Thus, even if this transaction helps
11 PGE immediately achieve greater efficiency – something that is not likely because
12 effective and efficient changes take time to design and implement – there would be no
13 savings to be shared. Additionally, the high level of capital expenditures planned by PGE
14 over the next several years will require Oregon Electric to allow PGE to retain earnings
15 to help fund these expenditures. In addition, our proposal calls for the annual rate credit
16 to be credited to a balancing account which will accrue interest for the benefit of
17 customers that we estimate could add as much as $2 million to the overall rate credit.

18 Finally, because the rate credit is based on potential savings in costs to operate
19 PGE, to the extent PGE, in its next general rate case, demonstrates savings in O&M and
20 other expenses which are the basis for the test year revenue requirement, our proposal
21 provides that such savings, passed along to customers in PGE's base rates, shall be
22 treated as satisfaction of the guaranteed rate credit obligation. In the event the savings
23 are less than $8.6 million, PGE would continue to pay the difference between
24 $8.6 million and the savings amount to PGE's customers.

25

[42] *See, e.g.,* Oregon Electric/22, Davis/10; Oregon Electric/100, Davis/17-18.

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Q. What are the terms of the proposed rate credit?

A. Oregon Electric proposes the following condition of approval, which sets forth the terms of the rate credit:

> 20. *Oregon Electric agrees that PGE will provide a guaranteed rate credit in the amount of $43 million to PGE's customers. The rate credit will be applied to customer bills in the amount of $8.6 million annually for five years beginning January 2007. PGE's tariffs will reflect this guaranteed savings in two ways:*
>
> *First, PGE will design a supplemental tariff rider to go into effect January 1, 2007 through December 31, 2011 to credit customers with an annual guaranteed rate credit amount of $8.6 million or, upon the effective date of the tariffs approved in the next PGE general rate case (currently anticipated for 2007), the "adjusted annual guaranteed rate credit amount," as defined below. For purposes of the guaranteed rate credit that will flow through this rider, PGE will establish a balancing account and credit that account in the appropriate amount on January 1, 2007, and on each subsequent January 1 through 2011. The balancing account will accrue interest on the unamortized balance, consistent with Commission policy, which is currently at PGE's authorized rate of return. PGE shall roll any balances (positive or negative) remaining on December 31 of each year the rider remains in effect into the balancing account for the following year. The bill credit shall be distributed pro rata based on distribution load (in kWh).*
>
> *The rider shall provide that in the event of a change of control of PGE before January 1, 2011, the annual amounts not yet credited to the balancing account shall be accelerated and credited to customers in a manner determined by the Commission at the time of closing of the transaction involving the change of control.*
>
> *Second, to the extent that Oregon Electric and PGE demonstrate to the Commission's satisfaction that the test year revenue requirement for PGE's next general rate case includes savings (including savings in the various categories of O&M and A&G expenses), PGE will pass that part of the guaranteed rate credit amount to customers through its standard, base tariffs. To the extent the savings passed through to customers through the standard, base tariffs are less than $8.6 million, such difference shall be the "adjusted annual guaranteed rate credit amount." If the savings are equal to or greater than $8.6 million, the "adjusted annual guaranteed rate credit amount" shall be zero.*

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Q. Why is Oregon Electric offering to accelerate the payment of the rate credits upon exit?

A. In the event that there is a change in control of PGE before all credits have been realized, acceleration will guarantee that all rate credit amounts will be paid to customers.

V. TRANSPARENCY

Q. Some parties continue to express concern regarding the level of transparency at Oregon Electric. Has Oregon Electric agreed to any conditions of approval that address these concerns?

A. Yes. As discussed in my rebuttal testimony, Oregon Electric has agreed to the following conditions of approval:

> 4. *Unless such a disclosure is unlawful, Oregon Electric shall notify the Commission of: (a) Its intention to transfer more than 5% of PGE's retained earnings to Oregon Electric over a six-month period, at least 60 days before such a transfer begins; (b) Its intention to declare a special dividend from PGE, at least 30 days before declaring each such dividend; (c) Its most recent quarterly common stock cash dividend payment from PGE within 30 days after declaring each such dividend.*
>
> 11. *Oregon Electric shall maintain and provide the Commission unrestricted access to a record of each instance in which TPG Applicants withhold their consent to a decision of the PGE Board of Directors. The record shall detail the basis for the decision, including any governing report or document that memorializes the exercising of the consent rights and shall identify the persons involved in making the TPG Applicant Consent Rights decision. Oregon Electric shall provide the records to the Commission upon request. Nothing in this paragraph shall prevent the Commission from disclosing to the public the number of times the TPG Applicants exercised their consent rights within a certain period of time.*
>
> 12. *Oregon Electric and PGE shall maintain and provide the Commission unrestricted access to all books and records of Oregon Electric and PGE that are reasonably calculated to lead to information relating to PGE, including but not limited to, Board of Directors' Minutes, Board Subcommittee Minutes, and other Board Documents.*
>
> 19. *Oregon Electric and PGE shall maintain (for a rolling five-year period)[43] and provide the Commission unrestricted access to all written*

[43] Oregon Electric has added language limiting the duration of the maintenance requirement to a rolling five-year period.

> *information provided to stock or bond rating analysts, which directly or indirectly pertains to PGE or any affiliate that exercises influence or control over PGE. Such information includes, but is not limited to, reports provided and presentations made to stock and bond rating analysts. For purposes of this condition, "written" information includes, but is not limited to, any written and printed material, audio and videotapes, computer disks and electronically-stored information.*
>
> *32. Beginning twelve months following closing, Oregon Electric will prepare and make available to the Commission and the public, on a quarterly and annual basis, financial and operating disclosure reports that are equivalent in scope to that of Form 10-Q and Form 10-K reports filed with the U.S. Securities and Exchange Commission.*[44]

In addition, many of the conditions regarding affiliate transactions (discussed below) also provide transparency regarding the activities of Oregon Electric and PGE.

Q. Has Staff proposed an additional condition regarding transparency?

A. Yes. Staff witness Morgan has proposed a condition of approval requiring the TPG Applicants[45] to notify the Commission of: (a) changes in the control of the General Partner of either of the TPG Applicants; (b) changes in the ownership interest in Oregon Electric or PGE, or of any of the TPG funds investing in Oregon Electric; (c) changes in the agreements governing the operation of the TPG funds investing in Oregon Electric; (d) changes in the Managing Members of Oregon Electric; (e) any actions by TPG Applicants concerning matters at Oregon Electric subject to certain provisions of ORS 63.130; and (f) any equity infusion that occurs with a subsidiary or partnership of PGE or Oregon Electric.

Q. Is Oregon Electric willing to agree to Mr. Morgan's proposed condition?

A. Yes, with some changes. Oregon Electric is willing to agree to the following condition of approval:

---

[44] In my rebuttal testimony, Oregon Electric previously committed to providing financial disclosure reports equivalent to that of SEC Form 10-K and Form 10-Q. Oregon Electric/100, Davis/44. This proposed condition formalizes that commitment.

[45] The TPG Applicants are TPG Partners III, L.P. and TPG Partners IV, L.P. Mr. Morgan would also like the condition to include Tarrant Partners, L.P. Staff/900, Morgan/26.

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1 31. *The following actions shall be reported to the Commission by TPG*
2 *Applicants or Oregon Electric, as appropriate, within 30 business days after their occurrence:*

3 a. *Any change of control of the General Partner of either of the TPG*
4 *Applicants.*

5 b. *Any change in the ownership interest in Oregon Electric or any of the TPG funds investing in Oregon Electric.*

6 c. *Any amendment to the terms and conditions of Oregon Electric's*
7 *Operating Agreement.*

8 d. *Any amendment to the terms and conditions of the Limited Partnership Agreement of either of the TPG Applicants.*

9 e. *Any designation, appointment, election, removal or replacement of any Member or Manager at Oregon Electric by a vote, approval or*
10 *consent of a majority of the Members.*

11 This condition gives the Commission access to information regarding the ongoing
12 operation of TPG Partners III, L.P. and TPG Partners, IV, L.P., as well as Oregon
13 Electric. This condition should allay Staff's concerns about potential changes in the
14 effective control of Oregon Electric or PGE without Commission knowledge.

15 **Q. Could you explain the differences between Oregon Electric's proposed condition**
16 **and Staff's proposed condition?**

17 A. Yes. My understanding is that Staff's proposed condition is designed to give the
18 Commission access to information that it might not otherwise have. Oregon Electric has
19 revised this condition to better serve the underlying purpose. Under subsection (b) of
20 Staff's condition, the TPG Applicants would be required to notify the Commission of
21 any change in the ownership interest of Oregon Electric, PGE, or any of the TPG funds
22 investing in Oregon Electric. Oregon Electric believes it is unnecessary for the proposed
23 subsection to apply to PGE because the obligation to report any change in control of
24 PGE is governed by statute.[46] Oregon Electric has revised subsection (b) accordingly.
25

[46] ORS Sections 757.415, 757.480 and 757.511.

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1 In subsection (c), Staff requests notification of a change in any agreement that
2 governs the operation of the TPG funds investing in PGE and Oregon Electric. Staff then
3 lists several different agreements or types of agreements. Oregon Electric has refined this
4 provision to more accurately reflect the governance structure at TPG and has moved the
5 provision regarding changes in Oregon Electric's operating agreement to a separate
6 subsection (Oregon Electric's proposed subsection [c]). There are two TPG funds
7 investing in PGE: TPG Partners III, L.P. and TPG Partners IV, L.P. These two funds are
8 governed by Limited Partnership agreements. Oregon Electric has agreed to provide
9 notice of any change to the terms and conditions of these Limited Partnership agreements
10 (Oregon Electric's proposed subsection [d]). Oregon Electric's proposed subsection
11 provides sufficient information to the Commission because no changes to the governance
12 of the two funds can be made without changing the terms and conditions of the Limited
13 Partnership agreements.[47]

14 Staff's proposed subsection (e) requires notice to the Commission if the TPG
15 Applicants take any actions over matters of Oregon Electric related to certain provisions
16 of ORS 63.130. The TPG Applicants can only effect changes in the management
17 decisions of Oregon Electric through the exercise of TPG's consent rights. Because
18 Oregon Electric has already agreed to maintain and provide to the Commission records
19 regarding each instance in which the TPG Applicants exercise a consent right over a
20 decision of Oregon Electric or PGE, the proposed condition is duplicative and
21 unnecessary.[48]

22

23

24 [47] There could be changes to the General Partner of the TPG Applicants without a change in the terms and conditions of the Limited Partnership agreements. However, changes in the General Partner are addressed by
25 subsection (a).

[48] *See* Oregon Electric's Proposed Condition 11. Oregon Electric/501, Davis/4.

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1 With regard to subsection (f) of Staff's proposed condition, Oregon Electric does
2 not understand exactly what Staff is requesting and, therefore, cannot agree to this
3 subsection.

4 **VI. EXIT CONSIDERATIONS**

5 **Q. Some of the intervenors continue to insist that Oregon Electric should agree to**
6 **conditions of approval regarding the timing and manner of Oregon Electric's exit**
7 **from PGE.[49] Do you believe it is appropriate to restrict Oregon Electric's exit**
8 **options at this time?**

9 A. No. As explained in my rebuttal testimony, restricting Oregon Electric's exit options is
10 not in the best interests of PGE, its customers, or Oregon Electric. At the time Oregon
11 Electric decides to sell its interest in PGE, there will be two potential alternatives: an
12 initial public offering or sale to a third-party buyer, which could include sale to a public
13 entity, a strategic buyer, or a private entity. It is impossible to know at this time which of
14 these options will be in the best interests of Oregon Electric, PGE, or PGE's customers in
15 the future. CUB witnesses Jenks and Brown go so far as to state that a strategic sale is
16 "not the preferred exit" for PGE and its customers, citing difficulties with regulating
17 utilities subject to multiple jurisdictions, alleged problems with PacifiCorp, "elusive
18 economies of scale,"[50] and lack of local focus. The problem with CUB's argument is
19 that we do not know if its concerns will actually be relevant to a hypothetical strategic
20 sale years from now. At this point, we do not even know if the possibility of a strategic
21

22 [49] CUB/300, Jenks-Brown/24-34.

23 [50] CUB asserts that because PGE can now replace services provided by Enron at a lower cost than the direct and indirect charges allocated to PGE by Enron, this must mean that Enron's services provided no economies of scale
24 in the first place. CUB/300, Jenks-Brown/31. The fact that PGE is *currently* estimated to be able to replace services provided by Enron for slightly less than the direct and indirect charges allocated to PGE by Enron does
25 not mean that no cost savings from corporate synergies were achieved *at the time of the merger* and certainly sheds no light on possible synergies that could be beneficial to customers in a future merger. *See* Oregon Electric's response to CUB data request 128, attached as Oregon Electric/510, Davis/1.

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sale will present itself, much less who the buyer may be and what unique benefits, as well as possible detriments, the buyer may offer. Moreover, the Commission has all of the authority that it needs, and the intervenors have all of the rights that they need, to vet any proposed future sale of PGE.

Q. CUB specifically proposed a condition giving a public entity the opportunity to negotiate for the purchase of PGE before Oregon Electric agrees to sell to a strategic buyer.[51] Please respond to this proposal.

A. As discussed above, I believe it is wholly inappropriate to determine *at this time* that any particular exit option or future owner would be in the best interests of PGE or its customers. Moreover, the condition proposed by CUB is completely unworkable from a business perspective. CUB's proposed condition requires Oregon Electric to allow an arbitrator to determine the purchase price for PGE. Allowing an arbitrator, rather than market forces, to determine the appropriate purchase price for PGE is contrary to basic business principles and would diminish the overall value of PGE. In addition, granting *any* entity a preferred right to negotiate for and purchase PGE would create a disincentive for another buyer to initiate negotiations with Oregon Electric. I understand that this is exactly CUB's point—to create a disincentive for Oregon Electric to sell to a strategic buyer. But as discussed above, it is inappropriate to create such a disincentive without any information about a potential future buyer and the accompanying benefits they might bring to PGE and its customers.

[51] CUB/300, Jenks-Brown/33-34.

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1 **VII. AFFILIATED INTERESTS AND THE MASTER SERVICES AGREEMENT**

2 **Q. Has Oregon Electric agreed to conditions of approval that address Staff's and**
3 **intervenors' concerns[52] regarding affiliate issues?**

4 A. Yes. Oregon Electric agrees to the following conditions[53] of approval:

5
6
> *1. PGE and Oregon Electric shall maintain separate books and records. All PGE and Oregon Electric financial books and records shall be kept in Portland, Oregon.*

7
8
9
10
> *7. The Commission or its agents may audit the accounts of Oregon Electric, its affiliates, and any subsidiaries that are the bases for charges to PGE to determine the reasonableness of allocation factors used by Oregon Electric to assign costs to PGE and amounts subject to allocation or direct charges. Oregon Electric agrees to cooperate fully with such Commission audits.*

11
12
> *8. Oregon Electric and its affiliates shall not allocate to or directly charge to PGE expenses not authorized by the Commission to be so allocated or directly charged.*

13
14
> *9. PGE shall maintain its own accounting system. PGE and Oregon Electric shall maintain separate books and records, both of which shall be kept in Portland, Oregon.*

15
16
17
> *13. PGE and Oregon Electric shall notify the Commission within 30 days of the formation of any subsidiary. Such notice shall include a copy of the business plan and capitalization strategy, as well as any planned or anticipated transactions of the subsidiary with PGE or Oregon Electric as applicable.*

18
19
20
> *14. Oregon Electric and PGE shall provide the Commission access to all books of account, as well as all documents, data and records of their affiliated interests, which pertain to transactions between PGE and all its affiliated interests, unless such transactions are exempt under applicable law or the Master Services Agreement.*

21 Given Oregon Electric's agreement to these conditions and the finalization of the
22 Master Services Agreement, Staff appears to be satisfied that all issues related to affiliate
23 transactions have been adequately addressed.[54]

---

24 [52] *See* Staff/1100, Hathhorn/1-4, CUB/100, Jenks-Brown/15-16.

25 [53] Each of these conditions is described in more detail in Ms. Hathhorn's testimony. Staff/1100, Hathhorn/3-4.

[54] Staff/1100, Hathhorn/3-6.

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Q. Have the parties been able to reach an agreement regarding a Master Services Agreement?

A. Yes. My understanding is that the interested parties reached a final agreement on the Master Services Agreement during a settlement conference on October 1, 2004. Staff witness Rebecca Hathhorn has indicated that she will submit supplemental testimony presenting the final Master Services Agreement.[55]

Oregon Electric has also agreed to the following condition of approval regarding the Master Services Agreement:

> *34. The Applicants will file a Master Services Agreement, which includes agreed-upon terms and conditions, no later than 30 days after a final order in UM 1121 is issued approving the transaction.*

VIII. SERVICE QUALITY MEASURES AND BILLING ACCURACY

Q. Staff and various intervenors have raised concerns regarding whether Oregon Electric's ownership will have an adverse impact on PGE's service quality.[56] Can you comment?

A. Yes. As I have said throughout my prior testimony in this proceeding, Oregon Electric is committed to maintaining and enhancing PGE's service quality and reliability.[57] Staff's and intervenors' testimony on this point is largely premised on the idea that Oregon Electric will make drastic cost cuts at PGE that will adversely impact service quality.[58] As discussed above and in my rebuttal testimony, Oregon Electric has no plans and no incentive to reduce costs to the detriment of PGE and its customers.[59] Although Oregon

[55] Staff/1100, Hathhorn/4-5.

[56] *See, e.g.*, Staff/1000, Durrenberger/4; CUB/Jenks-Brown/25-26.

[57] *See* Oregon Electric/3, Davis/13; Oregon Electric/22, Davis/3-8; Oregon Electric/100, Davis/6-7.

[58] *See, e.g.*, Staff/1000, Durrenberger/4; CUB/Jenks-Brown/25-26.

[59] Oregon Electric/100, Davis/6-18.

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Electric anticipates that some efficiencies may be identified in the post-closing review of PGE's operations as previously discussed in my supplemental direct testimony,[60] Oregon Electric is committed to ensuring that the realization of any such efficiencies does not result in the degradation of PGE's service quality and reliability.

Q. Has Oregon Electric agreed to any conditions of approval that address Staff and intervenors' concerns regarding service quality?

A. Yes. Oregon Electric has agreed to the following condition of approval:

> *5. Subsequent to its purchase by Oregon Electric, PGE shall continue to perform under the Service Quality Measures ("SQM"), as set forth in Stipulations for PGE Service Quality Measures UM 814/UM 1121 dated July 13, 2004, for a period of ten full calendar years after the date the current SQM is scheduled to retire. Nothing in any provision of this Stipulation is intended to affect the Commission's authority to directly administer the stated terms of the SQM. Notwithstanding the provisions described in this paragraph, the parties have agreed to replace the current R4 measurement with a CAIDI-related measurement, and further that PGE will maintain records of outages longer than three hours. In addition, PGE agrees to work with ICNU to evaluate and, if necessary, develop additional service quality standards related to service to industrial customers.*[61]

Staff has indicated that this condition is an improvement over the condition agreed to by Enron and is an "important regulatory tool."[62]

In addition, Staff has requested that Oregon Electric and PGE agree to a condition of approval regarding billing accuracy.[63] Oregon Electric and PGE will agree to the following condition of approval:

---

[60] Oregon Electric/22, Davis/3-8.

[61] *See* Partial Stipulation (Staff/801, Conway/1-6).

[62] Staff/600, Murray-Sipler/3.

[63] Staff/800, Conway/7-8.

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1 2 3 *29. PGE agrees to work in good faith with Staff and other interested parties to develop and present to the Commission, within 270 days of the closing of the transaction, a billing accuracy SQM consistent with Staff/702. At the time of the presentation to the Commission, parties, including PGE, may present their views to the Commission on the necessity for and content of the SQM.*

4

5 **IX. CONDITIONS OF APPROVAL**

6 7 **Q. Are there any additional conditions of approval to which Oregon Electric is willing to agree?**

8 A. Yes. Attached as Exhibit 501 is the full list of conditions and general provisions
9 proposed by Oregon Electric.[64] This list includes conditions to which Oregon Electric,
10 Staff, and certain other intervenors previously stipulated (Conditions 1 through 6).
11 Oregon Electric has worked hard to understand the parties' concerns about this
12 transaction and to develop a list of conditions to approval that will protect PGE and its
13 customers without unduly restricting the ability of PGE and Oregon Electric to manage
14 PGE in the most efficient and effective manner.[65] The conditions Oregon Electric
15 proposes are interrelated – changes to one condition may affect Oregon Electric's ability
16 to agree to the others. For that reason, Oregon Electric asks the Commission to view
17 these proposed conditions as a package replacing the conditions adopted in the Enron
18 merger. In addition to the conditions discussed above, this package includes conditions
19 regarding:[66]

20

21

22 [64] Oregon Electric/501, Davis/1-9.

23 [65] Attached as Oregon Electric/501, Davis/1-9, is a complete list of the conditions of approval to which Oregon Electric is willing to agree.

24 25 [66] The following is a brief statement of each additional condition to which Oregon Electric is willing to agree and is not intended to alter the language of the conditions as presented in Oregon Electric/501, Davis/1-9. To the extent the language below differs from the language in the condition itself, the language in the condition is controlling.

- ***Ring-fencing*:**[67]
  - Oregon Electric and PGE will maintain separate debt ratings and, if more than $5 million of preferred stock is outstanding, preferred stock ratings (Condition No. 6).
  - PGE will not make any distributions to Oregon Electric that would cause the common equity portion of PGE's total capital structure to fall below 48 percent without Commission approval (Condition No. 16).
  - Oregon Electric agrees to hold the customers of PGE harmless if PGE's return on common equity and other costs of capital, viewed on a stand-alone basis, rise as a result of Oregon Electric's ownership of PGE (Condition No. 17).
  - Oregon Electric agrees to hold the customers of PGE harmless if PGE's revenue requirement, viewed on a stand-alone basis, is higher due to Oregon Electric's ownership of PGE (Condition No. 18).
  - Oregon Electric will use each PGE distribution to Oregon Electric exclusively to pay operating expenses and debt service until certain conditions are met (Condition No. 25).
- ***Financial Conditions:***
  - Oregon Electric shall not re-leverage if the increased debt would bring the consolidated capital structure below 30 percent equity (Condition No. 27).
  - After closing, the TPG entities will not allocate or direct bill Oregon Electric for any goods, services, supplies or assets in excess of $5 million per year (Condition No. 28).
  - Until the total long-term debt at Oregon Electric is less than 70 percent of total capital, Oregon Electric, PGE, and any of their respective affiliates shall not, without prior notice to the Commission, directly or indirectly acquire, incorporate, or otherwise organize any subsidiary, or enter into substantially new lines of business, which were not in existence as of January 1, 2005 (Condition No. 33).
- ***Acquisition Adjustments, Goodwill, and Transaction Costs:***
  - Oregon Electric and PGE shall exclude all goodwill resulting from this acquisition from PGE's utility accounts (Condition No. 2).

[67] The ring-fencing and financial conditions are discussed in detail in the sur-surrebuttal testimony of Carrie Wheeler. Oregon Electric/600, Wheeler/*.

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- Oregon Electric and PGE shall exclude all costs and fees associated with the acquisition from PGE's utility accounts and will provide an accounting of these costs to the Commission (Condition No. 3).

- ***Enforcement:***
  - Oregon Electric and PGE agree to specific provisions regarding enforcement of the conditions of approval (Condition No. 10).
  - Oregon Electric and PGE agree to a process for expedited resolution of disputes between the Commission or Commission Staff and Oregon Electric or PGE regarding access to information (Condition No. 15).

The list of conditions presented by Oregon Electric is more extensive and considerably more stringent than the conditions of approval agreed to in prior merger dockets. Given these conditions, Oregon Electric believes that the potential risks of the transaction are more than adequately offset by the benefits.

X. CONCLUSION

Q. Can you summarize the benefits of the Proposed Transaction?

A. Yes. The Proposed Transaction provides significant benefits to PGE and its customers. These benefits include:

- A guaranteed $43 million rate credit, payable over five years beginning in 2007.
- PGE will receive the benefit of contractual indemnifications for two different classes of potentially significant liabilities, one in an amount up to about $94 million and the other in an amount up to $1.25 billion.
- Strong local representation and leadership on PGE's Board of Directors, ensuring accountability to customers and sensitivity to community concerns.
- An identified first-class Board of Directors, ensuring that PGE management has the best advice on how to navigate the challenges ahead.
- Capital reinvestment in PGE, ensuring reliability and efficiency from existing assets and the acquisition and development of new resources, including generation resources.
- A commitment to reinforcing high-quality service while instilling financial discipline to ensure that customers receive safe, reliable, and efficient electric service.

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- 10-year extension of the commitment to service quality measures; agreement to develop and, if approved by the Commission, implement a billing accuracy service quality measure.

3
- Oregon Electric will be an Oregon taxpayer.

4
5
- An immediate end to Enron's ownership of PGE, ensuring stability and unified ownership.

6
- PGE's headquarters will stay in Portland, jobs will stay in Oregon and PGE will continue its charitable leadership in the community.

7
8
- Commitment to work vigorously to have 10 percent of PGE's resources to meet peak capacity to be from renewable resources, if economical.

9
10
- Appointment of a manager within PGE with appropriate responsibility and authority to work with the advocacy groups for renewable energy sources, sustainability, energy efficiency, and environmental matters.

11
- 10-year extension of PGE's cash and in-kind donations to Oregon HEAT and a doubling of the cash portion of the donation.

12
13
- Periodic access to PGE's Board of Directors for various customer and environmental advocacy groups.

14
- Commitment to work on additional programs for low income assistance through a work group led by PGE.

15 **Q. Does this conclude your testimony?**

16 A. Yes.

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3 **BEFORE THE PUBLIC UTILITY COMMISSION**
4 **OF OREGON**
5 **UM 1121**
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7 In the Matter of
8 OREGON ELECTRIC UTILITY COMPANY, LLC, et al.,
9
10 Application for Authorization to Acquire Portland General Electric Company
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13
14 **SUR-SURREBUTTAL TESTIMONY**
15 **OF**
16 **CARRIE WHEELER**
17 **ON BEHALF OF OREGON ELECTRIC**
18
19
20
21 **October 11, 2004**
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1 ## I. INTRODUCTION

2 **Q. Please state your name.**

3 A. My name is Carrie Wheeler. I previously offered rebuttal testimony in this proceeding.

4 **Q. What is the purpose of your testimony?**

5 A. The purpose of my testimony is to respond to specific concerns raised in surrebuttal
6 testimony by the Staff ("Staff") of the Public Utility Commission of Oregon (the
7 "Commission") and various intervenors. In addition, I explain why some of the financial
8 conditions proposed by Staff are not necessary to protect PGE, and why Oregon
9 Electric's proposed conditions provide sufficient protection for PGE's customers while
10 not unduly restricting Oregon Electric's ability to operate effectively.

11 **Q. Please summarize your sur-surrebuttal testimony.**

12 A. Throughout this case, both Staff and intervenors have voiced concern about the amount
13 of debt at Oregon Electric[1] and have pointed to two financial risks that they believe are
14 raised by the debt: (1) the potential for increased financing costs to PGE; and (2) a risk of
15 bankruptcy at Oregon Electric.[2] In my rebuttal testimony I demonstrated that any
16 increase in financing costs would be immaterial[3] and I explained that, in any event,
17 Oregon Electric has agreed to hold PGE's customers harmless against any such increase.
18 I also pointed out that Oregon Electric has agreed to "ring-fencing"[4] conditions that not
19

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20 [1] Throughout this testimony, I will use "Oregon Electric" to refer to Oregon Electric Utility Company, LLC, or to all Applicants, as the context may imply.

21 [2] The parties also raise concerns about imprudent cost cutting. This issue is addressed at: Oregon Electric/700, McDermott/*; Oregon Electric/500, Davis/*.

22 [3] *See* Oregon Electric/200, Wheeler/15-16.

23 [4] By ring-fencing, I am referring to the following merger conditions imposed by the Commission in UM 814:

24 - PGE shall maintain separate debt and, if outstanding, preferred stock ratings.

25 - PGE shall not make any distribution to Enron that would cause PGE's equity capital to fall below 48 percent of the total PGE capital without Commission approval. The Commission Staff, PGE, and Enron

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1 only are consistent with conditions that have protected PGE in the past, but also offer
2 additional protections. Finally, I explained why the risk of bankruptcy is remote.

3 In surrebuttal testimony, Staff appears to accept that the "hold harmless"
4 provisions agreed to by Oregon Electric are appropriate and further agrees that the risk of
5 bankruptcy is unlikely.[5] Nevertheless, Staff has insisted that, as a condition to approval,
6 Oregon Electric accept a set of additional financial conditions. Staff's proposed
7 conditions go far beyond those adopted in the Enron case and offer no meaningful
8 additional protection to PGE's customers. Moreover, Staff's conditions would
9 significantly impair Oregon Electric's and PGE's ability to respond effectively to
10 changing market and other financial circumstances. For these reasons, Oregon Electric
11 cannot accept Staff's proposed financial conditions.

12 II. OREGON ELECTRIC'S PROPOSED RING-FENCING CONDITIONS ARE 13 SUFFICIENT TO PROTECT PGE AND ITS CUSTOMERS

14 **Q. You testified earlier that the ring-fencing currently in place at PGE provides**
15 **sufficient protection for the company and its customers. Do you still believe that to**
16 **be true?**

17 A. Yes. In my rebuttal testimony, I noted that Oregon Electric had agreed to the same ring-
18 fencing measures that have played such an important and effective role in insulating

19

20 may re-examine this minimum common equity percentage as financial conditions change, and may request that it be adjusted.

21 • Enron, PGE, and the Commission Staff agree that the allowed return on common equity and other costs
22 of capital will not rise as a result of the merger. These capital costs refer to the cost of capital used for purposes of rate setting, avoided cost calculations, affiliated interest transactions, Least Cost Planning,
23 and other regulatory purposes.

24 OPUC Order No. 97-196 (Jan. 4, 1997), Appendix A (Stipulation). Oregon Electric and Staff have already stipulated to the first of these ring-fencing conditions (Partial Stipulation, Staff/801, Conway/1-6 (Condition 6)).

25 [5] Staff/900, Morgan/13, 24.

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1 PGE's credit quality from that of Enron during its bankruptcy.[6] In particular, Oregon
2 Electric had agreed not to take dividends that would cause PGE's common equity ratio to
3 fall below 48 percent and had agreed to a hold harmless provision that ensures that PGE's
4 customers will not bear the costs of any increase in the cost of capital to PGE that directly
5 results from the Proposed Transaction. In sur-surrebuttal testimony, Oregon Electric is
6 agreeing to enhancements of the Enron conditions that provide added protections for
7 PGE's customers. I believe that these ring-fencing provisions serve to mitigate any
8 financial risks that might reasonably be thought to accompany the Proposed Transaction.

9 **Q. Have Oregon Electric and Staff agreed upon any specific ring-fencing conditions?**

10 A. Yes. Oregon Electric and Staff have agreed in principle[7] upon the following two "hold
11 harmless" conditions:

12–16
> *17. Oregon Electric agrees that the customers of PGE shall be held harmless if PGE's return on common equity and other costs of capital, viewed on a stand-alone basis, rise as a result of Oregon Electric's ownership of PGE. These capital costs refer to the costs of capital used for purposes of rate setting, avoided cost calculations, affiliated interest transactions, least cost planning, and other regulatory purposes.*

17–18
> *18. Oregon Electric agrees that the customers of PGE shall be held harmless if PGE's revenue requirement, viewed on a stand-alone basis, is higher due to Oregon Electric's ownership of PGE.*

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[6] Mr. Morgan states that "Staff has learned existing ring-fencing measures do not fully insulate utility from activities of the parent." Staff/900, Morgan/11. While no ring-fencing can completely insulate a utility from all events at the holding company level, it is widely agreed in the financial community that the Enron ring-fencing conditions showed great foresight by the Commission and have worked extremely well. *See* Oregon Electric/200, Wheeler/17.

[7] Staff's proposed versions of Conditions 17 and 18 differ slightly in their wording, but appear aligned with Oregon Electric's conditions in principle. *See* Staff/900, Morgan/17, 20.

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1 **Q. What is the purpose of these conditions?**

2 A. The parties continue to voice concerns that the financial structure proposed for Oregon
3 Electric will increase PGE's costs of capital.[8] These conditions ensure that any increases
4 in PGE's costs due to Oregon Electric's ownership will be borne by PGE's shareholders
5 and not its customers.

6 **Q. Are these conditions identical to the Enron hold harmless condition?**

7 A. No. They have been strengthened at Staff's request. The Enron hold harmless condition
8 provided that customers would be held harmless if the merger itself resulted in higher
9 costs to PGE. However, Staff has informed us that after the merger was complete,
10 disagreements arose as to whether customers were protected from only those higher costs
11 that may have resulted immediately from the merger, or whether they were protected
12 from higher costs that may have resulted at any other time during Enron's tenure as
13 owner. In order to eliminate any confusion and provide additional protection to PGE's
14 customers, Oregon Electric has agreed to hold harmless conditions that make it clear that
15 if Oregon Electric's ownership results in higher costs of capital at any time during the
16 period of its ownership, then PGE's customers will be held harmless.

17 **Q. Does Oregon Electric propose to adopt any other ring-fencing conditions?**

18 A. Yes. Oregon Electric proposes to adopt the following "minimum equity" condition:

19
20
21
> *16. PGE will not make any distributions to Oregon Electric that would, as determined in accordance with Generally Accepted Accounting Principles ("GAAP"), cause the common equity portion of PGE's total capital structure to fall below 48 percent without Commission approval.*

22
23
> *a. "Total capital structure" is defined as PGE's common equity, preferred equity, and long-term debt.*

24

25 [8] *See, e.g.,* Staff/900, Morgan/12; ICNU/300, Schoenbeck/6; CUB/400, Dittmer/7-9.

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> b. *"Long-term debt" is defined as PGE's outstanding debt with a term of more than one year, excluding revolving lines of credit except to the extent the amount of the rolling 12-month average of committed and drawn balances under PGE's unsecured revolving lines of credit (Unsecured Revolvers) less any balances related to collateral or security provided to counterparties for power supply and related agreements, is greater than $250 million.*
>
> c. *A "committed balance" is the sum of the commitments used to support any borrowing capacity or other purposes, such as a commercial paper program or letters of credit.*
>
> d. *A "drawn balance" is sum of amounts drawn against the Unsecured Revolvers.*
>
> e. *Hybrid securities (e.g., convertible debt) will be assigned to equity and long-term debt based on the characteristics of the hybrid security. The Commission, prior to their issuance, will determine the assignment of the equity and debt characteristics.*

Q. Is this condition identical to the Enron minimum equity condition?

A. No. The minimum equity condition adopted in the Enron merger did not include revolver balances in the definition of long-term debt. As I will explain in detail below, by including revolver balances in the calculation of long-term debt, our proposed condition is significantly more restrictive and provides more protection for PGE's customers.

Q. Does Staff support Oregon Electric's proposal?

A. No. Though the Enron ring-fencing conditions have worked admirably to protect PGE and its customers, Staff is recommending a significantly more onerous minimum equity condition.[9] Specifically, Staff's proposed condition states:

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[9] ICNU proposes a similar condition. *See* ICNU/301, Schoenbeck/2 (Condition 10).

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> 16. *PGE will not make any distributions to OEUC that would, or could reasonably be expected to, cause the common equity portion of PGE's total capital structure to fall below 48 percent.*
>
> a. *"Total capital structure" is defined as common equity, preferred equity, and long-term debt.*
>
> b. *"Long-term debt" is defined as (1) outstanding debt with an initial term of more than one year plus the sum of committed and drawn balances greater than $150 million on any of PGE's unsecured revolving lines of credit (Unsecured Revolvers); and (2) the sum of committed and drawn balances on PGE's secured revolving lines of credit (Secured Revolvers).*
>
> c. *A "committed balance" is the sum of the commitments used to support any borrowing capacity or other purposes, such as a commercial paper program.*
>
> d. *A "drawn balance" is sum of amounts drawn against the Revolvers.*
>
> e. *Hybrid securities (e.g., convertible debt) will be assigned to equity and long-term debt based on the characteristics of the hybrid security. For these hybrid securities, The Commission, prior to their issuance, will determine the assignment of the equity and/or debt characteristics.*

16 **Q. How do Staff and Oregon Electric's proposals differ?**

17 A. First, under Oregon Electric's proposal, PGE could not make any distributions to Oregon
18 Electric that would, *as determined in accordance with Generally Accepted Accounting*
19 *Principles ("GAAP")*, cause the common equity portion of PGE's total capital structure
20 to fall below 48 percent without Commission approval. Staff's proposed condition would
21 prohibit distributions that would, *or could reasonably be expected to*, cause the common
22 equity portion of PGE's total capital structure to fall below 48 percent without
23 Commission approval. Second, Staff's proposed condition would include unsecured
24 revolver balances in excess of $150 million in the definition of long-term debt and would
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include any balance on a secured revolver in the definition of long-term debt, whereas Oregon Electric's proposal would include average unsecured revolver balances in excess of $250 million and would not include balances on secured revolvers.

Q. Is Staff's proposal acceptable to Oregon Electric?

A. No.

Q. Can you explain why Staff's proposed change to the definition of "long-term debt" is unreasonable?

A. The basic purpose of the minimum equity condition is to protect PGE's financial health by limiting the distributions PGE can send to Oregon Electric. In the Enron merger, the parties agreed to prohibit a distribution that would cause the common equity portion of PGE's total capital structure to fall below 48 percent. There has been no suggestion in this docket or elsewhere that PGE is not financially healthy or secure with this capital structure. In fact, when ScottishPower applied to exercise influence over PacifiCorp in 1999, the Commission approved a merger condition allowing PacifiCorp to send dividends to ScottishPower so long as PacifiCorp's equity remained at or above 35 percent. The threshold today is 39 percent.[10] Despite the absence of any need to

[10] Condition 6 of the Stipulation in the ScottishPower/PacifiCorp merger requires that PacifiCorp maintain the following minimum equity levels:

After December 31, 1999: 35%
After December 31, 2000: 36%
After December 31, 2001: 37%
After December 31, 2002: 38%
After December 31, 2003: 39%

> After December 31, 2004, PacifiCorp shall not make any distribution to ScottishPower that will reduce PacifiCorp's common equity below 40 percent of total PacifiCorp capital without Commission approval. The Commission Staff and PacifiCorp may reexamine this minimum common equity percentage as financial conditions or accounting standards change, and may request that it be adjusted.

In the Matter of the Application of ScottishPower plc and PacifiCorp for an Order Authorizing ScottishPower plc to Exercise Substantial Influence Over the Policies and Actions of PacifiCorp, UM 918, Order No. 99-00616 (Oct. 6, 1999) (Appendix – Stipulation 5, pg. 6).

1 change the capital structure portion of the Enron ring-fencing conditions to protect the
2 financial health of PGE, and despite Staff's own recommendation that the common
3 equity floor be set at 48 percent,[11] Staff's proposed conditions would effectively raise the
4 threshold for dividends to a number *above* 48 percent.

5 **Q. How does Staff's proposal raise the threshold for dividends?**

6 A. As described by PGE's Chief Financial Officer, Jim Piro, PGE regularly uses revolvers to
7 fund short-term working capital needs.[12] The balances on these revolvers can vary
8 significantly over short periods of time and are not treated as long-term debt under
9 GAAP. For these reasons, revolver balances appropriately were *not* included in the
10 definition of debt in the Enron ring-fencing conditions. Staff is proposing to artificially
11 alter PGE's actual capital structure requirements by including such balances in the
12 definition of long-term debt and thereby further limiting the amount of dividends PGE
13 can send to Oregon Electric. It is difficult to overstate the importance of this point. The
14 inclusion of revolver balances in the calculation of long-term debt will unduly limit the
15 company's flexibility to respond to market conditions and may deter PGE from utilizing
16 its most cost-effective financing options. This change is proposed by Staff despite the
17 fact that there has been no evidence to suggest that the existing ring-fencing provision has
18 not been sufficient to protect PGE's financial health.

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24 [11] Staff/900, Morgan/14.

25 [12] PGE/400, Piro/*.

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1 **Q. Why has Staff sought to include unsecured revolver balances in excess of $150**
2 **million in the definition of long-term debt?**
3 A. Though Staff's testimony does not provide an explicit reason for this proposal, I believe
4 this condition may have been intended to restrict PGE's ability to incur unsecured
5 revolver debt in an amount in excess of its present unsecured revolver of $150 million.
6 **Q. Why has Oregon Electric agreed to include unsecured revolver balances in excess of**
7 **$250 million in the definition of long-term debt?**
8 A. Even absent this transaction, PGE plans to increase its revolver to $250 million, which is
9 more in line with the capacity it has had in the past.[13] To that end, Oregon Electric is
10 willing to agree to include balances above $250 million on its unsecured revolvers in the
11 calculation of long-term debt. While we disagree with the fundamental principle of
12 including ***any*** revolver balance in the definition of long-term debt, Oregon Electric is
13 willing, nonetheless, to in effect set a "ceiling" on the level of revolver balances.
14 However, this condition must stand the test of time, and it is difficult sitting here today to
15 predict what working capital needs PGE may have in the future. Considering the volatile
16 nature of power markets and the potential need to build additional generation resources, it
17 is important that this condition provide sufficient flexibility to PGE and Oregon Electric
18 over the long term.
19 **Q. Why have you not proposed to include any balances on secured revolvers in the**
20 **definition of debt?**
21 A. As Mr. Piro testifies, PGE does not currently have a secured revolver. Because a secured
22 revolver is backed by first mortgage bonds, PGE must seek Commission approval before
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[13] PGE has in recent years had a lower revolver because of the high cash balance it has maintained as a result of Enron not taking a dividend over the same period of time. *See* PGE/400, Piro/*. As Robert Bingham discusses in his rebuttal testimony, approximately $240 million of dividends will be paid out of PGE regardless of whether the Proposed Transaction is approved. Enron/2, Bingham/3.

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one may be issued. Given that the reasons PGE might seek a secured revolver are unknown at this time, we believe that the question as to whether balances should be included in long-term debt should be reserved until all the relevant information is known (*i.e.*, at the time the Commission's approval is sought).[14]

Q. Can you explain why the "reasonable expectation" language in Staff's proposed ring-fencing condition is unacceptable to Oregon Electric?

A. The phrase "could reasonably be expected to" is vague and unavoidably subjective. In business, we must deal with specific and predictable expectations. Reasonable business people evaluating a proposed dividend under Staff's proposed condition would very likely differ in their application of this "reasonable expectation" standard and would have no precedent to apply to determine its meaning. GAAP on the other hand is used throughout the business world. PGE uses these principles in its accounting, as do almost all other large businesses in the United States. Accountants can be called upon to interpret and apply these principles and their recommendations can be checked against a large, public body of precedent. In effect, Staff proposes to create a new, untested, and highly subjective standard to govern PGE's distributions to Oregon Electric, while Oregon Electric proposes using a known and predictable set of independent accounting principles.

III. STAFF AND INTERVENORS' ADDITIONAL FINANCIAL CONDITIONS ARE NOT NECESSARY TO PROTECT PGE AND ITS CUSTOMERS

Q. Has Staff recommended any additional financial conditions?

A. Yes. Staff has recommended a set of conditions designed to regulate Oregon Electric's finances in order to ensure that Oregon Electric's debt is paid down as quickly as

[14] *See* PGE/400, Piro/*.

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possible. Unfortunately, the conditions proposed by Staff impose unnecessary constraints upon Oregon Electric's ability to run its business and manage its affairs while offering no meaningful protections to PGE customers beyond those provided by the conditions to which Oregon Electric has agreed.

Q. Why do you say these conditions offer no meaningful protection to PGE's customers?

A. As I explained in my rebuttal testimony, Staff's concerns with regard to the potential effects of the level of debt at the holding company on PGE can be reduced to two financial issues: the potential for increased financing costs and risk of default. As I demonstrated in my rebuttal testimony, any effect the Proposed Transaction may have on financing costs would likely be immaterial.[15] Even if the Proposed Transaction were to increase PGE's financing costs, however, Oregon Electric has already guaranteed that the customers of PGE shall be held harmless and such increases would not be recovered in PGE's revenue requirement. Thus, this concern has been addressed and the potential risk mitigated. There is no reason to impose any additional financial conditions to address this concern.

With respect to the risk of default, I note that Staff witness Morgan agrees that the prolonged period of depressed earnings that would be required before such a risk presented itself is "highly unlikely."[16] Mr. Morgan further opines that although the risk of default itself is "small" he believes it needs to be addressed.[17] With regard to this concern, I would emphasize that the ring-fencing provisions Oregon Electric has agreed

[15] Oregon Electric/200, Wheeler/15-16.

[16] Staff/900, Morgan/13.

[17] Staff/900, Morgan/9.

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1 to adopt will prevent events at Oregon Electric from affecting PGE, just as they have very
2 effectively insulated PGE from Enron's bankruptcy.

3 **Q. Even if these risks are remote or fully addressed by existing ring-fencing, why**
4 **wouldn't it benefit PGE and its customers to regulate Oregon Electric and make it a**
5 **"less risky" proposition?**

6 A. This appears to be the intent of Staff's proposed financial conditions. Mr. Morgan states,

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8
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> The Commission should not allow the holding company of a rate-regulated public utility to risk harm to the utility and its customers by embracing a long-term leveraged structure. A highly leveraged structure, over time, is not in the best interests of PGE....[18]

10 Thus, even if the actual risks that accompany that leverage are mitigated, it appears that
11 Staff would still seek to reduce leverage at Oregon Electric based on the apparent belief
12 that leverage itself is a risk.

13 The problem with this approach is that it does not benefit PGE's customers or
14 reflect prudent business practice. While there may be a remote risk that Oregon Electric
15 might default on its obligations, it is neither necessary nor advisable to structure business
16 transactions to completely eliminate such remote risks.[19] As a practical matter, it would
17 be virtually impossible to structure financing to protect against every remote contingency,
18 and the costs associated with adopting such a "bullet-proof" business model would be
19 unacceptable. In particular, such financing would likely be cost prohibitive, could restrict
20 growth opportunities, and ultimately would likely discourage further investment. Most
21 importantly, however, while default or bankruptcy is certainly not an acceptable or even
22 remotely envisioned outcome to anyone at Oregon Electric, if such an event did occur,

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[18] Staff/900, Morgan/10.

[19] Dr. McDermott addresses the manner in which "remote" risks should be treated under the net benefits test. *See* Oregon Electric/700, McDermott/*.

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the existing ring-fencing would ensure that PGE's customers were not harmed by that bankruptcy.[20]

Q. Does Oregon Electric intend to use dividends to pay down debt?

A. Yes. Oregon Electric's intent has always been to use distributions from PGE to pay down debt at Oregon Electric. In recognition of this fact, Oregon Electric has agreed to the following "cash sweep" condition:

> *25. After closing, each PGE distribution to Oregon Electric will be used by Oregon Electric exclusively to pay operating expenses and debt service until all of the following conditions are met:*
>
> *a. The rolling 12-month average of the committed and drawn balances of all PGE's Unsecured Revolvers is less than $250 million; and*
>
> *b. Oregon Electric has paid down at least $250 million of its outstanding debt as compared to the level of outstanding debt at closing (no portion of the proposed "catch-up dividend" that will be paid at closing will be considered to have paid down debt).*

This condition should assure the Commission that PGE's and Oregon Electric's overall financial structure will be strengthened over time.

Q. Was there a "cash sweep" provision in the Enron merger?

A. No. In the Enron merger, Staff made no attempt to regulate finances at the parent company and Enron did not volunteer to any such condition.

Q. Has Staff agreed to Oregon Electric's "cash-sweep" condition?

A. No. Staff has proposed the following "cash sweep" provision instead:[21]

> *25. Each PGE distribution to OEUC will be used by OEUC exclusively to pay direct operating expenses and debt service*

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[20] *See* Oregon Electric/800, Bussel/4-8 (regarding the unlikelihood of involuntary consolidation in the event of a bankruptcy at Oregon Electric).

[21] ICNU also proposes a cash sweep provision. *See* ICNU/301, Schoenbeck/3 (Condition 11).

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> *for at least five years and until all of the following conditions are met:*
>
> *a. The sum of the drawn balances of all PGE's Secured Revolvers is zero and there has not been a balance for three months; and*
>
> *b. OEUC has paid down at least $250 million of its outstanding debt as compared to the level of outstanding debt at closing including the catch-up dividend from PGE.*
>
> *Direct operating expenses are expenses that were incurred from services, supplies or assets provided by OEUC personnel directly and are not based on any type of allocation from an affiliate (parent or subsidiary).*

Q. Does Oregon Electric object to Staff's proposed "cash sweep" condition?

A. Yes. Oregon Electric has every incentive to devote cash flow to pay down debt at Oregon Electric rather than to incur excess operating expenses. To that end, Oregon Electric will be a very "lean" company with few employees. However, to the extent that it requires legal, financial, accounting, and other general business advice, it may need to acquire those services from outside of the company. Staff's proposed definition of "direct operating services" within the cash sweep provision would not allow Oregon Electric to contract for services its own personnel could not efficiently provide.

Staff's proposal would also prevent dividends from Oregon Electric to its shareholders unless and until there are no balances under any secured revolvers at PGE. I disagree with Mr. Morgan's assertion that PGE would only seek a secured revolver in the face of "weak financial performance."[22] There are circumstances under which PGE might seek permission to open a secured revolver that would not indicate financial difficulties at PGE. In addition, as I discussed earlier, the Commission has the full

[22] Staff/900, Morgan/22.

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authority and discretion to approve any secured revolver and can condition its approval on any conditions it may deem necessary at the time.

Finally, Oregon Electric's proposed condition is effective "after close" of the transaction to allow for payment of the purchase price and transaction fees associated with the transaction and the financing, all of which will be paid "at close" of the transaction. For the same reason, the "after close" language is included in Oregon Electric's proposed condition regarding allocation of costs discussed below.

Q. Why is Oregon Electric's proposed cash sweep condition preferable to Staff's?

A. Oregon Electric's proposed condition would achieve the result Staff is intending – *i.e.*, it will make concrete Oregon Electric's promise to use distributions from PGE to pay down debt – while not unduly limiting PGE's ability to take advantage of least-cost financing opportunities and use its revolvers to pay for necessary services.

Q. Please describe Staff's proposed condition with regard to re-leveraging debt at Oregon Electric.

A. Staff's proposed condition would prohibit re-leveraging as follows:[23]

> *27. OEUC shall not re-leverage, i.e., increase the amount of its outstanding long-term debt once it has been liquidated, if the increased debt would, or could reasonably be expected to, bring the consolidated capital structure below 40% common equity. The capital structure calculations refer to the OPUC policy that does not include short-term debt capital.*

Q. Did Enron agree to such a condition?

A. No. None of the electric utility mergers approved by the Commission had a "re-leverage" condition.

Q. Is Oregon Electric willing to agree to a re-leverage condition?

A. Yes. Oregon Electric proposes the following re-leverage condition:

[23] ICNU proposes a similar re-leverage condition. *See* ICNU/301, Schoenbeck/3 (Condition 12).

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> *27. Oregon Electric shall not re-leverage, i.e., increase the amount of its outstanding long-term debt once such debt has been liquidated, if the increased debt would, as determined in accordance with GAAP, bring the consolidated capital structure (excluding short-term debt) below 30% equity.*

Q. Why does Oregon Electric object to Staff's proposed prohibition on re-leveraging?

A. As I discussed previously, Staff's proposed prohibition on re-leveraging at Oregon Electric seems to reflect a belief that leverage itself, rather than the potential effects of that leverage, is a risk that needs to be mitigated. While I do not believe such a condition is necessary to protect PGE's customers, Oregon Electric would nonetheless agree to such a condition, provided the limit on re-leveraging will not have an unnecessarily negative effect on Oregon Electric.

Q. What detrimental effects could Staff's proposed condition have?

A. Staff's proposed condition would have several detrimental effects. First, the market could evolve such that it is financially advantageous to re-leverage below 40 percent. With the hold harmless provision and minimum equity provisions in place, Oregon Electric could do so without adversely affecting PGE, yet Staff's proposal would prevent this. Denying Oregon Electric the ability to re-leverage could therefore result in unnecessary financial harm to Oregon Electric.

There are also circumstances in which it would be appropriate for Oregon Electric to send a dividend to its members. At some point down the road, Oregon Electric will need to provide a return to its shareholders. In order to do so, Oregon Electric could conduct an initial public offering ("IPO") or it could sell PGE. However, another way for Oregon Electric to provide a return to its shareholders would be to take on some debt that had previously been paid down and use that capital to provide a dividend. With the hold harmless condition in place, customers would not be affected by such actions. If the re-leverage condition proposed by Staff is adopted, however, Oregon Electric would have

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less flexibility to utilize prudent debt capacity to fund a dividend to its shareholders. This condition would actually put additional pressure on Oregon Electric to divest its interest in PGE, rather than giving it the flexibility to hold its investment for a longer period of time. Moreover, should these circumstances arise during a period of unfavorable market conditions, Oregon Electric could be financially harmed by the pressure to divest its investment in PGE.

Q. Please describe Staff's proposed condition regarding allocation of costs or direct billing of Oregon Electric.

A. Staff's proposed condition states:[24]

> 28. *TPG Applicants will not allocate or direct bill OEUC for any goods, services, supplies or assets until condition number 25 (cash sweep provision) has been satisfied.*

Q. Did Enron agree to such a condition?

A. No.

Q. Is Oregon Electric willing to agree to a condition regarding allocation of costs or direct billing of Oregon Electric?

A. Yes. Oregon Electric's proposed condition is as follows:

> 28. *After closing, the TPG entities will not allocate or direct bill Oregon Electric for any goods, services, supplies or assets in excess of $5 million per year.*

Q. Why does Oregon Electric object to Staff's proposed condition?

A. TPG may charge Oregon Electric for ongoing monitoring and advice, just as it does for many of its portfolio company investments. It is a common and accepted practice for investors to charge their portfolio companies for the expense of monitoring the investment and providing advice. These charges will not unduly burden Oregon Electric,

[24] ICNU proposes a similar condition. *See* ICNU/301, Schoenbeck/3 (Condition 12).

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1 and Oregon Electric is willing to cap the amount that TPG would charge to Oregon
2 Electric no more than $5 million per year.

3 **Q. ICNU witnesses John Antonuk and Randall Vickroy continue to voice concerns**
4 **regarding the level of protection afforded PGE given what is, in their view, the risk**
5 **of bankruptcy consolidation. Can you respond?**

6 A. Yes. I would direct Messrs. Antonuk and Vickroy to the testimony of Professor Dan
7 Bussel, who explains that there is no material risk of substantive consolidation in the
8 unlikely event that Oregon Electric becomes involved in a bankruptcy proceeding.[25]

9 **Q. Messrs. Antonuk and Vickroy propose that, as conditions of this transaction,**
10 **Oregon Electric should obtain various covenants from its lenders that would**
11 **prohibit them from seeking consolidation. They assert that obtaining these**
12 **covenants should not be a problem if the risk of consolidation is truly negligible.**
13 **Can Oregon Electric agree to these conditions?**

14 A. No. Apart from the fact that these conditions are unnecessary given the protections to
15 which Oregon Electric has agreed and the extreme unlikelihood of consolidation, Oregon
16 Electric cannot make a commitment with regard to a financing condition to which lenders
17 may not agree. As the final set of financing conditions will be based on negotiations with
18 multiple lenders, Oregon Electric cannot predict whether lenders would find such a
19 condition acceptable. I have been advised that the proposed conditions are not generally
20 found in "standard form" financing documentation upon which banks typically rely,
21 notwithstanding the fact that we believe the risks of consolidation are limited.

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25 [25] *See* Oregon Electric/800, Bussel/4.

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Q. You have discussed in this testimony the possibility of an IPO at some point in the future. Would any of the financial conditions you have discussed here change if such an event were to take place?

A. Yes. Under the terms of the package of conditions to approval Oregon Electric has proposed, in the event of an IPO the cash flow sweep provision and the re-leverage condition would cease to be in effect.

Q. Why does Oregon Electric propose that these conditions cease to be in effect in the event of an IPO?

A. In the event of an IPO, the publicly-traded entity would become subject to rigorous public reporting and disclosure requirements and oversight by the Securities and Exchange Commission ("SEC"). Such oversight, along with the scrutiny of public shareholders, obviates the need for these conditions. Furthermore, it may be problematic for Oregon Electric to conduct an IPO with such conditions in place. For example, the cash flow sweep provision could inhibit the ability to put a consistent dividend policy into place, which would be important to shareholders of a publicly-traded company. I would point out that none of the publicly-traded parents of utilities in Oregon are subject to a cash flow sweep or re-leverage condition.

Q. Are there any other conditions to which Oregon Electric has agreed that will cease to be in effect in the event of an IPO?

A. Yes, in such an event, Conditions 31 and 32 described in Mr. Davis' sur-surrebuttal testimony[26] would also cease to be in effect. With respect to Condition 31, the type of ownership information addressed in this condition would be required to be disclosed under federal law after an IPO. Condition 32 requires Oregon Electric to provide SEC-

[26] *See* Oregon Electric/500, Davis/*.

1 style reports that would clearly be unnecessary in the event that actual SEC reporting was
2 required.

3 **Q. Has Oregon Electric proposed any other conditions that provide additional**
4 **protection beyond that included in the Enron merger?**

5 A. Yes. Oregon Electric proposes the following condition:

6–9
> *33. Until the total long-term debt at Oregon Electric is less than 70% of total capital, Oregon Electric, PGE, and any of their respective subsidiaries shall not, without the prior notice to the Commission, directly or indirectly acquire, incorporate, or otherwise organize any subsidiary, or enter into substantially new lines of business, which were not in existence as of January 1, 2005.*

10 This condition ensures that the Commission will have adequate notice of any
11 actions taken by Oregon Electric, PGE, and related subsidiaries to establish substantially
12 new lines of business. However, unlike a similar condition proposed by Staff, Oregon
13 Electric's proposed condition will not unnecessarily or unduly restrict Oregon Electric's
14 and PGE's ability to respond to evolving business opportunities.

15 **Q. Does this conclude your testimony?**

16 A. Yes.

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3 **BEFORE THE PUBLIC UTILITY COMMISSION**
4 **OF OREGON**
5 **UM 1121**
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7 In the Matter of
8 OREGON ELECTRIC UTILITY COMPANY, LLC,
9 et al.,
10 Application for Authorization to Acquire Portland General Electric Company
11
12
13
14 **SUR-SURREBUTTAL TESTIMONY**
15 **OF**
16 **KARL A. McDERMOTT**
17 **ON BEHALF OF OREGON ELECTRIC**
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21 **October 11, 2004**
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1 ## I. INTRODUCTION

2 **Q. Please state your name.**

3 A. My name is Karl A. McDermott.

4 **Q. Are you the same Karl A. McDermott that filed direct and rebuttal testimony in this**
5 **proceeding?**

6 A. Yes.

7 **Q. What is the purpose of your sur-surrebuttal testimony?**

8 A. The purpose of my sur-surrebuttal testimony is to respond to certain aspects of the
9 surrebuttal testimony filed by the Staff (the "Staff") of the Public Utility Commission of
10 Oregon (the "Commission" or "Oregon Commission") and other intervenors in this
11 docket.

12 **Q. Please summarize your sur-surrebuttal testimony.**

13 A. Staff and intervenors have raised concerns about Oregon Electric's[1] profit motives, cost-
14 cutting incentives, and the ability of the regulatory structure to protect PGE and its
15 customers from what they believe to be a unique transaction and a unique owner. In fact,
16 the concerns and risks they posit are common to all utility owners. The regulatory
17 system, taken as a whole, has worked for decades to ensure adequate investment and
18 deter imprudent conduct, and it is my opinion that it will continue to do so if the
19 Proposed Transaction is approved. Moreover, I understand that Oregon Electric has
20 agreed to enhance the existing regulatory system and provide regulators with additional
21 authority to monitor and investigate PGE's capital and operations and maintenance
22 ("O&M") budgets. Given all of the tools that the Commission has and will have to
23 regulate PGE and Oregon Electric, I have every confidence that the utility, and in turn its
24 customers, will be protected from risks that may be posed by the Proposed Transaction.

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[1] Throughout this testimony, I will use "Oregon Electric" to refer to Oregon Electric Utility Company, LLC, or to all Applicants, as the context may imply.

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1 Finally, my conclusion remains that the Proposed Transaction will result in net benefits to
2 PGE's customers and will not harm the public at large.

3 **II. REGULATION WORKS TO PROTECT CUSTOMERS**

4 **Q. Several parties continue to raise concerns about Oregon Electric's potential to**
5 **engage in inappropriate cost cutting or to under-invest in PGE if the Proposed**
6 **Transaction is approved. Please summarize your response to these allegations.**

7 A. The regulatory system provides powerful incentives to prevent utilities from engaging in
8 imprudent cost cutting and making inadequate capital expenditures. As I discussed in my
9 rebuttal testimony, customers are protected by the ability of regulators to use all the tools
10 in their toolbox to encourage utilities to make adequate investments and maintain service
11 quality standards. Moreover, the regulatory system is enhanced by business incentives
12 that keep the interests of customers and investors in alignment. If you review the history
13 of utilities over time, you will find that regulation provides powerful checks and balances
14 that are more than capable of protecting customers and examples to the contrary are the
15 exceptions that prove the rule.

16 This is not to suggest that the regulatory system is perfect. Regulators cannot
17 prevent utilities – investor-owned, publicly-traded, or municipally-owned – from making
18 honest mistakes. Moreover, while it may be possible to find rogue utilities or bad actors
19 that temporarily ignore regulatory incentives and the consequences of imprudent conduct,
20 these are the exception, not the rule. And as CUB has pointed out, the regulatory
21 structure cannot always anticipate events that, when viewed in retrospect, render utility
22 decisions problematic.

23 However, this imperfection is not a risk unique to the Proposed Transaction. Staff
24 and intervenors have provided no evidence to show that TPG or Oregon Electric has bad
25 intentions toward PGE and its customers or even a history of making imprudent cost cuts

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1 or insufficient capital expenditures.[2] On the contrary, the evidence supports the
2 conclusion that Oregon Electric will be motivated to seek efficiencies that contribute to
3 the overall health of the company. Moreover, I understand that Oregon Electric has
4 agreed to several conditions that enhance the Commission's existing regulatory authority
5 and ensure greater oversight of PGE's operations and O&M and capital expenditure
6 budgets. Finally, the parties have agreed to the imposition of service quality measures
7 ("SQMs") that enhance the Commission's existing authority to review the results of
8 PGE's actions. I believe that the Commission will be able to use these regulatory tools to
9 effectively protect PGE's customers.

10 **Q. Some intervenors continue to argue that a serious risk of the Proposed Transaction**
11 **is the possibility that Oregon Electric will engage in short-sighted cost cutting or will**
12 **fail to make necessary investments, and that there is inadequate protection against**
13 **these risks.[3] Do you contend that the regulatory system can deter this type of**
14 **behavior?**

15 A. Yes. The Commission has a wide variety of tools it can use to protect customers from
16 imprudent cost cutting or under-investing. In previous testimony, I described some of
17 these tools, including ratemaking and investigation. I want to stress, however, that the
18 system of regulation must be viewed as a whole. None of the individual regulatory tools
19 is sufficient in itself to ensure utility compliance or protect customers. Rather, it is as a
20 comprehensive system that regulatory incentives provide effective protection for
21 customers.
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[2] *See* Oregon Electric/500, Davis/*.

[3] *See* ICNU/400, Antonuk-Vickroy/13, 17; CUB/300, Jenks-Brown/2, 5, 6-19.

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1 **Q. CUB pointed in its surrebuttal testimony to specific ways that regulatory tools such**
2 **as ratemaking and investigation are limited in their ability to prevent under-**
3 **investment.[4] How do you respond?**

4 A. CUB points to specific limitations of some of the Commission's regulatory tools as
5 support for its position that the system as a whole is flawed. I would agree that
6 investigatory budgets are limited and that ratemaking by itself cannot force utilities to
7 spend money. These examples, however, fail to prove CUB's point. While investigation
8 *by itself* cannot ensure compliance and ratemaking *by itself* cannot ensure adequate
9 investment, when used together these and the other regulatory tools are extremely
10 effective. In any event, the purpose of this process (*i.e.*, the process under ORS 757.511)
11 is not to redesign the regulatory paradigm. The purpose is to evaluate the Proposed
12 Transaction in the context of the existing regulatory framework.

13 **Q. Does CUB give any specific examples of instances in which the regulatory structure**
14 **failed to prevent overly aggressive cost cutting or inadequate investment in**
15 **infrastructure and maintenance?**

16 A. CUB references service quality and reliability problems experienced by Commonwealth
17 Edison ("ComEd") (an Illinois electric utility) and U S West (a western-region
18 telecommunications utility) as evidence that regulation cannot deter this type of behavior.
19 From the outset, I found this testimony puzzling because, on the one hand, CUB goes to
20 great lengths to argue that because Oregon Electric will be a "short-term owner" with
21 "perverse incentives" to cut costs, regulation will be unable to protect PGE's customers.[5]
22 Yet on the other hand, CUB attempts to prove this point by demonstrating how the

23 [4] *See* CUB/300, Jenks-Brown/11-19.

24 [5] *See* CUB/300, Jenks-Brown/25. "The regulatory structure...was neither envisioned nor intended...to counter the incentives of a short-term owner." CUB/300, Jenks-Brown/2. "The incentives for a short-term owner that
25 compel drastic cuts in the short-term and forestall long-term investment are real.... No matter what TPG's remarkably self-interested and shameless testimony says to the contrary." CUB/300, Jenks-Brown/25.

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1 regulatory system itself is the problem, not the time frame of the owner. Notably, the
2 utilities CUB points to in support of its position were either publicly held or a subsidiary
3 of a publicly-held corporation[6]—not "short-term" owners under CUB's terminology.[7]
4 While these examples show that regulation cannot always prevent undesirable outcomes,
5 I strongly disagree that they show regulation cannot protect customers from imprudent
6 cost cutting. Moreover, in the case of ComEd, the facts actually demonstrate how
7 regulation *does* work to protect customers.

8 **Q. Can you start by providing us with some background on the ComEd case?**

9 A. Certainly. In late summer 1999, ComEd and its customers experienced a series of service
10 interruptions that prompted the Illinois Commerce Commission (the "ICC") to initiate a
11 thorough investigation of ComEd's transmission and distribution system design and
12 reliability. The investigation took place in several stages from late fall 1999 to fall 2000.
13 The ICC also requested that ComEd complete a management review and assessment of
14 its transmission and distribution systems. (I note that ComEd had already instituted such
15 a review prior to the ICC's request.)

16 In 2001, the ICC commissioned an audit to determine the cost impacts of
17 ComEd's system upgrades, particularly those costs related to the 1999 blackouts and the
18 investigatory reports that followed.[8] This audit was presented in a 2001 rate case for
19 ComEd's unbundled distribution service for the specific purpose of determining whether
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22 [6] Prior to the merger with Qwest in 1999, U S West was a publicly traded company. ComEd is a subsidiary of Exelon Corporation, which is also publicly traded.

23 [7] I understand CUB's term "short-term owner" to apply to a situation where an investor like TPG has a limited time frame in which it can hold its investment. CUB does not appear to apply this term to a publicly-traded
24 company, which is one of its preferred outcomes for PGE.

25 [8] *See* Illinois Commerce Commission, Petition for Investigation and Audit of certain distribution system investments and other expenditures by Commonwealth Edison Company, Docket No. 01-0664, Order (Feb. 6, 2002) (courtesy copies available upon request).

1 ComEd was imprudent in its management and investment procedures related to its
2 regulated rate base and operating expenses.

3 **Q. How did you become involved with this case?**

4 A. I became involved as an expert witness in the rate case. I testified regarding the
5 appropriate standards for a prudence review. I was a Commissioner on the ICC from
6 1992 to May 1998, but I was not on the ICC when ComEd experienced the blackouts in
7 1999 or when the ICC initiated these various proceedings in the course of its oversight of
8 ComEd's transmission and distribution system.

9 **Q. Based on your participation in the rate case, do you agree with CUB's assertion that**
10 **ComEd failed to invest prudently in its transmission and distribution system?**

11 A. No, I do not. Though it became evident in retrospect that ComEd needed to invest to
12 improve and update its transmission and distribution system, the facts do not show that
13 the reliability problems were caused by an imprudent failure to invest on the part of the
14 utility.

15 **Q. What did the ICC conclude about ComEd's capital expenditures?**

16 A. The ICC found that ComEd had acted prudently. The ICC's opinion on the prudence of
17 ComEd's capital spending patterns in this time frame follows:

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> [T]he evidence, nonetheless, does not show that ComEd should have constructed $270 million of its 1999-2000 distribution capital additions in 1993-1998 and that it was imprudent not to have done so.... [T]he testimony...shows that ComEd applied reasonable distribution design criteria during those years to identify those projects that should be constructed, and those criteria did not call for the construction of any of the $270 million of projects...[to] be moved back in time.... [T]he evidence is not sufficient to overcome ComEd's showing that the distribution capital investment decisions made by ComEd in 1993-1998 were reasonable taking into account the facts that were available at the time.[9]

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[9] Illinois Commerce Commission, Petition for approval of delivery services tariffs and tariff revisions and of residential delivery services implementation plan and for approval of certain other amendments and additions to its rates, terms and conditions, Docket No. 01-0423, Final Order (Mar. 28, 2003), at 66 (courtesy copies available upon request).

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Thus, while ComEd may have experienced service quality problems and concluded that it needed to make additional capital investments to address those problems, this does not mean that the utility had acted imprudently.

Q. CUB refers to testimony you gave in the ComEd case and concludes that you argued that "[the ICC] cannot correct for continual under-investment, even after the under-investment has taken its toll on customers and the utility system."[10] Is this an accurate summary of your testimony?

A. Absolutely not. This statement seriously mischaracterizes my opinion on the prudence standard. In the testimony to which CUB refers, I stated "20/20 hindsight is inappropriate. The inquiry should be whether the decisions at the time they were made were reasonable under the circumstances, not based on hindsight."[11] CUB appears to confuse the central point of my testimony. While "20/20 hindsight" – an analysis based on facts as they are now known to be true – cannot be used in a prudence review, that does not prevent a regulator from reviewing the actions of a utility at the time investment decisions were made. If those investments were inappropriate *given the facts known at the time*, then the regulator is certainly empowered to disallow costs. Regulators must look retroactively to review actions taken in the past. CUB's mistake appears to be confusing this truism with the prohibition against using a prudence review to review the "*consequences* of the cost cutting."[12]

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[10] CUB/300, Jenks-Brown/15.

[11] *See* CUB/300, Jenks-Brown/14, citing CUB Exhibit 320.

[12] CUB/300, Jenks-Brown/15 (emphasis added).

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1 **Q. CUB suggests that ratemaking is "a terrible tool for preventing long term under-**
2 **investment" because 20/20 hindsight is inappropriate in a prudence review.[13] Do**
3 **you agree?**
4 A. No, I simply do not see the connection CUB makes between the prohibition on the use of
5 20/20 hindsight and ensuring adequate capital investment. Prudence reviews provide
6 significant incentives for a utility to make adequate and necessary capital investments. If
7 utilities fail to make prudent investments, they can be held responsible for such
8 irresponsible decisions by cost disallowances. Utility managers know they will be held to
9 this standard and must plan accordingly. If managers were to knowingly operate in any
10 other fashion they would be shirking their fiduciary responsibility to the utility's owners,
11 whether those owners were a concentrated group or a set of disperse shareholders.
12 **Q. What do you conclude from CUB's discussion of ComEd?**
13 A. I have had a difficult time determining what CUB thinks the ComEd case demonstrates.
14 The case does not support an assertion that regulation cannot provide sufficient incentives
15 to encourage utilities to invest prudently, because the ICC found that ComEd *did* invest
16 prudently. If CUB's point is that regulation is not omnipotent and cannot keep utilities
17 from making mistakes, then CUB is correct. However, I fail to see what relevance this
18 has to CUB's belief that Oregon Electric will have improper motives or incentives to
19 imprudently cut costs or under-invest.
20 **Q. You said earlier that the ComEd case actually demonstrated how regulation works**
21 **to protect customers. Can you explain?**
22 A. Yes. In 1999, ComEd's customers experienced service quality problems. Those
23 problems prompted the utility and the ICC to conduct investigations into the overall
24 adequacy and safety of its transmission and distribution system. As a result of those
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[13] CUB/300, Jenks-Brown/15.

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1 investigations, the utility determined that it needed to invest capital to overhaul its
2 transmission and distribution system. Without the ICC issuing any orders or making any
3 direct findings, new capital expenditures were made and service quality improved. After
4 an audit and ratemaking proceeding, the ICC examined all relevant facts and concluded,
5 in light of the facts available to ComEd at the time, the utility had acted prudently and
6 that its capital expenditures over the past had been reasonable. This says to me that the
7 regulatory structure worked.

8 **Q. Do you have any observations with regard to CUB's testimony concerning the**
9 **U S West situation in Oregon?**

10 A. Yes, although I will point out that I have not engaged in a specific study of the facts and
11 circumstances relevant to the U S West case. Moreover, I would suggest that
12 telecommunications and electric utilities exist under entirely separate and distinct systems
13 of regulation, so using the events at a telecom utility to predict what will happen at an
14 electric utility is a fundamentally flawed proposition.

15 However, as in the ComEd case, a key aspect of the U S West story is not whether
16 regulators could prevent it, but how they were able to fix it. After service quality
17 problems surfaced in 1998-99, the Commission worked with the Oregon legislature to
18 give regulators authority to directly fine telecom utilities for violations of SQMs.[14] Since
19 the enactment of SB 622, the bill that gives regulators direct fining authority, U S West
20 (now Qwest) engaged in a significant turnaround that has included updating its network,
21 improving service quality, and paying serious penalties along the way.[15] Rather than
22 being evidence that the Commission does not have the power to ensure adequate capital
23 investment, the U S West story illustrates how regulatory incentives can be adapted to

24 [14] Oregon 1999 Session Laws: Ch. 1093, S.B. 622.

25 [15] Oregon Electric/701, McDermott/1-2 (OPUC Press Release, "Qwest Service Quality Penalty $215,000 for 2003," March 2, 2004 (2004-005) (UM 1133)).

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meet specific circumstances, and what a powerful regulatory tool SQMs can be. I would point out that in the instant case, Oregon Electric has agreed to an extension of the SQMs initially established in the Enron/PGE merger. These SQMs, which include mandatory penalties for violations, should go a long way toward addressing CUB's concerns about the inability of regulators to address serious service quality issues such as those that occurred in the U S West case.

Q. Can you point to any examples that call into question CUB's premise that short-term owners will make excessive cost cuts and fail to invest prudently?

A. Yes. Enron purchased PGE in 1997, yet by 1999 Enron had made it clear that it was to be a short-term owner of PGE. Later, Enron experienced financial troubles that are well documented. If any "short-term" owner had an incentive to extract profits from PGE it would have been Enron, yet we have no evidence that this has happened at PGE. In fact, as I noted in my rebuttal testimony, the Commission has continued to effectively regulate PGE since Enron became a so-called "short-term" owner, and the health of PGE has been admirably preserved.[16]

Q. Are there other aspects of the regulatory system that work to protect customers?

A. I would also point to certain "intangible" regulatory tools that provide important incentives for utilities to comply with regulatory charges. One such tool is the importance to utilities of building positive relationships with regulators. As Mr. Jackson stated in his rebuttal testimony, a negative relationship with regulators can expose a utility to higher levels of scrutiny, prudence reviews, and possible financial penalties.[17] I think it is telling that Mr. Jackson, an experienced utility executive, made this point.

[16] Oregon Electric/400, McDermott/9-10.

[17] Oregon Electric/300, Jackson/6-7.

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1 Competent utility managers understand the importance of preserving quality relationships
2 with regulators and staff.

3 **Q. What role do business incentives play in ensuring adequate investment in utility**
4 **systems?**

5 A. Business incentives play an important role in ensuring that customer interests are
6 protected. As Mr. Davis noted in his rebuttal testimony and I noted in my direct
7 testimony, the interests of Oregon Electric and its customers are aligned because Oregon
8 Electric can only prosper and succeed if PGE is a healthy, stable, and responsive utility.[18]
9 This is an extremely powerful incentive and is certainly not unique to a private equity
10 investor. Far from being something to fear or something that makes Oregon Electric
11 more difficult to regulate, this basic business principle ensures that Oregon Electric's
12 actions will seek to maximize customer satisfaction and build the economic strength of
13 PGE and the region as a whole.

14 **Q. Are you aware of any conditions to which Oregon Electric has agreed that could**
15 **provide additional comfort to parties concerned with Oregon Electric's incentives**
16 **for aggressive cost cutting?**

17 A. Yes. In addition to the existing regulatory structure, I understand from Mr. Davis' sur-
18 surrebuttal testimony that Oregon Electric and PGE have agreed to three acquisition
19 conditions that will extend the authority of the Commission with regard to its review of
20 PGE's capital expenditures.[19] *First,* Oregon Electric has agreed to submit, in conjunction
21 with its annual Review of Operations ("RoO"), an O&M expense and capital expenditure
22 update report that will compare actual O&M and capital expenditures for the most recent
23 past year with: (i) the current year's budgeted O&M and capital expenditures; and (ii) the
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[18] Oregon Electric/100, Davis/6-12; Oregon Electric/4, McDermott/13-14.

[19] Oregon Electric/500, Davis/*.

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average of the preceding three calendar years' actual O&M and capital expenditures. *Second,* PGE has agreed to conduct an audit upon request by the Commission, using an independent auditor approved by the Commission, to review the company's O&M and/or capital construction plans and expenditures. *Third,* Oregon Electric has agreed to provide a Transition Plan within one year of closing to allow the Commission to review any potential areas of cost reductions identified by PGE's management and Board of Directors. These conditions provide an added layer of review by the Commission and should give Staff and intervenors comfort that the Commission indeed has the ability to effectively oversee PGE's level of capital investment on a prospective *and* retroactive basis.[20] Should any of these documents raise concerns, the Commission has full statutory authority to conduct further investigation, inspect PGE's books and records, and request any information it deems necessary to fulfill its regulatory duties.[21]

III. PROFIT SEEKING AND UTILITY COST CUTTING

Q. Can you summarize the concerns that have been raised about Oregon Electric's specific cost cutting incentives?

A. CUB appears to be primarily concerned that Oregon Electric has an unusual incentive to make imprudent cost cuts that will exploit an existing weakness in the regulatory system. ICNU suggests that this transaction is "unique" because the investors involved are seeking to purchase PGE "solely for financial gain."[22]

[20] These prospective and forward-looking conditions should also mitigate ICNU's concern that SQMs are lagging indicators. *See* ICNU/400, Antonuk-Vickroy/12, 13.

[21] *See, e.g.,* ORS 757.120(1) (public utilities required to keep and render to the Commission uniform accounts of all business transacted); ORS 757.135(3) (Commission may examine and audit any account); ORS 756.040(2) (general authority to do all things necessary to supervise and regulate every public utility); ORS 756.070 (Commission has the right to obtain from any public utility all necessary information to enable the Commission to perform its duties); ORS 756.075(2) (right to inspect the books, accounts, papers, records and memoranda of any public utility).

[22] ICNU/300, Schoenbeck/8.

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Q. Can you summarize your response to these assertions?

A. I disagree with both parties. All investor-owned utilities seek to operate the utility for financial gain. It would be naïve in the extreme to believe that public stockholders or long-term investors have a different motive. I certainly do not agree that Oregon Electric or its investors are uniquely motivated to make imprudent cost cuts at Oregon Electric.

Q. ICNU argues that this transaction is different because the investors are seeking returns "far in excess" of normal "utility-type" returns.[23] How do you respond?

A. My problem with this argument is that if the Proposed Transaction is approved, PGE will continue to operate just as it always has—it will seek to provide quality electric service while earning its regulated return on equity. What happens at the holding company level, *i.e.*, whatever profits Oregon Electric makes or hopes to make, is immaterial to PGE's operation. This, of course, is the entire purpose of ring-fencing—ensuring that the cost of serving the utility's customers is divorced from actions taken by the holding company. I will discuss this issue in more detail in Section IV, below.

Q. Do you believe Oregon Electric would be uniquely motivated, as a limited-term owner, to seek to cut costs at PGE?

A. No, I do not. Utilities always have an incentive to cut costs between rate cases to either maintain their earnings levels or to increase earnings.[24] Regulators around the country often encourage utilities to cut costs through the use of alternative regulatory plans. Interestingly, the drive to cut costs may be particularly evident in a publicly-traded utility, where diverse investors are concerned about their stock's value on a day-to-day basis. Whereas a private investor like TPG is concerned with the utility's ability to perform and increase in value over time, and TPG's investors do not expect to see returns

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[23] ICNU/400, Antonuk-Vickroy/12, 13.

[24] PGE/400, Piro/*.

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for years, Wall Street and public investors ensure a constant and unrelenting pressure to drive up stock prices for publicly-traded companies. I find it curious that a publicly-traded utility is a preferred outcome for so many intervenors when publicly-traded stock can be bought and sold with no Commission oversight and public investors may lack the long-range business incentive to build value in the utility that we find in a consolidated investor like Oregon Electric. Notably, neither of the companies that CUB contends exemplify the problem with the present regulatory structure (U S West and ComEd) are "short-term" owners.

IV. RISKS ASSOCIATED WITH LEVERAGE ARE MITIGATED

Q. Please describe the concern over leverage as described in the parties' surrebuttal testimony.

A. A great deal of testimony has been submitted concerning the risks associated with leverage at the holding company level. However, as I pointed out in my rebuttal testimony, when you examine this issue closely, these concerns amount to three distinct issues: 1) fears over cost of capital increases; 2) the potential for PGE to be affected by bankruptcy at the holding company level; and 3) the potential for aggressive cost cutting to meet debt service requirements. All of these concerns can be addressed or mitigated by the ring-fencing conditions to which Oregon Electric has already agreed.[25]

Q. Are you aware of any conditions to which Oregon Electric has agreed that mitigate the risk that the Proposed Transaction will cause an increase in the cost of capital for PGE?

A. I understand that Oregon Electric and PGE have agreed to a "hold harmless" condition that ensures PGE's customers will not be responsible for any increase in the cost of

[25] *See* Oregon Electric/501, Davis/*; Oregon Electric/600, Wheeler/*.

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capital directly caused by the Proposed Transaction.[26] I also understand from Ms. Wheeler's testimony that Oregon Electric and PGE have agreed to enhance the other ring-fencing provisions initially adopted in the Enron/PGE transaction that served to insulate PGE's credit ratings so effectively from the effects of the Enron bankruptcy.[27] These facts lead me to conclude that these conditions are sufficient to protect PGE from any increase in the cost of capital caused by the Proposed Transaction.

Q. How does Staff believe this risk should be mitigated?

A. Staff has proposed several conditions that purportedly address this risk. For example, Proposed Condition 25 is a cash flow sweep provision that will require that all available cash remitted to Oregon Electric be dedicated to paying down debt.[28] Proposed Condition 27 would prevent Oregon Electric from re-leveraging that debt once it has been extinguished if the leveraging would bring the consolidated capital structure below 40 percent common equity.[29] Proposed Condition 28 prohibits TPG Applicants from directly billing Oregon Electric for services until the cash flow sweep provision has been satisfied.[30]

Q. Do you agree that Staff's proposed conditions are necessary?

A. No. The purpose of ring-fencing is to create a barrier between the utility and its parent/holding company and thereby prevent actions by the parent/holding company from significantly affecting the costs associated with providing utility service. That barrier is designed to allow the Commission to forbear from any further regulation of the utility holding company. It is well known in the industry that Oregon has some of the strongest

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[26] *See* Oregon Electric/600, Wheeler/*.

[27] *See* Oregon Electric/600, Wheeler/*.

[28] *See* Staff/900, Morgan/21-22.

[29] Staff/900, Morgan/23.

[30] Staff/900, Morgan/23.

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ring-fencing provisions in the country. These provisions have protected PGE's customers from being significantly affected by the Enron bankruptcy. I have seen no evidence that suggests PGE has not maintained acceptable service quality levels, has under-invested in its system, or has passed on significant Enron-related costs to customers. Absent this type of evidence, the only conclusion I can come to is that the Oregon model has worked well to protect PGE's customers, even in the face of one of the most traumatic events in the energy industry in recent history. Staff's conditions are simply unnecessary given the nature of the ring-fencing already agreed to by Oregon Electric.

Q. Why shouldn't the Commission impose additional regulation on the holding company "just in case"?

A. The Commission's duty is to protect the utility from negative effects of the holding company's ownership. Once the risks of such negative effects have been mitigated, the Commission has no reason to impose further regulation, particularly regulation that would unduly constrain the ability of the utility to manage its own affairs. Recall that the purpose of regulation, and in particular ring-fencing, is to protect customers. The additional conditions suggested by Staff would not serve to protect PGE's customers and might instead discourage future investment in utilities such as PGE.[31]

Q. How do you respond to the parties' concerns that PGE will be forced to undertake undue or aggressive cost cutting in the event Oregon Electric is unable to meet its debt service requirements?

A. First, it is important to note that even Mr. Morgan clarifies in his surrebuttal testimony that such a risk is "small" and that it is "likely" that sufficient funds will be available for Oregon Electric to meet its debt service payments.[32] While I understand that Mr. Morgan

[31] *See* Oregon Electric/600, Wheeler/*.

[32] Staff/900, Morgan/9.

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1 may believe it is necessary to catalog even the most remote risks of this transaction,
2 highly unlikely risks should be accorded little weight in the "netting" of the benefits and
3 risks. Second, as noted above, it is simply unrealistic to believe that Oregon Electric is
4 uniquely motivated to cut costs to increase profits after an acquisition, or that this
5 represents a unique risk of the Proposed Transaction. Finally, as I have addressed in
6 Section II above, the current regulatory system provides sufficient safeguards to ensure
7 that Oregon Electric and PGE would be deterred from taking any imprudent cost-cutting
8 measures that were not in the interests of the utility and its customers.

9 **Q. Does this conclude your sur-surrebuttal testimony?**

10 A. Yes it does.

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Qwest Service Quality Penalty $215,000 for 2003

March 2, 2004 (2004 - 005) (UM 1133)

Contacts: Lee Beyer, Chairman, 503 378-6611; John Savage, Commissioner, 503 378-6611; Ray Baum, Commissioner, 503 378-6611; Bob Valdez, Public Information Officer, 503 378-8962

Salem, OR – Today the Oregon Public Utility Commission penalized Qwest Corporation $215,000 for lapses in statutory service quality standards in 2003.

The Commission directed Qwest to pay penalties of $95,000 in 2002, $255,000 penalty in 2001, and $725,000 in 2000.

"While the fine has increased compared with the previous year, Qwest really has made a pretty significant turnaround over the last three years," said Commission Chairman Lee Beyer. "We were concerned the company's difficult financial situation could have eroded past improvement, and with a few exceptions, our fears have proved unfounded."

According to an annual report by the Oregon Public Utility Commission $175,000 of the total was attributed to trouble report rates in three exchanges: Lowell, Mapleton and Marcola in Lane County.

A penalty of $10,000 is due to network blockage. Customers experience network blocking when they receive a fast busy signal or a recording telling them all circuits are busy. The remaining $30,000 was for not meeting the Sales Office Access standard in September and November. The standard requires a live person to answer calls to the business office within 20 seconds, 75 percent of the time. The time spent in the Voice Response Unit, a "voice computer" that uses touchtone input to route calls, does not count toward the 20 seconds.

"What was impressive is that Qwest had no held orders for the entire year, Chairman Beyer said. And the standards for trouble reports cleared and repair center access were met every month during 2003."

The Commission is directing $215,000 be spent on the targeted investment of providing Digital Subscriber Line (DSL) service to rural customers served by selected small wire centers, which did not meet service quality standards

in 2003.

"It makes a lasting and meaningful way to direct these penalties to customers in parts of the state that otherwise may be in for a long wait to receive DSL," added Chairman Beyer.

The candidate exchanges are DSL are Blue River, North Plains, Lowell, Marcola, Mapleton and Warm Springs.

Senate Bill 622, approved by the 1999 legislature, requires the annual report. The legislation included automatic penalties when Qwest did not meet statutory service quality standards. 2003 is the last year for enforcement of these statutory service quality standards.

The Commission will continue to enforce Commission service quality standards, which are more stringent, but require court approval to impose fines.

-30-

Oregon Public Utility Commission Last Updated March 02, 2004 04:47 PM

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2 **BEFORE THE PUBLIC UTILITY COMMISSION**
3 **OF OREGON**
4 **UM 1121**
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6 In the Matter of
7 OREGON ELECTRIC UTILITY COMPANY, LLC,
8 et al.,
9 Application for Authorization to Acquire Portland General Electric Company
10
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12
13 **SUR-SURREBUTTAL TESTIMONY**
14 **OF**
15 **DANIEL J. BUSSEL**
16 **ON BEHALF OF OREGON ELECTRIC**
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21 **October 11, 2004**
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I. INTRODUCTION

Q. Please state your name, occupation and business address.

A. Daniel J. Bussel. I am a bankruptcy lawyer and law professor. My business address is at Klee, Tuchin, Bogdanoff & Stern LLP, 2121 Avenue of the Stars, Suite 3300, Los Angeles, California 90067 ("KTBS").

Q. Please describe your education and professional experience.

A. I received my Bachelor of Arts Degree, magna cum laude, from the University of Pennsylvania in 1981. I received my Juris Doctor Degree from Stanford Law School in 1985. I have been a member of the State Bar of California since 1985. From 1985 to 1988, I served as a law clerk to the Hon. Stephen G. Breyer, then of the United States Court of Appeals for the First Circuit, and to the Hon. Sandra Day O'Connor of the Supreme Court of the United States. Since 1988, I have specialized in bankruptcy law as both an academic and practicing lawyer. Since 2001, I have been a partner at KTBS, a law firm specializing in insolvency matters, located in Los Angeles, California. As a member of KTBS, and previously as an associate at O'Melveny & Myers LLP, I have represented debtors, creditors, committees, acquirers and other interested parties in Chapter 11 proceedings and out-of-court debt restructurings throughout the United States. In the electric power field I have been involved in counseling creditors in connection with the pending Chapter 11 proceedings involving National Energy & Gas Transmission, Inc. and Northwestern Corporation. Since 1992, I have also held an appointment as a professor of law on the faculty of the University of California, Los Angeles ("UCLA") School of Law and I have held the rank of full professor with tenure at UCLA since 1996. My primary field of teaching and scholarship has been and continues to be bankruptcy law. I have co-authored BANKRUPTCY (FOUNDATION PRESS 6TH ED. 2000), a leading casebook used to instruct students in bankruptcy law at

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1 numerous law schools throughout the United States. In addition, I have published
2 scholarly articles, held visiting professorships and lectured on various aspects of
3 bankruptcy law and practice as set forth in my curriculum vitae attached hereto as
4 Oregon Electric/801, Bussel/1-2.

5 **II. PURPOSE AND SUMMARY OF TESTIMONY**

6 **Q. What is the purpose of your testimony in this case?**

7 A. I have been retained by counsel for Oregon Electric[1] to express an expert opinion on
8 whether, in the event of the commencement of Chapter 11 bankruptcy proceedings by
9 or against Oregon Electric, there would be any material risk of the "substantive
10 consolidation" of Oregon Electric and its wholly-owned Oregon-regulated utility
11 subsidiary Portland General Electric Company ("PGE"), such that the assets and
12 liabilities of Oregon Electric and PGE could be nonconsensually pooled for purposes of
13 a bankruptcy reorganization plan and the allowance of claims and distributions to
14 creditors and interest-holders.[2]

15 **Q. Have you formed such an opinion?**

16 A. Yes.

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20 [1] Throughout this testimony, I will use "Oregon Electric" to refer to Oregon Electric Utility Company, LLC, or to all Applicants, as the context may imply.

21 [2] I use and understand the term "nonconsensually" in the technical bankruptcy sense that the substantive consolidation is imposed through a bankruptcy court order or confirmed reorganization plan over the objection of
22 a class of PGE creditors or PGE interest-holders. Under the U.S. Bankruptcy Code, a plan is deemed accepted by a class of claims if two-thirds in amount and one-half in number of the allowed claims voting in good faith accept
23 the plan. 11 U.S.C. § 1126(c). A class of interests accepts a plan if two-thirds in the amount of the allowed interests voting in good faith accept the plan. 11 U.S.C. § 1126(d). Substantive consolidation would not, in
24 bankruptcy terms, be "consensual" simply because Oregon Electric caused PGE to consent to it through its influence over PGE's Board of Directors and management. The consent of all classes of creditors and interest-
25 holders, not common equity or the debtor-in-possession alone, would be required to deem the substantive consolidation "consensual."

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1 **Q. What is your opinion?**

2 A. There is no material risk of "substantive consolidation" in the event that: (1) the Oregon
3 Electric-PGE transaction is consummated on the proposed terms; and (2) at some time
4 subsequent thereto Chapter 11 proceedings are commenced in respect of Oregon
5 Electric.

6 **III. BASES OF OPINION**

7 **Q. On what do you base this opinion?**

8 A. I have reviewed the Application of Oregon Electric Utility Company, LLC et al. to
9 Acquire Portland General Electric Company, dated March 8, 2004, and the Exhibits
10 thereto including in particular Exhibit 1 (Direct Testimony of Robert S. Bingham) and
11 Exhibit 6 (Stock Purchase Agreement), the Supplemental Direct Testimony of Kelvin L.
12 Davis dated May 27, 2004, a summary of the applicable statutes and regulations relating
13 to the powers of the Public Utility Commission of Oregon (the "Commission") prepared
14 by Ater Wynne LLP, the Direct Testimony of John Antonuk and Randall Vickroy dated
15 July 21, 2004 (Confidential Version) and Exhibits thereto, the Rebuttal Testimony of
16 Carrie Wheeler dated August 16, 2004 (Redacted Version) and Exhibits thereto, the
17 Rebuttal Testimony of Karl A. McDermott dated August 16, 2004, Exhibit 107 to the
18 Rebuttal Testimony of Kelvin L. Davis dated August 16, 2004, the Memorandum from
19 Brian Leitch dated September 11, 2004,[3] and the Surrebuttal Testimony of John
20 Antonuk and Randall Vickroy dated September 22, 2004. From these materials, I have
21 gathered an understanding of the legal and financial structure and regulatory
22 environment for the proposed acquisition of PGE and the substance of the bankruptcy
23 related objections thereto. In addition, I have performed legal research with the
24 assistance of Brendt Butler, Esq., an attorney at KTBS, and reviewed the relevant legal
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[3] A copy of this memorandum is attached as Oregon Electric/802, Bussel/1-8.

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1 authorities relating to substantive consolidation. Finally, I have relied upon the
2 experience and judgment I have developed over the years as a practitioner, scholar, and
3 professor of bankruptcy law wherein I have had repeated occasion to advise and
4 advocate with respect to the issue of substantive consolidation.

5 **IV. REASONS FOR OPINION**

6 **Q. Please explain the reasoning supporting your opinion.**

7 A. The legal standard one must meet to impose substantive consolidation is quite high. In
8 general, there are two alternative branches to the test for nonconsensual substantive
9 consolidation. While it is possible in some instances to consolidate non-filed entities
10 (affiliates that are not Chapter 11 debtors) with Chapter 11 debtors, bankruptcy courts
11 are even more reluctant to authorize the consolidation than they would otherwise be if
12 some of the entities for whom consolidation is sought are not Chapter 11 debtors.

13 The more commonly used branch of the substantive consolidation standard
14 relies on the factual predicate that under the particular circumstances it is difficult or
15 impossible to "unscramble the eggs," the several entities being so entangled that
16 consolidation will benefit all creditors. *See In re Auto-Train Corp., Inc.*, 810 F.2d 270,
17 276 (D.C. Cir. 1987) (substantive consolidation ordered "typically to avoid the expense
18 or difficulty of sorting out the debtor's records to determine separate assets and
19 liabilities of each affiliated entity"). In short, substantive consolidation may be
20 appropriate where corporate formalities have not been observed and the entities have on
21 a practical level been operated as one so that sorting out separate assets and liabilities
22 on an entity-by-entity basis is impracticable. While a credible case can often be made
23 in other contexts that it is impracticable to sort out assets and liabilities of affiliated
24 corporations, I am aware of no case where anyone has ever even attempted to make
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1 such a showing with respect to a separately regulated public utility and its parent
2 holding company.

3 In my view, absent a complete abdication of regulatory oversight by the
4 Commission, there would be no basis whatsoever for consolidating Oregon Electric and
5 PGE on grounds that it was impracticable to "unscramble the eggs." As initially
6 structured, Oregon Electric and PGE would have entirely different creditors and debt
7 structures. Oregon Electric would be a non-operating entity. Affiliate transactions
8 would be subject to regulatory review.[4] Given the reporting and recordkeeping
9 requirements imposed by Oregon's regulatory scheme (not to mention the applicable
10 securities laws because PGE would have separately issued public debt), the separateness
11 of PGE's records and operations would be necessarily maintained.[5] It is simply
12 impossible to believe that a separately regulated investment grade public utility with its
13 own publicly issued debt could somehow fail to maintain sufficient corporate identity
14 and records that it would be impractical to separately account for its assets and
15 liabilities. I note that even in cases where the burden is extreme in sorting out separate
16 assets and liabilities, courts generally refuse to impose substantive consolidation so long
17 as it remains at all possible to maintain separateness, if any demonstrable prejudice to
18 any objecting party results from consolidation. *See In re Augie/Restivo Baking Co.*, 860
19 F.2d 515, 519 (2d Cir. 1988) ("Commingling, therefore, can justify substantive
20 consolidation only where 'the time and expense necessary even to attempt to
21 unscramble them [is] so substantial as to threaten the realization of any net assets for all
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[4] *See, e.g.*, OAR 860-027-0040 (applications for approval of transactions between affiliated interests); OAR 860-027-0100 (reporting requirements for affiliated transactions).

[5] *See id. See also* OAR 860-027-0045 (imposing Uniform System of Accounts for electric utilities); OAR 860-027-0070 (annual reporting requirements for electric utilities); OAR 860-027-0120(1) (preservation and destruction of electric utility records).

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1 the creditors' [citations omitted] or where no accurate identification and allocation of
2 assets is possible.").

3 The second branch of the substantive consolidation standard is generally said to
4 permit consolidation where "creditors dealt with the entities as a single economic unit
5 and did not rely on their separate identity in extending credit." *See Alexander v.*
6 *Compton (In re Bonham)*, 229 F.3d 750, 766 (9th Cir. 2000), citing *In re Reider*, 31
7 F.3d 1102, 1108 (11th Cir. 1994) and *In re Augie/Restivo*, 860 F.2d at 518. Given the
8 separate debt structures of PGE and Oregon Electric, the strict regulatory regime
9 applicable to PGE, the distinct credit ratings assigned to the entities, and that
10 substantially all operating debt will be at the PGE level, it would be absurd for Oregon
11 Electric's creditors to take the position that PGE creditors and other constituents did not
12 rely on the separateness of PGE in extending credit and otherwise dealing with PGE.

13 Finally, as I understand the concern expressed by the objectors, the fear is that a
14 financially healthy PGE might on some generalized and unclear "equitable" basis be
15 consolidated into an insolvent Oregon Electric such that PGE assets might become
16 subject to the claims of Oregon Electric's creditors and PGE electric power rates would
17 be raised to fund repayment of Oregon Electric's liabilities. I note that recent
18 controlling case authority in the United States Court of Appeals for the Ninth Circuit
19 expressly rejects free-form equitable balancing as a basis for nonconsensual substantive
20 consolidation and adopts the standard two branch approach described above. *See, e.g.,*
21 *In re Bonham*, 229 F.3d at 766. In any event, given the obvious and compelling public
22 interest in maintaining a financially viable operating utility, the regulatory compact by
23 which all constituents at the Oregon Electric level are bound to respect the separateness
24 of PGE, and the gross unfairness and prejudice to all constituents (except common
25 equity) at the PGE level in authorizing consolidation into a (by hypothesis) insolvent

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1 parent, I cannot imagine a court imposing substantive consolidation for the benefit of
2 Oregon Electric's constituents based on a balancing of equities, even if that were
3 permitted, under the circumstances presented here. In my judgment no serious party
4 would even attempt to invoke substantive consolidation towards that end given its
5 impropriety and the lack of authority for doing so, notwithstanding the obvious
6 advantages to Oregon Electric's creditors that such a lawless consolidation would
7 afford. I note in passing that none of the countless well-represented and well-financed
8 constituents in the Chapter 11 proceedings involving PGE's current insolvent parent
9 corporation, the Enron Corporation, has even attempted to go down this path. I am
10 aware of no precedent in any jurisdiction supporting consolidation in comparable
11 circumstances.

12 Finally, I note that the proposal made in passing for a "golden share" of
13 preferred stock that would have special voting rights on bankruptcy issues is a solution
14 in search of a problem in this case. The "golden share" structure is a creature of
15 structured finance transactions where assets are removed from below investment grade
16 operating companies into investment grade special purpose entities to facilitate
17 securitization of those assets and permit the below investment grade operating company
18 to borrow at investment-grade rates. The purpose of the golden share is to prevent, or at
19 least make more unlikely, a bankruptcy restructuring of the securitized debt. Denying
20 PGE access to bankruptcy through a golden share structure does not address the
21 consolidation risk (which is not material in any event) and moreover might prove to be
22 an impediment for PGE in seeking debt relief in the highly unlikely event that it, a
23 regulated public utility, suffers some catastrophic event that renders it insolvent.

24 **Q. Does this conclude your testimony?**

25 A. Yes.

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Education

Stanford Law School, Palo Alto, CA
J.D. 1985. Nathan Abbott Scholar (First in graduating class). Order of the Coif. Second Year Honor. First Year Honor. East Palo Alto Community Law Project.

University of Pennsylvania, Philadelphia, PA
B.A. 1981 magna cum laude in Urban Studies, Political Science and Spanish (minor). Study abroad: Instituto Internacional, Madrid, Spain, 1980-81.

Employment

Klee, Tuchin, Bogdanoff & Stern LLP, Los Angeles, CA
Partner, 2001-date

UCLA School of Law, Los Angeles, CA
Professor, 1996-date; Acting Prof., 1992-1996; Visiting Prof., 1991-92.Visiting Prof. University of Miami School of Law, 1997, Visiting Prof. Aoyama Gakuin University Faculty of Law, Tokyo, Japan, 1997.

Courses: Bankruptcy, Corporate Reorganization Seminar, Commercial Law, Advanced Commercial Law, Contracts, Copyright.

Books: BANKRUPTCY (Foundation Press 2002) (with Warren); CONTRACT LAW AND ITS APPLICATION (Foundation Press 1999) (with Rosett).

Lead articles: The Limits on Assuming and Assigning Executory Contracts in Bankruptcy, 74 Am. Bankr. L. J. 321 (with Friedler); Textualism's Failures: A Study of Overruled Bankruptcy Decisions, 53 Vand.L.Rev. 887; Coalition Building Through Bankruptcy Creditors' Committees, 43 UCLA L.Rev. 1547; Liability for Concurrent Breach of Contract, 73 Wash.U.L.Q. 97; Power, Authority and Precedent in Interpreting the Bankruptcy Code, 41 UCLA L.Rev. 1063; The Plaintiff's Case in Defamation, 25 Wm.&Mary L.Rev. 825 (with Franklin).

O'Melveny & Myers, Los Angeles, CA
Associate, Bankruptcy Department, 1987-91.

Associate Independent Counsel for James C. McKay, Wash., D.C., 1987.

Law Clerk to Justice Sandra Day O'Connor, Supreme Court of the United States, Wash., DC, 1986-87.

Law Clerk to Judge Stephen G. Breyer, United States Court of Appeals for the First Circuit, Boston, MA, 1985-86.

Other Professional Experience

Expert Witness

Robinson & Wood, Pettit & Martin, Greenberg, Glusker, Fields, Claman & Machtinger, Argue, Pearson, Harbison & Myers, Fenigstein & Kaufman, Law Offices of James Uyeda, Esq. , Katten Muchin & Zavis, Morrison & Foerster, Dressler Rein Evans & Sestanovich, Kaye Scholer LLP.

Law Reform

California State Senate Special Committee on Local Government Investments (Orange County Bankruptcy Hearings), ABA Joint Task Force on Bankruptcy Court Structure, Commission on Structural Alternatives for the Federal Courts.

Various Invited Lectures & Other Writing.

Professional Societies

Los Angeles County Bar Commercial Law and Bankruptcy Committee; Financial Lawyers' Conference, Board of Governors; American Bar Association, Business Bankruptcy Committee, Executory Contracts Subcommittee, Joint Task Force on Bankruptcy Court Structure; Society of Professionals in Dispute Resolution; American Bankruptcy Institute; Reviewer for various legal publishers.

Mediation

US Bankruptcy Court, Central Dist. of Calif., Bankruptcy Mediation Panel.

Boards

ASUCLA Board of Directors (1995-1996); Financial Lawyers' Conference Board of Governors (1995-1998; 2001-2004); American Bankruptcy Institute Law Review Advisory Board (2001-date).

Bar Admissions

All State and Federal courts in California; District of Arizona; Supreme Court of the United States.

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PRIVILEGED AND CONFIDENTIAL
ATTORNEY WORK PRODUCT

Memorandum

To: Rick Schifter

From: Brian Leitch

Date: September 11, 2004

Re: Substantive Consolidation of PGE and Oregon Electric

This memorandum follows up on and summarizes the conclusions from our discussion regarding whether, if Oregon Electric Utility Company LLC ("Oregon Electric") were to acquire Portland General Electric Company ("PGE") and then were to become a debtor in a bankruptcy proceeding, the entities could be substantively consolidated.

As we discussed, both you and I have addressed substantive consolidation issues in a variety of contexts over the past twenty years. Accordingly, I am not providing to you the level of detailed description of the case law that I would provide if you were less knowledgeable on the issues.

For the reasons we discussed, the risk appears remote that PGE could ever be substantively consolidated with Oregon Electric, so long as PGE continues to be regulated by the OPUC.

I. Factual Background

Oregon Electric was established to purchase and hold the stock of PGE, and upon consummation of the transaction with Enron, will own all of the stock of PGE. PGE is currently regulated by the Oregon Public Utility Commission ("OPUC"), and will continue to be so regulated after acquisition by Oregon Electric.

II. Substantive Consolidation

Substantive consolidation is a judicially created doctrine arising from the general equity powers granted to bankruptcy courts. F.D.I.C. v. Colonial Realty Co., 966 F.2d 57, 59 (2d Cir. 1992); Eastgroup Properties v. Southern Motel Assoc., 935 F.2d 245, 248 (11th Cir. 1991); In re Auto-Train Corp., 810 F.2d 270, 276 (D.C. Cir. 1987). Under this doctrine, a bankruptcy court may consolidate assets and liabilities of different entities and treat them as a single entity for purposes of a bankruptcy proceeding. When consolidated, "intercompany claims of the debtor companies are eliminated, the assets of all debtors are treated as common assets and claims of outside creditors against any of the debtors are treated as against the common fund." Chemical Bank New York Trust Co. v. Kheel, 369 F.2d 845, 847 (2d Cir. 1966); accord Eastgroup Properties, 935 F.2d at 248 ("pooling of assets and liabilities of two or more related entities; the liabilities of the entities involved are then satisfied from the common pool of assets created by consolidation."). The two overarching principles of substantive consolidation are that it should be granted only when (1) it is not possible to separate the assets and liabilities of the two entities, and (2) it would be materially more unfair and prejudicial to creditors to honor the corporate separateness than to grant the consolidation. Equitable considerations alone, however, are not grounds for substantive consolidation where the

two entities' assets and liabilities can be readily identified separately.

Broadly, there are two types of substantive consolidation. First, two debtors that have filed separate Chapter 11 petitions can be consolidated. Second, as we discuss here, a debtor's bankruptcy proceeding may be expanded to include in the debtor's estate the assets of a related entity that is not under bankruptcy protection. See In re Munford, Inc., 115 B.R. 390, 397-98 (Bankr. N.D. Ga. 1990) (substantive consolidation "is recognized as an alternative means to bring a non-debtor's assets into a debtor's estate.").

Substantive consolidation is an extraordinary remedy that should only rarely be granted because it redistributes value among creditors of otherwise separate entities. Auto-Train, 810 F.2d at 276; Augie/Restivo Baking Co., 860 F.2d 515, 518 (2d Cir. 1988); Kheel, 369 F.2d at 847. It is rare that substantive consolidation is granted in a litigated context -- but it is even more rare that a non-debtor is consolidated with a debtor.

III. Deciding Whether To Substantively Consolidate

This substantive consolidation determination is generally based on the equities of the particular factual situation. For example, substantive consolidation was granted when "the time and expense necessary even to attempt to unscramble [the intercompany relationships and transactions] are so substantial as to threaten the realization of any net assets for all creditors." Kheel, 369 F.2d at 847; accord Continental Vending Mach. Corp., 517 F.2d 997, 1001 (2d Cir. 1975), cert. denied, 424 U.S. 913 (1976) (inequities of consolidation "must be heavily outweighed by practical considerations such as the accounting difficulties (and expense) which may occur where the interrelationships of the corporate group are highly complex, or perhaps untraceable"); Augie/Restivo, 860 F.2d at

519 ("should be used only after it has been determined that all creditors will benefit because untangling is either impossible or so costly as to consume the assets").

It is important to note that a court will generally decline to order consolidation where it appears that, through consolidation, the rights of certain creditors may be impaired, while others unfairly benefit. Augie/Restivo, 860 F.2d at 515; Eastgroup Properties, 935 F.2d at 249 ("The basic criterion by which to evaluate a proposed substantive consolidation is whether 'the economic prejudice of continued debtor separateness' outweighs 'the economic prejudice of consolidation'"); In re Hemingway Transp. Inc., 954 F.2d 1, 12 (1st Cir. 1992) ("party requesting substantive consolidation must satisfy the bankruptcy court that, on balance, consolidation will foster a net benefit among all holders of unsecured claims").

After deciding whether it would be practicable and "fair" to consolidate two particular entities, a court often explains its decision by reference to certain of the factors on a well-recognized list. For informational purposes, following is a oft-quoted version of the list: (1) parent owns all or a majority of capital stock of subsidiary; (2) parent and subsidiary have common directors or officers; (3) parent finances subsidiary; (4) parent corporation subscribes to all the capital stock of subsidiary or otherwise causes its incorporation; (5) subsidiary has grossly inadequate capital; (6) parent pays salaries or expenses or losses of subsidiary; (7) subsidiary has substantially no business except with parent or no assets except those conveyed to it by parent; (8) parent's officers or papers refer to subsidiary as a department or division; (9) directors or executives of subsidiary do not act independently in the interest of subsidiary, but take direction from parent; and (10) formal legal requirements of subsidiary as a separate/independent corporation are

not observed. The most important of these factors tend to be numbers (5), (7) and (10) on this list.

The other seven factors are usually inapplicable to the actual basis of the court's decision. Most of these factors apply to virtually any parent-subsidiary relationship, and the general rule is that corporate parents and subsidiaries retain their corporate separateness. Accordingly, it is not useful at best, and generally confuses the issue, to simply count up the factors that apply to a particular case, or apply the factors in a rigid way.

IV. The Prospect of Substantive Consolidation of PGE Into Oregon Electric Appears Remote

After the acquisition, there is almost no prospect that the business activities and/or assets of PGE and Oregon Electric will be commingled in any way such that substantive consolidation would be appropriate. We understand that Oregon Electric has no intention to ignore formal legal requirements or to treat the two entities as one. Most importantly, Oregon statutes and OPUC's regulatory oversight ensure that PGE cannot be "scrambled" with Oregon Electric.

Under Oregon law, OPUC review is required before a utility (like PGE) may enter into any of the following transactions with a person with an affiliated interest[1] in the utility: give a note, loan funds, give credit or enter any contract that results in a capital expenditure or operating expense (at least if the utility wants to recognize the expense in

[1] An entity shares an "affiliated interest" with a regulated utility if, *inter alia*, it owns 5% or more of the utility's voting shares or "actually exercis[es] any substantial influence over [its] policies and actions." OR. REV. STAT. § 757.015 (2003).

a rate valuation). OR. REV. STAT. § 757.495 (2003).[2] Further, Oregon law generally requires OPUC approval before a utility may guarantee debt or dispose of, mortgage or encumber certain assets (whether or not with an affiliate). Id. at §§ 757.440, 757.480.

Along with complying with the above statutes that prevent entanglement of their affairs, Oregon Electric and PGE will maintain the requirements of separate corporate entities, such as separate books, assets, and financial statements. Further, PGE is adequately capitalized, is not dependent on Oregon Electric for funding, and does most of its business with entities other than Oregon Electric. Thus, there should be no serious likelihood that a court would find that the two entities could not easily be held separate for purposes of bankruptcy administration of the parent.

Further, since PGE has been a separate entity for many years, if one were to allow creditors of Oregon Electric to directly reach PGE's assets, such a result would badly prejudice PGE's creditors, who reasonably believed that they were extending credit to PGE as a distinct entity. Similarly, Oregon Electric's creditors will be extending credit to the parent entity, as a distinct entity, not to the subsidiary. Given the unfairness to PGE's independent creditors if substantive consolidation were granted, and the lack of any equitable basis for Oregon Electric's creditors (who extended credit to a known parent entity) to claim that substantive consolidation should be granted, there would be no equitable justification for substantive consolidation. Further, if Oregon Electric were

[2] To obtain any of these approvals, the utility must submit a host of information to the OPUC, including costs and market price of providing transferred goods and services, the actual contract for such goods or services, and board/stockholder approvals. OR. ADMIN R. 860-027-0040 (2004).

attempting to reorganize, consolidation with PGE could subject Oregon Electric to regulation as a public utility, adding delay and complexity to a reorganization plan.

It is telling that while the vast majority of the entities in the Enron bankruptcy were partially substantively consolidated, by agreement in the Enron Chapter 11 plan, PGE was never joined as a debtor and never substantively consolidated. The Enron case involved broad allegations of financial mismanagement by persons associated with the corporate parent, yet there was not substantive consolidation of PGE. These facts, alone, should provide a high level of comfort that the risk of future substantive consolidation would be remote when PGE is owned by Oregon Electric.

Further, we have searched the reported decisions and not found any case in which a regulated utility was substantively consolidated into a corporate debtor parent.

* * *

Based on all of the foregoing, we believe that there is little or no material likelihood under existing law and in view of our anticipation that PGE will operate in compliance with Oregon law and regulations, that PGE would be substantively consolidated into Oregon Electric if Oregon Electric were to become a debtor in a Chapter 11 proceeding..

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3 **BEFORE THE PUBLIC UTILITY COMMISSION**
4 **OF OREGON**
5 **UM 1121**
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7 In the Matter of

8 OREGON ELECTRIC UTILITY COMPANY, LLC,
9 et al.,

10 Application for Authorization to Acquire Portland General Electric Company

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14 **SUR-SURREBUTTAL TESTIMONY**
15 **OF**
16 **RICHARD SCHIFTER**
17 **ON BEHALF OF OREGON ELECTRIC**
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21 **October 11, 2004**
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Q. Please state your name.

A. My name is Richard Schifter. I previously offered direct testimony in this proceeding.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to update the parties on the TPG Applicants'[1] progress with regard to its request for a no-action letter from the U.S. Securities and Exchange Commission ("SEC") and to notify the parties of changes to consent rights proposed by TPG.

Q. As discussed in previously filed testimony, the TPG Applicants' receipt of a no-action letter from the SEC is required before the closing of the transaction.[2] Could you update the parties regarding the status of this request for a no-action letter from the SEC?

A. Yes. In April 2004, the TPG Applicants submitted a draft request for a no-action letter to the SEC.[3] The structure of the Proposed Transaction is patterned on a recognized structure for investment by non-utility companies in utilities. This structure has been the subject of a number of no-action letters issued by the staff of the SEC ("SEC Staff") in recent years.[4] In each of these no-action letters, the SEC Staff agreed not to recommend enforcement action under Section 2(a)(7) of the Public Utility Holding Company Act of 1935 (the "1935 Act" or "Act") for an entity's failure to register under the Act in situations in which an entity had acquired up to 9.9 percent of the voting securities of a

[1] The TPG Applicants are TPG Partners III, L.P., and TPG Partners IV, L.P.

[2] *See, e.g.*, Oregon Electric/3, Schifter/3; Oregon Electric/100, Davis/59-60.

[3] *See* Oregon Electric/100, Davis/60.

[4] *See, e.g., Berkshire Hathaway, Inc.*, SEC No-Action Letter (March 10, 2000); *SW Acquisition, L.P.*, SEC No-Action Letter (April 12, 2000); *General Electric Capital Corp.*, SEC No-Action Letter (April 26, 2002; *kl Ventures*, SEC No-Action Letter (July 28, 2003); and *Evercore MTC Investment, Inc.*, SEC No-Action Letter (Nov. 25, 2003). Copies of these no-action letters are available upon request.

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1 utility or utility holding company and had also made a significant investment in the non-
2 voting securities of the utility or utility holding company.

3 In a meeting in late August 2004, the SEC Staff advised the TPG Applicants that
4 they should submit an application under Section 2(a)(7) of the 1935 Act, rather than
5 pursue its request for a no-action letter. Our understanding is that the SEC is taking this
6 approach in order to allow for greater transparency, including notice to interested parties
7 and an opportunity for a hearing.

8 Based on discussions with SEC Staff, we are optimistic that the SEC will issue a
9 declaratory order granting the application. Although the statute does not expressly
10 provide for the issuance of a declaratory order in these circumstances, Section 5(d) of the
11 Administrative Procedure Act, 5 U.S.C. §544(e), provides that "[t]he agency, with like
12 effect as in the case of other orders, and in its sound discretion, may issue a declaratory
13 order to terminate a controversy or remove uncertainty." The SEC has relied on this
14 provision previously to issue declaratory orders in the absence of express provisions
15 under the 1935 Act. *See, e.g., Pacific Northwest Power Company*, 41 S.E.C. 863
16 (March 4, 1964) (declaring that applicant would not become an electric utility holding
17 company within the meaning of the Act prior to the occurrence of certain defined events).

18 **Q. As part of the Section 2(a)(7) application, the SEC considers the consent rights**
19 **proposed by the TPG Applicants. Have any changes been proposed to those consent**
20 **rights?**

21 A. Yes. The TPG Applicants have decided to reduce the number and scope of the consent
22 rights contained in their proposal. A revised list of consent rights is attached as Oregon
23 Electric/901, Schifter/1-2.

24 **Q. Does this conclude your testimony?**

25 A. Yes.

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CONSENT RIGHTS

The consent of a majority in interest of the Class A Investors in Oregon Electric Utility Company, LLC, would be required for any of the following matters:

1. any recapitalization, reorganization, reclassification, merger, consolidation, liquidation, dissolution or other winding up, spin-off, subdivision or other combination of OEUC or PGE;

2. any declaration, setting aside or payment of any dividend or other similar distribution (including a redemption or repurchase of capital) in respect of any class of capital stock of OEUC, PGE or any of their respective subsidiaries, other than payments of cash dividends on the Preferred Stock of PGE outstanding as of the date of the Acquisition in accordance with the terms of the Preferred Stock as in effect on the date of the Closing of the Acquisition;

3. any authorization, sale, or issuance of equity securities (or any warrants, options or rights to acquire equity securities or any securities convertible into or exchangeable for equity securities) of OEUC, PGE or any of their respective subsidiaries in excess of 5% of the fully diluted equity of such entity calculated as of the Closing of the Acquisition;

4. any incurrence of indebtedness of any nature by OEUC, PGE or any of their respective subsidiaries in the aggregate in excess of $20,000,000, or any material acceleration of payment of, or modification or waiver of the terms of, any indebtedness of any nature previously incurred by OEUC, PGE or any of their respective subsidiaries, in either case other than in accordance with any then-current annual operating or capital budget and business plan approved in accordance with these consent rights;

5. any extension of credit of any nature in excess of $5,000,000 by OEUC, PGE or any of their respective subsidiaries, other than trade credit in the ordinary course of business consistent with past practice;

6. the entering into or amendment of any agreement or arrangement with respect to the procurement of goods or services or otherwise in the nature of operating expenditures which creates or could reasonably be expected to create a financial obligation in an amount, whether payable at one time or in a series of payments, in excess of $20,000,000, except as contemplated by any then-current annual operating or capital budget and business plan approved in accordance with these consent rights;

7. any capital expenditures in an amount greater than $20,000,000, in any transaction or series of related transactions, except as contemplated by the then-current annual operating or capital budget approved in accordance with these consent rights;

8. any sale, lease, exchange, transfer, or other disposition of OEUC's, PGE's or their respective subsidiaries' assets or businesses (including, without limitation, the capital stock of any subsidiary), other than dispositions in the ordinary course of business consistent with past practice or dispositions pursuant to the then-current annual operating or capital budget and business plan approved in accordance with these consent rights;

9. any joint venture, partnership or other material operating alliance by OEUC, PGE or any of their respective subsidiaries with, or any purchase of debt or equity securities of, any other person;

10. any voluntary proceeding or filing of any petition by or on behalf of OEUC, PGE or any of their respective subsidiaries seeking relief under the Bankruptcy Code or the voluntary wind up, dissolution or liquidation of OEUC, PGE or any of their respective subsidiaries;

11. the employment, compensation and other terms of employment, and termination of the Chief Executive Officer, Chief Operating Officer or Chief Financial Officer of PGE;

12. any change in the principal line of business of OEUC, PGE or any of their respective subsidiaries;

13. the adoption of, or material amendment to, PGE's annual operating budget, capital budget and three-year financial plan, each of which will be updated annually;

14. any transaction involving conflicts of interest between OEUC or PGE and the Managing Member or any member or Affiliate thereof (including employees and directors of the Managing Member or any member or Affiliate thereof) or payment of any advisory or similar fees by OEUC, PGE or any of their respective subsidiaries to the Managing Member or any member or Affiliate thereof;

15. any amendment or modification of OEUC's, the Managing Member's or PGE's organizational documents (including limited liability company agreements);

16. any filing to obtain a material governmental permit or approval outside the ordinary course of business consistent with past practice, any material filing in connection with a PGE rate proceeding or any material change to the rates or other charges under any PGE tariff, or any material amendment to any such filings;

17. initiation, settlement or compromise of any action, suit, claim, dispute, arbitration or proceeding by or against OEUC, PGE or any of their respective subsidiaries (i) that would materially adversely affect such party, (ii) that would result in an aggregate value/cost of more than $10,000,000, or (iii) would require OEUC, PGE or any of their respective subsidiaries to be subject to any material equitable relief or to take or refrain from taking any material action in connection with the conduct of its business;

18. any action (or decision not to act) by OEUC, PGE or any of their respective subsidiaries that (a) would result in any holder of a membership interest in OEUC or any Affiliate thereof being subject to regulation as a "holding company" or a "subsidiary company" or an "affiliate" of a "holding company" or a "public-utility company" under the 1935 Act or any other federal or state regulation, in each case that is reasonably determined by such affected party to have an adverse effect, or (b) would result in OEUC or PGE or any Affiliate being required to register as a holding company under Section 5 of the 1935 Act; or

19. any contract, agreement, arrangement or commitment to do or engage in any of the foregoing.