Report on Ring-Fencing

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I. SUMMARY AND RECOMMENDATIONS

“Ring-fencing” as used in this report refers to the operational and structural isolation of a regulated utility from its parent and affiliates. The purpose of such isolation is primarily defensive in that it seeks to protect the utility and its ratepayers from being affected by negative factors affecting the parent holding company or affiliates. A recent example of successful ring-fencing is the matter of Portland General Electric in which Oregon regulators ordered it ring-fenced from its parent Enron. When Enron imploded Portland General was relatively unscathed, although its debt rating was reduced below investment grade and it had difficulty raising funds in the short-term credit markets. Ring-fencing strategies may also help to protect ratepayers from overcharges resulting from transactions between the utility and its parent or affiliates. On the downside, ring-fencing may also protect ratepayers from receiving the benefits of economies of scale, centralization, and financial strength enjoyed by the parent and the non-regulated affiliates.

Ring-fencing is useful only in situations where the financial strength of a parent holding company or major affiliate is less than that of the utility, or is expected to weaken over a relatively short time. As a long-term strategy employed by regulators or the parent company, ring-fencing may protect the bond rating of the utility and keep it from being dragged into bankruptcy should the parent holding company falter.

Typical ring-fencing strategies include a holding company structure where the regulated utility is organized as a subsidiary separate from non-regulated business or even other regulated companies within the parent; specified minimum common equity capital on the balance sheet; separate books and records; separate debt and credit; separate bond rating; restrictions on transactions between the utility and its parents and affiliates; restrictions on acquisition and disposition of property; and restrictions on dividends. Other requirements might include the requirement to have an independent board and management and a "golden share" owned by an independent director who can veto voluntary filing for bankruptcy or other major actions, or guarantees by the parent holding company not to file the utility into bankruptcy due to situations affecting the non-regulated operations of the parent.

The Division of Public Utilities recommends that the Public Service Commission of Utah (Commission) implement minimum ring-fencing conditions in conjunction with mergers or other company reorganizations pursuant to Utah law. The minimum ring-fencing conditions include the parent holding company structure, separate debt, separate books and records, and restrictions on investments and transactions between affiliates and the utility.

The Commission may want to investigate proposing legislation to bolster its ring-fencing authority, or it may determine that existing law permits ring-fencing. Seeking legislation may have become more important following the federal legislation repealing PUHCA. Proposed legislation might grant statutory authority to require a regulated company to be organized into a holding company structure, and allow the Commission to instigate such a process. The Commission should seek clear statutory authority to investigate and audit the records of affiliated companies involved in transactions with a regulated utility. The Commission might also seek clear penalties for failure to maintain ring-fence provisions up to and including divestiture; i.e. the Commission could order the divestiture or "spin-off" of a regulated utility from its parent.

II. INTRODUCTION

This report was prepared at the request of the Utah Public Service Commission to assess current "ring-fencing" concepts and practices, and to comment on the possibilities and practicalities of ring-fencing in Utah as it pertains to public utilities operating in Utah. A review is also made of the ring-fencing practices already in effect in Utah. Ring-fencing is viewed from historical, international, economic, and legal perspectives. An attempt is made to estimate the long-term bond rating using publicly available financial and statistical data.

The term "ring-fencing" appears to have originated in England in the 1980's;[1] although many of the ideas that make up ring-fencing have been around longer. The concept of ring-fencing is used in a number of different contexts. For example, it is used to mean isolating patients in a hospital such that they cannot affect or infect the surrounding environs, and that the surrounding hospital cannot affect the patient.[2] In a business context the term means to isolate a division or subsidiary from affecting or being affected by the rest of the company. One business-related definition of ring-fencing is "the legal walling off of certain assets or liabilities within a corporation. For example, a firm may form a new subsidiary to protect, or ring-fence, specific assets from creditors."[3] In some countries ring-fencing is employed to promote competition by protecting competitors from the depredations of the former monopoly utility.[4] In the United States, ring-fencing in the regulated utility arena is the structuring of the legal and operational aspects of a utility such that the utility is substantially insulated from the activities and status

[1] Phrasefinder.org.uk

[2] Medical News Today, "Simple measures can eradicate MRSA." July 16, 2004, www.medicalnewstoday.com/medicalnews.php?newsid=10812

[3] Dictionary.com under "ring-fencing." January 12, 2005.

[4] Independent Competition and Regulatory Commission (Australia), "Ring Fencing Guidelines For Gas and Electricity Network Service Operators in the ACT." November 2002. Note: this report contains detailed definitions and discussions of ring-fencing from a foreign perspective.

(good or bad) of its parent and affiliated companies. Often ring-fencing in this context is viewed as protecting the credit rating, and indirectly the ratepayers, of the utility from adverse conditions that may affect the parent or any affiliated companies.

An alternative use of ring-fencing in a regulatory-related circumstance was Pacific Gas & Electric's isolating unregulated generation, trading, and other assets from the rest of the company in order to protect those assets from the fall-out of the California electric energy deregulation debacle. This occurred in January 2001 when PG &E, the publicly traded parent of Pacific Gas & Electric, ring-fenced its National Energy Group (NEG). NEG was then able to continue obtain credit and operate at a time when the other subsidiaries of PG & E were unable to tap the financial markets.[5] However, "[a] major battle over judgment-proofing erupted in 2001 when Pacific Gas and Electric Co. filed for Chapter 11. But just [three] months before the filing, the huge California utility's parent, PG&E Corp., had "ring-fenced" an asset-rich subsidiary [NEG], a move that critics claim was done solely to shield the assets from creditors."[6] PG&E claimed that the move was made solely to protect the subsidiary's credit rating. Several laws suits have been filed, including one by the California attorney general. With the way PG&E structured its ring-fence, UCLA law professor Lynn LoPucki says that "even if the creditors prevail in court, the new LLC structure blocks creditors from accessing the value of the assets in National Energy Group. All that creditors could get is PG&E Corp.'s economic interest in the new LLC—but not the voting rights. And without the voting rights, creditors wouldn't be able to get money."[7]

[5] Dictionary.com, op. cit.
[6] Kris Frieswick , "Separate but Liable," CFO.com, CFO Magazine, March 01, 2003.
[7] Ibid.

Despite these efforts to protect the non-regulated assets from the utility (!), National Energy Group was forced into bankruptcy.[8]

A different ring-fencing effort was undertaken about the same time as PG&E's by another California utility, Edison International, the parent company of Southern California Edison. As with PG&E a holding company was set up beneath the ultimate parent. This holding company had an independent director who was unaffiliated with the holding company or any of its affiliates or subsidiaries. A unanimous vote of the board was required for certain major corporate actions (of the holding company subsidiary) such as filing for bankruptcy, liquidation, consolidation and merger, and the payment of dividends in excess of certain tests. "In the case of Edison International, these tests have been established in connection with the financing (to the parent company) which depends on the new structure being put in place. These characteristics are typical of the 'Special Purpose Vehicles' used to float securitization financings."[9] Edison established a holding company and put the stock of its non-utility subsidiaries, principally independent power projects, into this holding company. The holding company then used the stock of the non-utility subs as collateral for new financing. The difference here between Edison and PG&E is that the new financing is explicitly to be funneled from the subsidiary holding company up to the parent. The purpose of the ring-fencing in this case was to finance at a better credit rating than could be obtained directly by the parent and hence lower the cost of the debt.

"Two things are probably responsible for the evolution of the ring-fencing concept and its emergence as a basis of securing utility assets. First, the recent securitization experience in California is clearly on the minds of the companies and their lenders because it created a pattern of providing protection for investors. Moreover, it was one aspect of the last major financing

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[8] Public Citizen, "Changes in the Financial Health of the Electric and Natural Gas Utility Industries Since the PUHCA Hearings of 2001," Washington, D.C. March 2004.
[9] Thelen Reid & Priest, "Energy Notes," Summer 2001, at www.thelenreid.com/articles/article/art_98.htm.

transaction in which lenders to California utilities were involved, so they are now comfortable with it. Second, utility commissions have frequently asserted that because funds held by public utility holding companies are derived at least in part from dividends from the utility subsidiaries, ratepayer monies are involved in some way. Under this theory, the ratepayer/customers are asserted to be in some sense the equitable co-owners of those funds and the investments established with those funds. The New York PSC's "royalty" cases, where an override on non-utility businesses was established to benefit ratepayers, is one example. Ring-fencing therefore developed as a defense against this approach."[10]

III. DRIVERS OF CURRENT INTEREST IN RING-FENCING

While many of the ideas associated with ring-fencing are not new, recent events have given ring-fencing concepts increased impetus in the regulatory environment. As discussed briefly above, the PG&E bankruptcy stemming from the California energy crisis and the difficulties faced by merchant plants resulting from the over-build that occurred during the five years leading up to and including 2001, not to mention Enron and similar corporate disasters, pointed regulators to the need to protect utility assets for the benefit of customers. In addition to recent events, the federal Public Utilities Holding Company Act (PUHCA) was repealed effective February 8, 2006, weakening protections at the federal level.

[10] Ibid.

A. Ring-Fencing Before and After PUHCA

Robert Burns, senior research specialist with the National Regulatory Research Institute, outlined the various pressures associated with utilities that may require ring-fencing strategies and the strategies themselves.[11] The following summarizes his presentation.

Utility managements frequent yearning for the flexibility of unregulated energy (or other business) often conflicts with the utility's business of providing reliable, low-cost energy to utility customers. This desire for diversification is not a new problem and indeed was one of the reasons PUHCA was passed in 1935. The problems and issues associated with utility diversification into unregulated arenas include transfer pricing for goods and services purchased from or sold by the utility to its corporate affiliates. Related to transfer pricing is the cross-subsidization and cost allocation of goods and services between affiliates; and the financial abuse of the utility by the parent where through various mechanisms including transfer pricing and cross-subsidization schemes the parent "milks" the utility for cash while investing little back into the utility to the detriment of the utility's customers. The parent can shift risks from affiliates to the utility through various means including backing the debt of a riskier unregulated affiliate with the utility's cash flow or assets. Other transactions between the utility and affiliate such as contractual relationships to buy and sell power may reduce the perceived risk of the non-regulated entity while increasing the perceived risk of the utility.

Sometimes called the double leverage problem, the utility's actual capital structure can be obscured by a dramatically different capital structure at the parent level. For example, last year Kohlberg Kravis Roberts & Co. (KKR) along with other partners did a leveraged buyout of

[11] Burns, Robert E., Esq., Senior Research Specialist, Regulatory Research Institute, "Ring-fencing the Utility to Protect the Consumer from Corporate Abuse Before and After PUHCA Repeal: Déjà vu." 27th Annual Conference of Regulatory Attorneys, Chicago, Ill., May 2004.

UniSource Energy, the parent company of Tucson Electric.[12] The holding company set up to purchase UniSource was funded with approximately 90 percent debt and only 10 percent equity. Arizona regulators required that Tucson Electric's common equity be raised to and maintained at 40 percent or better, and KKR complied. The regulators put in some additional ring-fencing conditions. The balance sheet of Tucson Electric showed that common equity made up at least 40 percent of the total capital. But this equity was funded by the parent company which is 90 percent debt. So is the common equity of Tucson Electric really 40 percent of capital? Does it matter what the capital structure of the owner is? Some people argue no. No one cares how the purchase of publicly traded stock was financed, for example. However, the typical purchaser of 1,000 shares of stock on the New York Stock Exchange does not have any control over management and the disposition of the assets of the firm. The KKR/UniSource deal at the present has significant backing on Wall Street. With proper ring-fencing the utility should be insulated from even a 100 percent owner. But backing from the financial markets may change with time. Some people remain uneasy with the overhang of so much debt at the parent level. Whether these concerns regarding the parent's debt are ever realized, only time will tell; but this is an added wrinkle in a complex situation.

There are potential benefits to ratepayers by not ring-fencing a utility too tightly. The parent company can achieve economies of scale and reduce costs in such areas as legal, accounting, and human resource staffs; the cost of capital may be cheaper on a consolidated basis than the utility could achieve on its own; and power and fuel purchases and sales may be more efficient. On the other hand, the "best managers tend to seek out and be assigned to the

[12] Richard Stavros, "Taking Utilities Private: Return of the Babbarians,", Public Utilities Fortnightly, February 2004, pp. 24-29.

unregulated activities because those activities can produce the greatest profits, which lead to the greatest rewards."[13]

The repeal of PUHCA is expected to result in increased merger and acquisition activity involving regulated utilities. In the face of lessening federal oversight in certain areas, state regulatory bodies will need to prepare to deal with these issues.

B. Legal Breaches of Ring-fences

There have been some concerns raised that the courts may not always uphold the ring-fences, allowing them to be penetrated. The issue revolves around actions that are called "judgment proofing," which, according to CFO Magazine, courts are increasingly taking a close look at. For example, in New Jersey a landlord successfully sued Blimpie International for back rents after one of its subsidiaries defaulted on a lease agreement. "The subsidiary observed required corporate proprieties: it had its own board of directors, filed annual reports, and kept a separate bank account. [It] never expressly claimed to be Blimpie…But in this case, the court ruled that [the subsidiary] misled the landlord into thinking it was Blimpie; for instance, the men who signed the contract wore Blimpie uniforms, and correspondence was done on stationery that had Blimpie's logo. The court ruled Blimpie liable for the rent and interest."[14]

The personnel who dealt with the above landlord may have been employed by a "service corporation" set up by Blimpie to provide various business services to the parent and subsidiaries and affiliates. Typically these centralized services include legal, accounting, tax, human resources and insurance functions. While this may be a cost-effective way of providing these types of staff services within a holding company structure, it may open the way for liability to the parent or other subsidiaries.

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[13] Burns, op. cit.
[14] CFO.com, op. cit.

This could have ramifications in ring-fencing a utility where some representation of the parent holding company is present with the utility. For example, Qwest International Corp. has this type of structure where a service corporation provides support to the various subsidiaries including the land line telephone company, Qwest Corporation. Further, the various subsidiaries also performed services for one another and on Qwest vehicles, and in advertising and marketing there was little or no effort to distinguish where, say, Qwest Communications (the long-distance subsidiary) ended and Qwest Corporation began.

This may be an example where, in order to protect ratepayers, ring-fencing strategies could ban the use of service entities outside of the utility, thus reducing the likelihood of liabilities generated by the parent or affiliates from affecting the utility. On the other hand, forcing the utility to have internally complete staffs of attorneys, accountants, engineers, human resource and insurance professionals, etc., may not be as efficient as the centralized business service organization of the parent, resulting in higher costs to ratepayers.

Ring-fencing of utilities is often done to "judgment-proof" the utility from the bankruptcy court. Regulators are concerned that the fall-out of the bankruptcy of a utility's parent or affiliates will negatively affect the utility's costs and access to the credit markets, or worse, drag the otherwise healthy utility itself into the bankruptcy, to the detriment of ratepayers and the regulator's own authority. Recently, with more utility-related bankruptcies, tensions have increased between state and federal regulators and the bankruptcy courts. To date there have been conflicting decisions. Mostly parties have settled before the courts did anything definitive. The PG&E case discussed above featured a battle between the California Public Utilities Commission (CPUC) and the PG&E. In its original plan for reorganization, PG&E wanted to divide itself into four entities placing most of the assets and three of the four entities outside the purview of the CPUC. The CPUC objected with the support of other parties including the United States, claiming "that PG&E did not have the authority to preempt the state laws in its plan of reorganization."[15] The bankruptcy court generally sided with the CPUC; but on appeal to the district court PG&E won a reversal of the bankruptcy court. CPUC appealed to the Ninth Circuit which reversed the district court saying that bankruptcy law could only preempt state laws that relate to "financial condition," without defining what that meant. The Ninth Circuit remanded it back to the bankruptcy court for further hearings. The parties settled before any clear precedent could be created.

Federal regulatory bodies have also been involved in the bankruptcy process with mixed results. FERC is given authority over energy contracts under the Federal Power Act. In the NRG contract dispute, the courts in New York have mostly sided with FERC to date. In a similar-appearing contract dispute involving Mirant, courts in Texas have support the Company.

With regard to issues between state and federal regulators and bankruptcy law, the "answers to the following questions remain unclear and continue to be the subject of much litigation in pending Chapter 11 cases of utilities:

- Whether the applicable state regulatory agency continues to control utility rates in Chapter 11 or whether the bankruptcy court will inject itself into the approval process,
- Whether state regulatory approval is required to confirm a plan of reorganization, and
- Whether a debtor can stop performing under a contract without regulatory approval. While a bankruptcy court is likely to be sympathetic to the importance of uninterrupted service to customers and to consider the views of regulatory officials, the ultimate impact of the bankruptcy of a utility on customers is impossible to predict."[16]

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[15] South, George B. et. al. "Current Issues Affecting Utility Bankruptcies," The Journal of Structured and Project Finance, Winter 2004, p 37.
[16] Ibid. p36.

A recent federal bankruptcy case may be relevant to the utility ring-fencing issues. In New York, the domestic branches of two Yugoslavian banks had been ring-fenced by state banking regulators in order to protect domestic customers and creditors. The ring-fencing apparently was part of the approval to receive a state banking license. The banks failed and the New York regulators proceeded to seize the assets of the domestic branches. The U.S. District Court for the Southern District of New York has reversed the seizure relying on the U.S. bankruptcy law. Joining in support of New York's legal fight included the Federal Reserve Bank of New York. While the legal fight continues, it highlights that federal courts may overturn the best-laid plans of state regulators.[17]

In a review of the ring-fencing landscape, Matias Avila Nores investigated whether or under what conditions courts might pierce the corporate veil to allow access to ring-fenced assets. She concludes that "courts are more likely to disregard the legal entity in tort cases and to closely held corporations, where there are no market consequences for holding these corporations liable."[18]

C. Portland General Electric

"FERC's experience with Enron demonstrates that the agency is no match for the sophisticated, competitive, profit-driven companies it regulates."[19] The collapse of Enron and its impact on its regulated utility bond ratings has forced many state regulators to reexamine the scope of their role. SEC and FERC oversight was lax in the Enron matter. The Company was often able to bend, sometimes even break federal rules governing affiliate transactions.

[17] American Banker, 8/19/2004, Vol. 169 Issue 160, p.4.
[18] Matias Avila Nores, "Ring-Fencing and Other Bankruptcy-Remote Techniques." Duke University School of Law, Spring 2002. p. 17.
[19] Committee on Governmental Affairs Investigation of FERC Oversight of Enron, Staff Memorandom, November 12, 2002.

Consequently, when Enron filed for federal bankruptcy protection in 2001, many of its subsidiaries were forced into fiscal insolvency. The exception, however, was Portland General Electric (PGE), an electric public utility and subsidiary of Enron that maintained a credit rating eight notches above that of its bankrupt parent company. By the September 30, 2003, fiscal quarter, Portland General had 52% common stock equity as a percentage of total capitalization. Portland General's secured and unsecured debt ratings are presently investment grade from both Moody's Investors Service and Standard and Poor's. Fitch Ratings rates Portland General's secured debt at investment grade and unsecured debt at below investment grade. While federal regulation failed to protect other utilities, PGE survived because state regulators took precautionary action.

The Oregon Public Utility Commission ring-fenced PGE in its affiliate transactions and dealings between Enron and PGE, before there was "blood in the water." Ring-fencing, in this instance, was a precautionary measure rather than a reaction. As state utility regulators consider the efficacy of federal oversight and the need for state commissions to ensure the viability of public utilities, it is important to examine PGE and the steps taken by the Oregon Public Utility Commission (OPUC) to ensure its viability.

With the acquisition of PGE in 1997, Enron became a Public Utility Holding Company subject to PUHCA rules and FERC oversight. Regulators in Oregon, however, insisted on a number of stipulated conditions that reinforced federal rules and imposed more stringent oversight by state authorities. It is through these conditions, put forward by the Oregon commission, that PGE's assets and transactions were essentially ring-fenced, protecting the company from Enron's liabilities and debts.

The Enron-PGE merger was contingent upon terms stipulated by the commission (Stipulation UM814). PGE was required to maintain books and records separate from Enron; to maintain separate accounts; to continue to hold all of its assets in its own name; and to enter into transactions with Enron only as permitted by federal and state regulators. All of PGE assets, accounts and transactions were maintained separately from those of its parent company. In this way PGE was "fenced" by a high degree of transparency and oversight by the state.

The stipulation's first three conditions call for access by the Oregon commission to investigate and review of inter-corporate transactions "that result in direct charges or cost allocations to PGE."[20] Enron, and its unregulated subsidiaries must provide auditors with transactional and account information upon the commission's request. With respect to PGE, the Stipulation mandates that the company maintain its own accounting system and locate all financial books and records in Portland. In sum, Stipulation conditions one through three holds Enron accountable to the findings of Oregon Commission audits. With access to holding company and unregulated affiliate books, auditors enjoy a level of transparency without relying on federal investigations or regulators.

Conditions five through nine provide financial protection for PGE. The Commission requires that PGE:

1. "maintain its own long-term debt ratings and preferred stock ratings for as long as it has preferred stock outstanding;"
2. "maintain the common equity portion of its capital structure at 48% or higher unless the Commission approves a different level;" and
3. notify the Commission of certain dividends and distributions to Enron."[21]

As further protection against cross-subsidization, conditions twelve, thirteen, fourteen and sixteen "require more frequent and expanded reporting of affiliated interest transaction as

[20] Public Utility Commission of Oregon Order No. 97-196
[21] Ibid

well as a direct prohibition on allocations or direct charges from Enron to PGE without Commission authorization."[22] Rather than waiting for a rate case, the Commission requires Enron to make more frequent filings that specifically address cooperative charges and affiliate transactions costs to PGE.

Oversight, in this case, seeks to enforce a distance of an "arm's length" between PGE and Enron. Quarterly reports regarding employee transfers, consulting and training activities ensure that PGE is being treated as a separate entity outside of Enron. Under its own name, PGE manages its own cash; holds its own assets; maintains a separate workforce; funds its own payroll; and runs its own pension plan. In short, PGE "holds itself out solely as a separate entity."[23]

In the event that PGE, Enron or any affiliate violates the conditions of the stipulation, "the Commission may impose an Order, without first acquiring an order of the Circuit Court."[24] In this way the Commission grounds the terms of the stipulation by providing specific grounds for assessing penalties without the permission of another body and sets itself up as the primary enforcer of the contract. Federal intervention or intervention by an outside court is not needed. The process is streamlined within one state agency.

D. Credit Rating Agencies

Of concern to regulators is the impact on a utility's credit standing due to problems of a parent holding company or affiliates. Fitch Ratings and Standard & Poor's have commented on the issue. Both rating agencies will link, i.e. will affect utility's own debt due to the parent's or affiliate's problems, unless there exists a tight "ring-fence" around the utility. Absent a

[22] Public Utility Commission of Oregon Order No. 97-196
[23] Memorandom, Council for PGE, December 4, 2001. SEC Form 8-K, Commission File Number 1-55-32-99
[24] Public Utility Commission of Oregon Order No. 97-196

sufficient ring-fence, a significant downgrade of the parent's or affiliate's debt could result in an increasing cost of capital to the regulated utility which could then result in higher costs to ratepayers. "In fact, Fitch indicates that ratings linkages caused about half of all rating changes for electric and gas utilities."[25] Although hailed as a successful instance of ring-fencing, Portland General Electric did suffer from the Enron implosion including a "junk-bond" rating and being closed out of the commercial paper market.[26]

Credit rating agencies prefer that a public service commission have specific statutory authority to implement ring-fencing rather than basing it on general powers, and they prefer the general powers of a PSC to stated corporate policies of a holding company. They also want the ring-fencing to be in place well before any signs of trouble rather than as acts of desperation to save the company. The factors a particular rating company may consider may vary somewhat between rating agencies, but generally they will consider a ring-fence to be sound if it meets the following structural and operational factors.

> "[T]he utility should be viewed as a stand-alone company with a separate corporate identity and an appropriate capital structure… The utility should be, at the very least, a separate subsidiary with its own accounting system, separate debt and preferred stock ratings, cash management system, and operations financed separately from its parent…Optimally, a special-purpose entity or limited-purpose operating entity would be created that would achieve almost complete credit isolation and bankruptcy remoteness. Finally, the parent must guarantee that it will not include the utility in a petition for bankruptcy protection.
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> "While structural ring-fencing is a necessary antecedent to effective insulation of a utility, it alone is insufficient unless coupled with operational ring-fencing policies. These policy tools are more of an administrative burden for PUCs because they require active oversight of: (1) affiliated transactions; (2) dividend policies; (3) securities issuances and financings; (4) ownership changes; (5) diversification investments; and (6) asset transfers."[27]

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[25] Grygiel, Dr. Fred and John Garvey, "Fencing in the Regulated Utilities," Public Utilities Fortnightly, August 2004, p. 32.
[26] Ibid.
[27] Ibid.

Typically when a corporate parent's debt is downgraded due to default or bankruptcy, any debt issued through a subsidiary will be similarly downgraded. Standard & Poor's cautions that factors such as the potential "stand-alone" rating of the subsidiary, provisions inhibiting the parent from including the subsidiary in a bankruptcy filing and regulation affecting the parent and/or the subsidiary may "slightly" improve the subsidiary's debt rating.[28] In the cases of Edison International and PG&E discussed above, "novel circumstances permitted an extensive ratings differential for specific subsidiaries. Standard & Poor's concluded that these circumstances create a powerful financial disincentive for the parent or its creditors to file the subsidiary [into bankruptcy]; it is the existence of these so-called "negative" criteria that allow specific subsidiaries…to maintain investment-grade ratings...Typically, Standard & Poor's will not rate even ring-fenced subsidiaries much higher than the rating of the consolidated entity. Nonetheless, certain circumstances can lead to exceptions to the weak-parent/strong-subsidiary linkage, such as independent finance subsidiaries and regulated entities. Even in such instances, however, there typically remains some linkage."[29] What appears to be critical to Standard & Poor's in the cases of Edison International and PG&E is that should the subsidiaries file for bankruptcy, either "voluntarily" or involuntarily, there would be immediate consequences related to their contractual arrangements that would seriously threaten their ability to continue as going concerns.[30] The sudden significant loss of value that would result in a bankruptcy filing convinced Standard & Poor's that there were powerful disincentives for either the parent

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[28] Rigby, Peter N., (, Standard & Poor's) "'Ring-Fencing'" Subsidiaries to Protect from Parent Bankruptcies During the California Power Crisis," *The Financier*, Vol. 9, Nos. 1-4, 2002, pp. 30-33.
[29] Ibid. pp. 31-32.
[30] For instance, many of the subsidiary's energy-trading partners require that entities they do business with have and maintain investment grade credit ratings. A bankruptcy filing by the subsidiary would have ruined its credit rating, which would have precluded it from doing any further business with most, if not all, energy traders.

companies or creditors to bring the subsidiaries into the bankruptcies. This disincentive plus the other ring-fencing strategies kept the bond ratings of the subsidiaries at investment grade.

As suggested earlier, Standard & Poor's cautions that ring-fencing is not a cure-all for protecting a subsidiary's credit rating. The Edison International and PG&E situations are considered by Standard & Poor's to be fairly unique fact situations. "In general, ring-fencing will only create a marginal rating differential between subsidiary and its parent entity. In many cases, a distressed parent, or its creditors, will perceive that significant economic incentives exist to file a solvent subsidiary into bankruptcy. Those incentives may well give rise to strategies that can trump the legal structures that may be in place. Surprise outcomes are not unheard of in the bankruptcy context…Standard & Poor's cautions that each ring-fencing exercise must be viewed on its own merits."[31]

Fitch has commented in several forums on ring-fencing. Maximum effectiveness of ring-fencing is the result of "concurrent deployment of numerous ring-fencing methods."[32] Similar to Standard & Poor's, Fitch cautions that "ring-fencing techniques rarely provide total insulation of a U.S. utility from problems relating to an insolvent parent. Furthermore, even if affiliates are segregated in numerous ways, the presence of a single important unifier, such as a large intercompany loan or an intercompany supply contract critical to continuing operations, may nullify all other ring-fencing efforts."[33] This rather severe observation suggests that a service company operations within a holding structure need to be carefully organized and maintained in order to keep Fitch, or another rating agency, from concluding that the utility and its affiliates are sufficiently intertwined to devalue or even ignore ring-fencing mechanisms. More to this last

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[31] Ibid. pp. 32-33.
[32] Bonelli, Sharon, et. al., "Rating Linkage Within U.S. Utility Groups: Ring-Fencing Mechanisms," Fitch Ratings (see www.fitchratings.com), April 8, 2003. p.1.
[33] Ibid. p. 1.

point, Fitch states further that if "a linkage between a regulated utility and a nonregulated affiliate is critical to the continuing operations of the entities and difficult to replace by an independent third party, then narrower rating differentials between the regulated and nonregulated issuers' ratings are likely."[34] Fitch indicates that separate management, boards, bank accounts, and books and records are important components of separating the risk of the utility from the parent and affiliates. Finally, Fitch indicates that it will evaluate all ring-fencing conditions to estimate the likelihood that the utility could be drawn into bankruptcy along with any troubled affiliates, or a troubled parent.[35]

IV. RING-FENCING MEASURES

To protect a utility's credit rating from serious affect from parent or affiliate actions or problems, credit rating agencies typically want to see a ring-fence in place before problems develop. Ideally there will be specific statutory authority for a public utilities commission to implement ring-fencing procedures. More often the state regulatory agency relies on its general regulatory powers to implement ring-fencing as conditions for approval of mergers, acquisitions, or some other reorganization. "Ring-fencing insulates a healthy company form the risks associated with having a financially distressed parent and/or affiliate, by restricting or limiting:

1. The distressed company's ability to deplete the assets of the subsidiary;
2. The ability of a distressed company or its creditors to force the utility into bankruptcy; and
3. The ability of a court overseeing the Chapter 11 cases of the distressed company to substantively consolidate the assets and liabilities of the healthy subsidiary with the assets and liabilities of the distressed parent and/or affiliate."[36]

[34] Ibid., p. 3.
[35] Ibid., p. 4.
[36] South, George B., et. al. Op. Cit. p. 38.

A. "Best Practices"

The following is a list of "best practices" that can be gleaned from Standard & Poor's and Fitch rating services.[37] These "best practices" are not exhaustive of the items that could be included by regulators for their purposes in a ring-fence, such as extending conditions on transactions with affiliates.

1. The regulated utility is a corporate subsidiary in a holding structure
2. The regulated utility is placed in a Special Purpose Entity, which is legally separate from the non-regulated affiliates of the parent.
3. The provision of so-called "nonpetition" (bankruptcy) language by the parent.
4. The utility is managed separately and has a separate board of directors.
5. The utility's books and records are kept separate from any affiliates.
6. The utility has its own bank accounts and credit facilities, its own separate debt and has its own separate credit rating.
7. Limits imposed on capital structure, e.g. setting a minimum common equity percentage in the capital structure.
8. Limits on inter-company guarantees and loans—including loans to money pools.
9. Limits on dividends.
10. A written Affiliate Code of Conduct is in place.
11. Finally, violations of these practices are supported by clear penalties from regulatory authorities.

In a paper prepared by NARUC's Subcommittee on Accounting and Finance outlined five areas of possible ring-fencing measures:[38]

1. Commission authority to restrict and mandate use and terms of sale of utility assets. This includes restriction against using utility assets as collateral or guarantee for any non utility business.
2. Commission authority to restrict dividend payments to a parent company in order to maintain financial viability of the utility. This may include, but is not limited to, maintenance of a minimum equity balance.
3. Commission authority to authorize loans, loan guarantees, engagement in money pools and large supply contracts between the utility and affiliate companies.

[37] The Standard & Poor's items are taken from the Rigby article cited above. Information from Fitch was taken a PowerPoint presentation by Sharon Bonelli, Senior Director, Fitch Ratings, dated September 17, 2003 and located at the following website: www.puc.state.id.us/RELATEDSITESACCT/bonelli.ppt

[38] NARUC Subcommittee on Accounting and Finance, "Ring-fencing Mechanisms for Insulating a Utility in a Holding Company System." www.naruc.org/associations/1773/files/ringfencing060503.pdf This paper is undated but appears to have been completed in 2003.

4. Commission authority over establishment of a holding company structure involving a regulated utility.
5. Expand commission authority over security applications to include the ability to restrict type and use of financing.

B. Alternative Views and Cautions on Ring-Fencing

There is some downside to ring-fencing, especially the more extreme forms. Standard & Poor's analysts have commented that ring-fencing seldom results in a bond rating noticeably higher than the parent's rating. "Ring-fencing costs a lot of money. It restricts the way you can do business…Generally, a ring-fence strategy is a defensive move or a survival move," according to Dan Streek, at the time the interim CFO of Missouri-based UtiliCorp United.[39] "UCLA law professor Lynn LoPucki agrees. 'The only time it matters whether you have ring-fenced is when you are in financial trouble, or a creditor is anticipating the possibility that you may be in trouble,' he says."[40]

Former Michigan regulator and utility consultant, Steve Fetter, goes further with his recent critique of ring-fencing.[41] He asserts that regulators assume they know the future when they commit to build tight ring-fences around a utility; that ring-fencing may, due to unforeseen events, create more problems than it solves. He points out that there can be legitimate benefits to consumers from cost-sharing and close interaction of all members of management of in both the regulated and non-regulated affiliates of a holding company. Overall he believes that the best protection for the consumer is "open and frank communication between regulators and utility management." However, there are certain ring-fencing ideas he is open to. The first is that the accounting of the utility be kept separate or, at least separable from the non-regulated activities. He agrees that regulators need access to the books and records of the utility and sometimes may

[39] Reason, Tim, "Ring Around the Subsidiary," CFO.com, CFO Magazine, October 1, 2001.
[40] Ibid.
[41] Fetter, Steve, "Don't Fence Me Out," Public Utilities Fortnightly , October 2004, pp. 20 & 22.

need access to the books and records of the parent or other affiliates. Second, he agrees with corporate structural separation, i.e. that the utility be a separate subsidiary from the parent's other businesses. Third, if the utility gets into financial trouble, regulators may mandate "a certain percentage level of equity to ensure the financial health of that utility going forward." But he thinks that such a mandate should only last as long as the negative financial situation continues. Finally, he agrees that regulators have a legitimate concern in protecting utility assets from being mortgaged or otherwise encumbered to support or stand behind transactions of other, possibly riskier, affiliates of the parent. He does not agree that restrictions on dividends is a good policy since it may have serious repercussions in the investment community given that investors in utilities are looking at management's dividend policy and would view regulatory intervention as adding to risk. He believes that the "mere setting of a required equity level should be enough." His conclusions is that regulators should be cautious about putting into place restrictions that limit management discretion in the future.

V. BRIEF REVIEW OF FEDERAL LAW

Under the Public Utility Holding Company Act (1935), the SEC is charged with regulating public utility holding companies; their corporate structure, affiliate transactions, securities issuance and holdings, and debt. The Federal Power Act (FPA) authorizes the Federal Energy Regulatory Commission (FERC) to oversee public utility companies and the generation, transmission and distribution of energy involved in interstate commerce.   Under this scheme the SEC assumes responsibility for holding company regulation, while FERC maintains control over utility companies and the energy market.

A. The Public Utilities Holding Company Act of 1935 (PUHCA)

In 1935 PUHCA was put in place to protect public utilities from "the problems" and "evils connected with public-utility holding companies engaged in interstate commerce or in activities which directly affect or burden interstate commerce."[42] Prior to 1935, holding companies used regulated public utilities as cash cows, milking them to subsidize affiliates or provide collateral for unrelated investments. In the "absence of 'arms-length' bargaining…when services, management, construction and other contracts involve the allocation of charges among subsidiary public-utility companies,"[43] the interests of investors, ratepayers and affiliates are not protected.

Lawmakers responded to public utility exploitation with the 1935 passage of PUHCA. The Act imposes federal regulation on holding companies engaged through their subsidiaries in the electric utility business or in the retail distribution of natural or manufactured gas.

PUHCA charges the SEC with the regulation and investigation of holding companies. Specifically, the Act sets up mechanisms for the SEC to investigate and approve or disprove holding company action. It calls for holding companies to register with the agency and to file reports containing detailed information about their organization, financial structure, and operations. With filed information the SEC can investigate company operations to ensure that the public utility and its ratepayers are not harmed by dealings with its affiliates or holding company.

Under the Act, registered holding companies are limited to "a single, integrated public utility system and to those non-utility businesses that are 'reasonably incidental, or economically

[42] PUHCA § 1 (c)
[43] Ibid.

necessary or appropriate' to the system's utility operations."[44] Intra-holding company loans and extensions of credit; affiliate services, sales and contracts; as well as profit sharing agreements are all subject to SEC orders. Therefore, SEC approval must be obtained before a holding company may:

1. Issue or sell securities or alter the rights of security holders *(Section 6)*
2. Acquire interest in an electric and gas utility company serving the same territory (Section 8)
3. Acquire any securities and/or utility assets or any interest in a non-utility business *(Section 9)*
4. Sell utility assets or other interests *(Section 12)*
5. Borrow or receive any extension of credit or indemnity from any public utility company in the same holding company or from any subsidiary company in the same system. *(Section 12)*
6. Take action to enter into a contract for sales, service, or construction with a utility company or negotiate such a contract between an affiliate and a utility company. *(Section 13)*

B. Federal Failures

In the aftermath of Enron and the California Energy Crisis the efficacy of federal regulation has been called into question. Despite direction provided by PUHCA, the FPA and PURPA, the FERC and SEC have failed to secure electric utilities and energy markets as witnessed after the recent energy crisis. Investigations conducted by both bodies were infrequent and often inconclusive. In some instances regulators recognized problems, but took no action to correct them. During congressional investigation the Committee on Governmental Affairs criticized FERC as an "inadequate" body with many failures.[45]

There is no communication between the SEC and FERC regarding regulation. Each agency operates independently, allowing holding companies to escape many of federal mandates

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[44] SEC Division of Investment Management. "The Regulation of Public Utility Holding Companies." June 2005. Retrieved from: http://www.sec.gov/news/studies/puhc.txt

[45] Committee on Governmental Affairs, "Committee Staff Investigation of the Federal Energy Regulatory Commission's Oversight of Enron Corp," Staff Memorandum, November 12, 2002.

through loopholes created by the lack of interagency communication. Neither commission has established any coordinated effort to resolve this communication gap, leaving many to wonder just how seriously they are taking calls for reform.

Internally, however, FERC has taken steps to more closely monitor cash management and utility debt issues. In 2002 it established the Office of Market Oversight and Investigations (OMOI). FERC has also imposed new conditions on the public utility issuances of secured and unsecured debt:[46]

1. Public utilities seeking authorization to issue secured debt backed by a utility asset must use the proceeds of the debt for utility purposes only
2. If any utility assets that secure debt issuances are "spun off" the debt must follow the asset and also be "spun off"
3. If any of the proceeds from unsecured debt are used for non-utility purposes, the debt must follow the non-utility assets. If non-utility assets are "spun off," then a proportionate share of the debt must follow the spun off non-utility asset.
4. If utility assets financed by unsecured debt are "spun off" to another entity then a proportionate share of the debt must also be spun off.

[46] FERC, "Commission Sets New Conditions for Utility Debt Acquisition," Docket No ES02-51-000, News Release, February 20, 2003.

C. PUHCA Repealed: The Electricity Policy Act of 2005

There have been a number attempts to totally repeal or dramatically reform PUHCA. On August 8, 2005 President Bush signed the Domenici-Barton Energy Policy Act of 2005 effectively repealing PUHCA. The repeal becomes effective six-months later on February 8, 2006. The Act among other things (1) repeals PUHCA; (2) removes the SEC from utility regulation; and (3) "simplifies" holding company and public utility company regulation by consolidating it within FERC.[47] Given FERC's previous failures to effectively oversee energy markets and QF transactions, many lawmakers are concerned that it will be unable to assume additional duties imposed by the Act.

VI. STATUS OF RING-FENCING IN UTAH: SUMMARY OF UTAH LAWS AND COMMISSION DECISIONS

Most ring-fencing-type of activities in Utah derive their authority from the general powers of the Utah Public Service Commission (i.e. UC 54-4-1). There are presently no administrative rules specific to this issue. As discussed earlier, rating agencies prefer to see specific statutes empowering a public service commission to implement ring-fencing conditions. There are specific statutes regarding certain transactions that the Commission is given specific authority which entail ring-fencing concepts.

UC 54-4-25 Requires the Commission to issue a certificate of convenience and necessity before a utility is allowed to begin construction or operation of a "line, route, plant, or system."

UC 54-4-26 A utility may not enter into a contract for purchase or requires any other expenditure without approval of the Commission.

UC 54-4-27 A utility must inform the Commission of any dividends it has declared. The Commission may investigate the dividend payment and if the payment of the dividend is

[47] H.R. 6, Title XII, Subtitle G

likely to impair the capital of the utility, then the Commission may order that the dividend be retained until the risk of impairment is eliminated.

UC 54-4-28 The Commission must approve of any merger, consolidation, or combination of a utility.

UC 54-4-29 The Commission must approve of a utility acquiring the voting stock or securities of another utility.

UC 54-4-30 A utility must receive the approval from the Commission for the acquisition of any property, plant or equipment from another utility.

UC 54-4-31 An electric corporation must receive approval from the Commission to issue any security or assume any debt or obligation. Issuance or renewal of debt or assumption of debt or obligation that has a maturity of one year or less is exempt from this requirement.

The Commission has exercised its authority in cases of merger and reorganization on a number of occasions. PacifiCorp, the primary electric utility in Utah, has experienced two mergers or reorganizations in the last 20 years, and, prospectively is about to go through another one. Questar Gas (formerly Mountain Fuel Supply Company) was reorganized in 1984. The ring-fencing conditions of these mergers and reorganizations are discussed below.

A. PacifiCorp

ScottishPower was required by state regulators to implement a number of ring-fencing procedures as conditions for the approval of its buyout of PacifiCorp announced in 1997. About a decade prior to the purchase by Scottish Power, Pacific Power & Light merged with Utah Power & Light to form PacifiCorp.

As conditions for the Utah Power & Light merger to form PacifiCorp, the Utah Public Service Commission required, among other things, that the Company keep detailed records of affiliate transactions and provide the Division of Public Utilities with its 5-year strategic planning documents. However, there were few if any other items that were required that are currently considered ring-fencing related. For instance, PacifiCorp maintained a non-holding company structure where non-regulated affiliates were subsidiaries of the utility.[48]

This changed significantly with the subsequent acquisition of PacifiCorp by ScottishPower in 1999. In the Commission's press release announcing its approval of the merger, the Commission pointed out that the merger was approved with "51 conditions to ensure customer benefits and to eliminate risks of the merger for customers."[49] A highlight of the approval was a $48 million credit to customers to be paid out over four years. There were conditions imposed by Utah and other state commissions. Foremost is the imposition of a holding company structure (required specifically by the state commissions of Idaho, Washington and Wyoming). A domestic holding company was created in which the utility became a subsidiary of the holding company with the non-regulated businesses separated from the regulated business in their own subsidiaries under the holding companies. The utility was required to maintain a separate accounting system and to make its records available in Portland, Oregon and Salt Lake City, Utah (Condition 23).[50] Per Conditions 10 and 11, the Commission retains authority to audit any ScottishPower and unregulated subsidiary records applicable to transactions involving PacifiCorp. Condition 9 requires ScottishPower to seek Commission approval to "divest, spin-off, or sell an 'integral utility function.'"[51]

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48 Public Service Commission of Utah "In the Matter of the Application of UTAH POWER & LIGHT and PC/UP&L MERGING CORP (to be renamed PacifiCorp)…. Docket 87-035-27, September 28, 1988 (reaffirmed December 13, 1988).

49 Public Service Commission of Utah, "Public Service Commission of Utah Approves the ScottishPower Merger with PacifiCorp." Press Release, November 23, 1999.

50 Condition numbers are from the Stipulation between ScottishPower, PacifiCorp, the Division of Public Utilities, and the Committee of Consumer Services, which is included as Appendix I in the Commission's "Report and Order," Docket No. 98-2035-04, November 23, 1999.

51 Public Service Commission of Utah, "Report and Order," Docket No. 98-2035-04, November 23, 1999.

Additionally, the Commission's order provides that PacifiCorp will maintain its own separate long-term debt (Condition 21), transfer pricing policy (Condition 6), and apply to the Commission for approval of security issuances by or on behalf of PacifiCorp (Condition 22).

Rebuttal testimony filed by Larry O. Martin in the recent PacifiCorp rate case (04-035-42) indicates PacifiCorp's view of the conditions regulators placed on the ScottishPower/PacifiCorp acquisition. "The state utility commissions that regulate PacifiCorp have gone to great lengths to ensure adequate separation between PacifiCorp and its non-regulated affiliates in order to protect ratepayers. For example, during the merger, the Idaho, Washington, and Wyoming commissions specifically ordered the Company to separate out non-utility businesses from PacifiCorp and to put into place "ring-fence" provisions for the diversified activities…In addition, in approving the merger, this Commission placed particular emphasis on merger stipulation provisions designed to keep PacifiCorp separate from other Scottish Power nonregulated [sic] activities.

"PacifiCorp has taken steps, encouraged by its commissions to maintain separation of its utility operations for the benefit of ratepayers. In 2001, PacifiCorp sought approval from FERC and other state utility commission [sic] for which it was required to do so to insert PHI into the holding company structure and move PPM and other non-regulated companies to a position of being affiliates of PacifiCorp rather than a subsidiary. The FERC and the commissions approved the reorganization.

Even prior to the merger, the Company had also consistently made an interest synchronization adjustment in its general rate case filings to remove the portion of actual interest paid to fund rate base not allowed into rates."[52]

[52] Rebuttal Testimony of Larry O. Martin, Docket 04-035-42, pp. 11-12.

As can be seen, with the ScottishPower merger, the state commissions, including Utah's, imposed significant ring-fence conditions on the merger with PacifiCorp. In summary these conditions included:

- Holding Company Structure with the utility separated from the non-regulated businesses.
- Acknowledgement of commission authority to audit not only the utility's books, but the relevant records of the parent and affiliates.
- Separate debt.
- Separate accounting system.
- Commission approval for divestitures of utility property, or the acquisition of non-regulated property either directly or indirectly.

Additional ring-fencing measures could have been required including separate management and boards, but these apparently weren't considered. In any case, significant ring-fence conditions were put in place to protect the utility and its customers.

B. Questar Gas

Prior to 1984 Questar Gas, operating as Mountain Fuel Supply, was a publicly traded natural gas distribution utility company with several subsidiaries operating outside of the natural gas utility business. These subsidiaries included Mountain Fuel Resources, Wexpro, Celsius, Questar Development Corporation, and Interstate Brick. In August 1984, Mountain Fuel notified the Utah Public Service Commission of its intent to create a holding company structure under the name of Questar. As part of this reorganization, Mountain Fuel Supply stock would be merged into Questar and through a stock dividend issued by Mountain Fuel Supply, Mountain Fuel's other subsidiaries would be transferred to the new holding company. Mountain Fuel would then be, more or less, a pure natural gas distribution company within a holding company structure.

The Public Service Commission in its order dated October 1, 1984 approved the reorganization with conditions. The Commission concluded that as a matter of law, the

"Commission possesses the requisite jurisdiction to approve, modify or prevent corporate reorganizations which are found by the Commission to be detrimental to the public utility or injurious to the public interest."[53] In its order, the Commission recognized that "[s]ubstantial involvement in nonutility activities changes the risk characteristics of the corporate entity. Unsuccessful nonutility ventures could severely affect the holding company and ultimately the financial condition and cost of capital for the utility corporation. Additional complexities are created in the obtaining of sufficient information to ensure adequate and informed regulation. Potential conflicts of interest between affiliated entities grow as the operations of the entity become more diverse, particularly as the entity shifts its emphasis away from utility operations, requiring careful regulatory oversight of the utility operations."[54] In order to solve or mitigate these concerns, the Commission listed fourteen conditions as part of its order of approval. The Division of Public Utilities recommended most of the conditions. The Commission modified some of these and added a number of conditions itself. These conditions contain aspects of ring-fencing that have been discussed above.

Several of the conditions dealt with the Company filing requirements, testimony and information requests. For example the Condition 14 asserts that the Commission and the Division may review and analyze any costs allocated between Questar and the utility. Condition 11 goes further in requiring that Questar provide the Commission and Division "financial records, books or documents when requested." Condition 3 indicates that any services provided to the utility by the holding company or its subsidiary shall be on a preferential or arms-length basis. Condition 4 requires that the holding company loan money to the subsidiary at the best rate available to the holding company or to the utility. The utility or the holding company must

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[53] Public Service Commission of Utah, Case No. 84-057-10, Order dated October 1, 1984, "Conclusions or Law," paragraph 2.
[54] Ibid., "Findings of Fact" paragraph 5.

submit for Commission approval to do any of the following: for the holding company to lend money to the utility; for the utility to declare dividends; for the utility to redeem any common stock; for assets or liabilities to be transferred from the utility to the holding company or its affiliates; for the holding company to divest itself of the utility.

Another positive of the reorganization is that within Questar another major subsidiary is a regulated natural gas pipeline. Essentially all of Questar's non-regulated activities are in the natural gas industry as well. Thus Questar management only has to develop expertise in one industry rather than across diverse industries.

The Commission Order contemplates that the parent company would operate so as to use its larger size or economies of scale to benefit the utility in a number of ways. This relationship between the utility and its parent may be generally beneficial to ratepayers. However, in the event of significant difficulties in the parent or one of the other subsidiaries, the utility might not be protected from the fallout.

C. Other Companies

Other companies regulated by the Utah Public Service Commission include rural telephone companies and rural electric associations. For these companies there is light regulation, particularly of associations, where the customers are essentially the owners. In recent years, however, rural telephone companies have branched out from the traditional, regulated, utility arena and into unregulated services including wireless and cable TV. There may be increasing concern as some of these companies, including associations, become mini-telecommunications conglomerates, that subsidies to and credit impacts of the non-regulated businesses may be increasing the risks to the regulated utility. Further, companies supported by state universal service funds perhaps should be scrutinized more carefully to assure that these funds are needed and properly used. There may be a need for specific ring-fencing of rural, basic, telephone service from the diversified entities.

VII. RECOMMENDATIONS OF POSSIBLE FUTURE ACTIONS

The following are a summary of recommendations and future actions the Commission may undertake. First is a discussion of the ring-fencing procedures the Commission may undertake as it has opportunity. Next is a brief discussion of items for which the Commission may wish to seek statutory authority.

A. Public Service Commission

As described above the Public Service Commission of Utah has a number of ring-fencing-related powers available to it in state statutes. The Commission has exercised these powers as well as its general regulatory powers in the past to put in place ring-fencing-like conditions on companies that were merging or otherwise reorganizing. It is recommended that the Commission continue to implement at least minimum ring-fencing conditions as it has the opportunity including:

1. A holding company structure with the regulated company in a separate subsidiary;
2. That the regulated company keeps separate books and records;
3. That the regulated company have its own separate debt and seek to maintain its own credit rating;
4. That the Commission retain oversight over transactions between the parent and affiliates;
5. That the Commission require a specific level of common equity be maintained on the utility's balance sheet;
6. That the utility be required to make an annual report to the Commission regarding its maintenance of its ring-fencing conditions;

7. That the Commission continue to enforce its oversight over issuance of securities and the acquisition and disposal of significant utility assets.

The Commission, of course, should include or adjust ring-fencing conditions to meet specific circumstances.

B. Legislation

While the Commission has specific statutory authority for certain ring-fencing aspects, it may wish to seek additional legislative authority for other specific procedures. For example, the Commission may seek legislation giving it authority to require any company to adopt holding company structure that legally separates the regulated business from non-regulated activities on its own initiative without waiting for the company to merge or reorganize. Included in such legislation could be other ring-fencing types of procedure as well including the keeping of separate books and records, keeping debt separate, and explicitly be able to limit and regulate transactions between the regulated company and the parent and affiliates, require the company to maintain specific capital structure as determined appropriate by the Commission.

Additional legislation might also be considered related to penalties that the Commission could impose for failure of a company to maintain its ring-fencing conditions. The most extreme "hammer" might be for the Commission to order the divesture of affiliates or the utility from its parent.[55]

These legislative suggestions are made by the Division without legal review. The Division does not have an opinion regarding the constitutionality or other legality of the suggestions at either a state or federal level. Adequate legal research should be undertaken before any legislation is attempted.

[55] Burns, Robert E., Esq., op. cit., recommends that Commissions possess (and by implication be willing to use) "A divestiture hammer for diversification abuse."

APPENDIX 1: SUMMARY OF LAWS OF SELECTED STATES

Credit rating agencies stress that ring-fencing measures imposed by state commissions should be proactive: enforced to prevent the utility from being adversely impacted by its holding company or affiliates. "However, from a credit perspective, *Standard & Poor* believes most of these laws and regulations to be reactive measures: they do not prevent the diversified businesses from weakening the regulated business. These rules typically enable state regulators to take action only after the damage has occurred."[56]

In a presentation to the Subcommittee on Accounting and Finance, S&P presented four basic measures states can take to ring-fence utilities:

1. Capital structure requirements
    - min/max equity or debt allowed in the utility's capital structure
    - In case of PGE , the OPUC established minimum common equity parameters that PGE needed to maintain in its capital structure. Approval of Enron merger required that PGE maintain a min 48% equity ratio
2. Dividend Pay Out Limitations
3. Non-Utility Asset Investment Limitations
4. Limitations on Asset Transfers and Cross-Collateralization

Addressing the NARUC Subcommittee on Accounting and Finance, S&P points to measures taken by three states, Virginia, Oregon, and Wisconsin as examples of "adequate regulatory insulation mechanisms."[57] This paper briefly summarizes measures taken in these three states as well as regulation in New Jersey and Maryland. These states have acted to preemptively, ring-fencing state regulated utilities to deter holding companies and affiliates from action that might prove detrimental to the utility. They do this through legislation and

[56] Ferara, William (2002). Research: Is State Utility Regulation Coming Back into Vogue?. Statndard and Poor's Ratings Direct, October 4.
[57] NARUC Subcommittee on Accounting and Finance. Ring-fencing Mechanisms for Insulating a Utility in a Holding Company System

commission rulemaking. It is important to note, however, that from a credit perspective: "Insulation brought about by legislative statutes is a great deal more certain than state utility commission rulemaking and will provide for greater ratings separation."[58]

Maryland

The Maryland Public Service Commission is in the process of refining current ring-measures. Currently, the Commission relies on the Annotated Code of Maryland and on the state's Electric Restructuring Act to ring-fence utilities incorporated in Maryland. Though both measures give the Commission broad authority, there have been calls for additional legislation that would provide more specific means of regulating affiliate transactions. In a report released in March of 2005, Maryland Commission staff recommended the passage of COMAR Subtitle 49 as well as annual reporting requirements that address ring-fencing issues.

Though COMAR Subtitle 49 was withdrawn shortly after the report's release, a discussion of its provisions are still relevant. Despite broad authority already granted to the Commission to oversee affiliate transactions, COMAR Subtitle 49 would have "prescribe an affiliate code of conduct for electric and gas companies. These draft regulation address loans, financial guarantees, and asset transaction issues." It was hoped that with a clearly defined code of conduct that included penalties, there would be little incentive for holding companies to disregard Commission orders. The mere drafting of this title seems to demonstrate a trend among state regulators to address ring-fencing issues and to step in where federal oversight has failed.

To facilitate the implementation of existing ring-fencing measures and those proposed by Subtitle 49, Commission staff also concluded that "requiring the utilities to file an annual ring-fencing report should provide the Commission with the opportunity to act on a perceived

[58] NARUC Subcommittee on Accounting and Finance. Ring-fencing Mechanisms for Insulating a Utility in a Holding Company System

weakness in a utility's "ring-fence" on a case-by case basis prior to an event that affects the utility's service or the rates charged to its customers (2-3)."[59] As demonstrated by lax federal oversight, Companies lack the incentive to create transparency on their own.

The Annotated Code of Maryland in Section 5-203 and Sections 6-101 through 6-104 establish certain restrictions on securities and debt transactions of utilities **incorporated in Maryland**. Subject to Commission authorization:

- A utility may not acquire the stock of another utility incorporated in Maryland;
- A utility incorporated in Maryland may not assume or guarantee an A-2 liability payable

Title 6 of the PUC Article enumerates provisions relating to the business structure of utilities:

> Subtitle 1 relates to financing and restricts certain financing activities of utilities incorporated in Maryland, subject to Commission approval.
>
> Subtitle 2 relates to reporting requirements.
>
> Section 6-205 requires utilities to file annual reports, which contain information on the corporate structure, affiliations of its officers and directors, and debt holdings.
>
> Section 6-207 requires certain information about stock and indebtedness.
>
> Section 6-208 requires information on the basis of control and principal business activities of a public service company and each parent, subsidiary or organization the utility controls and joint ventures in excess of $1 million. Section 6-209 addresses reporting about officers and directors and their relationships with a utility, parent, or subsidiary, or an affiliation with any entity doing business with the utility.

[59] Beach, Andrew, Elert, Gunter J., Hutton, Brock C., Mitchell, Miles H. . Commission Staff Analysis of Ring-Fencing Measures for Investor-Owned Electric and Gas Utilities. Maryland Commission Staff Report. February 18, 2005

Wisconsin[60]

The Wisconsin Commission relies on a series of statutes to govern affiliate dealings of energy utilities. The PSC is required by state law to audit public utility holding companies and report its findings to the state legislature for review. Statute 196.795

- (3) Commission approval before anyone can own more than 10% of the outstanding voting securities of the holding company
- Limits subsidies between utility and nonutility affiliates
- (5)(g) "no holding company system may be operated in any way which materially impairs the credit if of any public utility
- (5)(c) and (d) prohibit the utility from lending money or guaranteeing the obligations of its parent holding company or affiliates
- (6m) Asset cap that limits nonutility investments to 25% of public utility assets

- Statute 196.80 requires Commission approval for an energy utility to mergy, consolidate, acquire stock in any public utility, or sell acquire, lease or rent any public utility plant or property
- Statute 201.03 requires Commission approval for any securities issueance
- Statute 201.11 allows the Commission to order a utility to cease paying dividends on its common stock when there is a finding of capital impaiment

Virginia

The Virginia Commission also draws on statutes to regulate affiliate transactions with public utility. The Commission's approval is required for utility security issuances (Chapter 3, §56-58); utility guarantees), affiliate loans, dividend payments to affiliates (Chapter 4 § 56-82); and for the change in ownership or control of a public utility (Chapter 5). Virginia is unique in that its Commission has had some success in establishing penalties that are enforced when utilities' bond ratings fall below an ordered standard. Under SEC Rule 53, the Virginia Commission has been able to convince utility companies to agree to include certain contractual agreements that authorize the commission to levy fines if certain standards are not met.

[60] NARUC Staff. "Ring-fencing Mechanisms for Insulating a Utility in a Holding Company System."

Oregon:

Unlike Virginia, Maryland and Wisconsin, Oregon's ring-fencing measures have been ordered by the commission and not brought about by the state legislature. Nevertheless, the OPUC seems to have effectively imposed ring-fencing measures as per the example of PGE. The Commission included both conditions of the PGE-Enron merger in addition to provisions granting the Commission authority to assess fines and penalties to Enron and/or PGE.[61]

New Jersey:

The New Jersey Commission sets out very specific rules regarding asset sharing and joint purchases. The regulated utility and its parent must be separate entities. It requires that both companies and their affiliates undergo annual audits to assess company compliance with ring-fencing measures and to ensure that the fiscal health of the utility is not in jeopardy.[62]

The Commission has also included a section on penalties assessed to holding companies and or utilities and their affiliates if any one of the Commissions rules is violated[63]. Namely, the Commission can: impose a penalty of up to $10,000 for each violation committed; order the utility to reimburse ratepayers including interest; or order the utility restructure itself under the direction of the Commission in such a way to prevent future violations.[64]

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[61] Public Utility Commission of Oregon Docket UM 814, Oder No. 97-196 Stipulation §21
[62] New Jersey Board of Public Utilities. Adopted Rules: Affiliate Transactions, Fair Competition and Accounting Standards and Related Reporting Requirements
[63] Section 6
[64] New Jersey Board of Public Utilities. Adopted Rules: Affiliate Transactions, Fair Competition and Accounting Standards and Related Reporting Requirements. Section 6 §8 (b)

APPENDIX 2: MODEL ESTIMATING BOND RATINGS

One of the reasons for implementing ring-fencing techniques is to protect the bond rating of the regulated utility. A number of utility companies, most notably rural telephone companies do not have their own bond ratings, as such. It may be useful to estimate what these companies may receive in the way of a bond rating should they, hypothetically, apply for one. It may also be useful to test the bond rating of utilities with bond ratings that are part of a larger holding company, or have significant unregulated businesses, to check what the rating would be as a free-standing, pure regulated utility. To this end a preliminary regression model based on commonly available financial ratios and other financial data has been developed with limited testing. This model is not represented here to be definitive or complete, but rather is an indication of what may be done using common financial data. Bond rating agencies indicate that while they certainly consider common financial ratios and other financial measures, they consider many aspects of a company, its industry, the economy and its specific bond issue that are not easily quantifiable: in the end the rating agencies say they make a judgment call. Nevertheless, as indicated by this brief analysis, a quantitative model is often able to predict bond ratings with some accuracy. Further refinements to the model set forth below may improve the accuracy.

The model used data from 46 publicly traded utility companies. Most of these companies are holding companies, many of which have regulated operations besides that of an electric utility. Most of these companies have non-regulated activities, and for some the non-regulated activities are substantial. The data for these companies were compiled from Value Line[65] or

[65] Value Line Investment Survey, March 2005.

AUS.[66] The model was tested on a second group of 12 publicly traded companies which were not part of the 46 companies used to develop the model (the "hold-out" group).

One difficulty inherent in the model is the question of what bond rating to use. Ratings from both Standard & Poor's and Moody's were available for most of the companies. The bond ratings for a given company from each rating agency were generally similar and sometimes identical. However, sometimes there were notable differences between the two rating agencies. This required a "command decision" from the analyst regarding what rating exactly to build and test the model against. For this analysis the "average" of the two ratings was used when the two ratings differed. This could result in some differences in precision on a company by company basis.

The variables were chosen from a group of common financial variables. The cash flow-to-interest and long-term debt-to-capital ratios were selected specifically because Standard & Poor's has indicated that they are two of the three primary ratios that rating company looks at. The third ratio, cash flow-to-long-term debt, was excluded because of high statistical correlation with the other two variables, which means that it did not improve the model and caused the signs on the other variables to be counterintuitive. The long-term debt-to-capital ratio was also not statistically significant, but was left in the model because of its use by Standard & Poor's and the fact that the sign of its coefficient was as expected.

The actual bond ratings were converted from the letter grade given by Standard & Poor's to a numerical value by using the current relative bond yields associated with those ratings. That is the higher ratings such as AA have a lower yield than the lower ratings. The signs on the coefficients (the minus signs, or no sign for a plus) may at first blush appear counterintuitive since factors that would tend to raise or improve a rating have negative signs.

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[66] AUS Monthly Utility Newsletter. February 2005

Bond Rating Model
Regression Equation and Results

Excel Regression Results

Regression Statistics	
Multiple R	78.64%
R Square	61.84%
Adjusted R Square	55.97%
Standard Error	27.69
Observations	46

ANOVA

	df	*SS*	*MS*	*F*	*Significance F*
Regression	6	48,446.62	8,074.44	10.53	0.000062%
Residual	39	29,895.32	766.55		
Total	45	78,341.93			

	Coefficients	*Standard Error*	*t Stat*	*P-value*
Intercept	163.53	47.32	3.46	0.13%
Variable 1	-12.82	5.23	-2.45	1.90%
Variable 2	26.28	51.29	0.51	61.13%
Variable 3	-0.63	0.22	-2.89	0.63%
Variable 4	-401.47	160.32	-2.50	1.66%
Variable 5	0.26	0.19	1.38	17.42%
Variable 6	-0.42	0.13	-3.14	0.33%

Where:

Variable 1 is the ratio "cash flow" divided by interest expense. "Cash flow" is approximately net income plus depreciation.
Variable 2 is the ratio long-term debt divided by total capital.
Variable 3 is the one-year revenue growth rate in percent.
Variable 4 is the ratio of operating earnings divided by total revenues
Variable 5 is the percent of total revenues of the holding company derived from its electric utility.
Variable 6 is the ratio of dividends paid divided by operating income.

However, as just explained, the numerical value of the bond rating is lower for the higher ratings and higher for lower ratings (much higher for the lowest ratings), which results in the factors improving the estimate are subtracted from the mean (i.e. the “intercept”).

Comparison of Predicted vs. Actual Bond Ratings
Companies Used to Create the Model

Company	*Predicted Rating*	*Actual Rating (S & P/Moody's)*	*Rating Difference (Steps)*
Allegheny Energy, Inc. (NYSE-AYE)	BB+/Ba1	BB/Ba1	0.5
Alliant Energy Corporation (NYSE-LNT)	BBB/Baa2	A-/A2	2.5
Ameren Corporation (NYSE-AEE)	A/A2	A-/A2	0.5
American Electric Power Co. (NYSE-AEP)	BBB-/Baa3	BBB/Baa1	1.5
Avista Corporation (NYSE-AVA)	BBB-/Baa3	BBB-/Baa3	0.0
Central Vermont Public Serv. Corp. (NYSE-CV)	BBB+/Baa1	BBB+	0.0
CH Energy Group, Inc. (NYSE-CHG)	AA/Aa2	A/A2	3.0
Cinergy Corp. (NYSE-CIN)	BBB-/Baa3	BBB-/Baa3	0.0
Cleco Corporation (NYSE-CNL)	A-/A3	BBB+/A3	0.5
Consolidated Edison, Inc. (NYSE-ED)	A-/A3	A/A1	1.5
Constellation Energy Group, Inc. (NYSE-CEG)	AA+/Aa2	A/A1	3.0
Dominion (NYSE-D)	A-/A3	A-/A2	0.5
DTE Energy Company (NYSE-DTE)	BBB+/Baa1	BBB+/Baa2	0.5
Edison International (NYSE-EIX)	BBB/Baa2	BBB/A3	1.0
El Paso Electric Company (ASE-EE)	BBB-/Baa3	BBB/Baa2	1.0
Energy East Corporation (NYSE-EAS)	BBB+/Baa2	BBB+/Baa1	0.5
Entergy Corporation (NYSE-ETR)	A-/A3	A-/Baa2	0.5
Exelon Corporation (NYSE-EXC)	A/A2	A-/A2	0.5
FirstEnergy Corporation (NYSE-FE)	BBB-/Baa3	BBB/Baa1	1.5
Green Mountain Power Corp. (NYSE-GMP)	BBB/Baa2	BBB/Baa1	0.5
Hawaiian Electric Industries, Inc. (NYSE-HE)	A-/A3	BBB/Baa2	2.0
IDACORP, Inc. (NYSE-IDA)	BBB-/Baa3	A-/A3	3.0
MDU Resources Group, Inc. (NYSE-MDU)	AA+/Aa1	A-/A2	4.5
MGE Energy, Inc. (NDQ-MGEE)	A/A2	AA-/Aa3	2.0
NiSource Inc. (NYSE-NI)	BBB/Baa2	BBB/Baa2	0.0
Northeast Utilities (NYSE-NU)	BBB/Baa2	BBB+/A3	1.5
NSTAR (NYSE-NST)	BBB+/Baa2	A/A1	3.0
OGE Energy Corp. (NYSE-OGE)	BBB+	BBB+/Baa2	0.5
Otter Tail Corporation (NDQ-OTTR)	A	A-/A2	0.5
Pepco Holdings, Inc. (NYSE-POM)	BBB/Baa2	A-/A3	2.0
Pinnacle West Capital Corp. (NYSE-PNW)	BBB+/Baa1	BBB/Baa1	0.5
PNM Resources, Inc. (NYSE-PNM)	BBB+/Baa2	BBB/Baa2	1.0
PPL Corporation (NYSE-PPL)	BBB+/Baa2	A-/Baa1	1.0
Progress Energy Inc. (NYSE-PGN)	BBB+/Baa2	BBB/A2	0.5
Puget Energy, Inc. (NYSE-PSD)	A-/A3	BBB/Baa2	2.0
SCANA Corporation (NYSE-SCG)	BBB/Baa2	A-/A1	2.5
SEMPRA Energy (NYSE-SRE)	A-/A3	A+/A1	1.0
Sierra Pacific Resources (NYSE-SRP)	BB+/Ba1	BB+/Ba2	0.5
Southern Company (NYSE-SO)	A+/A1	A+/A1	0.0
UIL Holdings Corporation (NYSE-UIL)	A-/A3	Baa2	2.0
UniSource Energy Corporation (NYSE-UNS)	BBB-/Baa3	BBB-/Ba2	0.5
Vectren Corporation (NYSE-VVC)	BBB+/Baa1	A-/A3	0.5

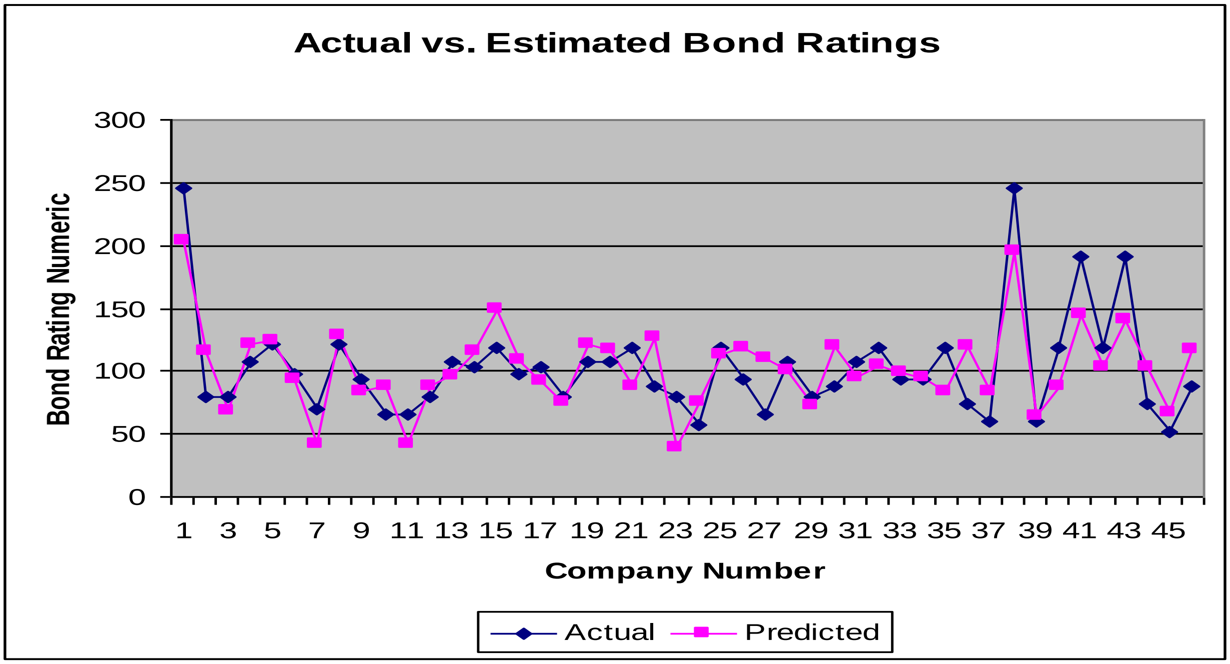
Westar Energy, Inc. (NYSE-WR)	BBB-/Baa3	BBB/Ba1	0.0
Wisconsin Energy Corporation (NYSE-WEC)	BBB+/Baa1	A-/A1	2.0
WPS Resources Corporation (NYSE-WPS)	A/A2	AA-/Aa2	2.5
Xcel Energy Inc. (NYSE-XEL)	BBB/Baa2	A-/A3	2.0
Average			1.2

Comparison of Predicted vs. Actual Bond Ratings
"Hold-Out" Companies

"Hold-Out" Company	*Predicted Rating*	*Actual Rating (S & P/Moody's)*	*Rating Difference (Steps)*
Aquila Inc. (NYSE-ILA)	B+/B1	B-/B2	1.5
Black Hills Corporation (NYSE-BKH)	AAA	BBB/Baa1	7.5
CenterPoint Energy (NYSE-CNP)	BBB-/Baa3	BBB/Baa2	1.0
CMS Energy Corporation (NYSE-CMS)	BB+/Ba1	BBB-/Baa3	1.0
DPL Inc.(NYSE-DPL)	BBB+/Baa1	BBB-/Baa3	2.0
Duke Energy Corporation (NYSE-DUK)	A/A3	BBB/Baa2	2.5
Duquesne Light Holdings Inc. (NYSE-DQE)	BBB+/Baa1	BBB+/Baa1	0.0
Empire District Electric Co. (NYSE-EDE)	A-/A3	A-/Baa1	0.5
FPL Group, Inc. (NYSE-FPL)	A+/A2	A/Aa3	0.5
Great Plains Energy (NYSE-GXP)	A+/A1	BBB/A2	2.5
PG&E Corporation (NYSE-PCG)	AA/Aa2	BBB/Baa2	6.0
Public Service Enterprise Group (NYSE-PEG)	BBB+/Baa2	A-/A3	1.0
Average			2.2

Overall on the original group used to create the regression model, the predictions are fairly accurate. In several instances, though, the predicted bond rating was too high. Mostly, the model did not do too well in predicting the lowest bond ratings, that is, the relative extremes. It isn't too surprising that the model was less accurate with the hold-out group. As an initial attempt to model bond ratings with a small number of readily available financial measures the model performed reasonably well, suggesting that further study may improve the results.

Chart 1



In the hold-out group two of the companies had anomalous data: Black Hills' year-over revenue growth according to the data used was over 120 percent; PG&E ratio of operating earnings to revenue was 33 percent. These anomalous figures account for most of the difference between the actual and predicted bond ratings. Chart 1 suggests that there are "cut-off" levels for the lower bond ratings that aren't modeled well. This suggests that one or more non-linear variables might improve the prediction. The results suggest, then, that there are some model specification and data issues to explore in order to improve this preliminary model.

APPENDIX 3: PORTLAND GENERAL OREGON STIPULATION

WHEREFORE, the Settlement Parties stipulate and agree as follows:

CONDITIONS

The Settlement Parties agree that the following conditions shall be incorporated in a final Commission order approving the Application:

1. To determine the reasonableness of allocation factors used by Enron to assign costs to PGE and amounts subject to allocation or direct charges, the Commission or its agents may audit the accounts of Enron and its unregulated subsidiaries which are the bases for charges to PGE. Enron agrees to cooperate fully with such Commission audits.

2. Enron 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.

3. PGE shall maintain its own accounting system, separate from Enron's accounting system. All PGE financial books and records shall be kept in Portland, Oregon.

4. Enron and PGE shall exclude all costs of the merger, including merger transition costs, from PGE's utility accounts. Within 90-days following the merger completion, Enron will provide a preliminary accounting of these costs. Further, Enron agrees to provide the Commission a final accounting of these costs, within 30 days following the accounting close of the merger.

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

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

7. Enron, PGE and Commission Staff agree that the allowed return on common equity and other costs of capital will not rise as a result of the merger. 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.

8. Enron and PGE shall provide the Commission unrestricted access to all written information provided to common stock, bond, 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 to, and presentations made to, common stock analysts and bond rating analysts. For purposes of this condition, "written" information includes but is not limited to any written and printed material,

audio and video tapes, computer disks and electronically-stored information. Nothing in this condition shall be deemed to be a waiver of Enron's or PGE's right to seek protection of the information.

9. Unless such a disclosure is unlawful, Enron shall notify the Commission of:
   a. Its intention to transfer more than 5 percent of PGE's retained earnings to Enron over a six-month period, at least 60 days before such a transfer begins.
   b. Its intention to declare a special cash 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.

10. Enron guarantees that the customers of PGE shall be held harmless if the merger between Enron and PGE results in a higher revenue requirement for PGE than if the merger had not occurred.

11. PGE shall stipulate to, adopt, and implement service quality performance measures, as fully described in Commission Staffs Proposed Stipulations for Service Quality Measures, to ensure that its current levels of service quality are maintained or improved. The P 1 and P2 measures for 1997 shall be:

	P1	P2
C1	.10	.13
RI	1.5	1.7
R2	1.2	1.4
R3	NA	NA

12. PGE and Enron agree to comply with all Commission requirements regarding **affiliated** interest (AI) transactions, including timely filing of applications and reports. For 199'7, 1998, and 1999, PGE will file semi-annual AI reports, as otherwise required by OAR I860-27-200. The AI report due dates shall be April 1, 1998, for the second half of 1997 and October 1, 1998, and June 1, 1999, respectively, for the 1998 semiannual reports. For 1999, the semiannual AI report due dates shall be October 1, 1999 and June 1, 2000.

13. Within 45 days of the end of each calendar quarter for 1997, 1998, and 1999, beginning with the first full quarter following completion of the merger, PGE shall file detailed quarterly reports with the Commission regarding: (a) employee transfers, permanent and temporary, between PGE and Enron; and (b) consulting and training activities conducted by both PGE and Enron personnel for the other entity.

14. Enron shall not subsidize its activities by allocating to or directly charging PGE expenses not authorized by the Commission to be so allocated or directly charged.

15. PGE shall not give its. affiliates preferential access through any prearranged, formal or informal, agreement with any of its affiliates regarding PGE's excess pipeline capacity

and related capacity assets. PGE's capacity releases will be posted on the appropriate interstate pipeline Electronic Bulletin Board ("EBB"). PGE shall not give its affiliates preferential access through any prearranged, formal or informal, agreement with any of its affiliates regarding PGE's power or natural gas assets. If PGE and an affiliate engage in a blind (i.e. arm's length) exchange transaction (e.g. NY1vflEX, EBBs and similar exchanges), **the Commission will presume that the** transaction meets the Commission's affiliated interest transfer pricing policy requirements.

16. PGE shall file detailed quarterly reports with the Commission regarding transactions between PGE and Enron involving: (a) gas commodity sales and pipeline capacity releases, and (b) electric power exchanges and sales, and (c) competitive ancillary electric services sales. Commission Staff, Enron, and P GE will promptly develop a report acceptable to the Commission. Such quarterly reports shall be filed for 1997, 1998, and 1999, within 45 days of the end of the quarter, beginning with the first full quarter after completion of the merger.

17. PGE shall not provide to any marketing personnel of any of PGE's affiliates or to any other person not affiliated with PGE, data or information regarding any individual PGE franchise retail customer unless the customer grants written permission, which may be by electronic means. PGE shall provide information developed by it on end-use customer opinions, end-use customer usage, end-use customer characteristics, or similar aggregated retail customer market information to all entities, on the same terms, and conditions, as stated below:'
    a. All entities including PGE affiliates shall provide PGE a written request for information, with a copy to the Commission. PGE shall maintain, at its headquarters, a list of all requests within the last 12 months, and shall make it available to any person requesting it.
    b. If the identical information has been previously provided to the marketing personnel of any of PGE's affiliates or to any other entity not affiliated with PGE, PGE must provide the information within 10 business days of receiving the request.
    c. If the identical information has not been previously provided to the marketing personnel of any of PGE's affiliates or to any other entity not affiliated with PGE, *PGE* must, within ten business days, either (1) provide the requested information; (2) provide an estimate of the date by which it can provide the information and an explanation of why more than ten business days is necessary; or (3) deny the request with an explanation of the reason for denial.
    d. If PGE denies a request for information by an entity not affiliated with PGE, it shall not make the information available in response to a request from the. marketing personnel of any of PGE's affiliates for three months.
    e. Any requesting person may file a complaint under ORS 756.500 with the Commission.
    f. PGE shall be entitled to collect, in advance of providing the requested information, reasonable compensation for the cost of providing it.

18. The Commission understands that PGE and Enron will abide by the agreements reflected in the Memorandum of Understanding (MOLT), entered into in January 1997 between PGE, Enron, Natural Resources Defense Council, Northwest Conservation Act Coalition, The Nature Conservancy of Oregon, Northwest Environmental Advocates, Renewable Northwest Project, Oregon Citizen's Utility Board, Oregon Trout, Trout Unlimited, Native Fish Society, American Rivers, Oregon Energy Coordinator's Association, Community Action Directors of Oregon, and Oregon' HEAT. The Commission acknowledges the MOLT and the commitments made therein. However, such acknowledgment by the Commission does not include acceptance or denial of 1) any of the costs or benefits contained within the MOU, for which PGE may desire to seek inclusion in rates, or 2) any filings that PGE may make to the . Commission in accordance with the terms of the MOU. The parties maintain whatever enforcement rights exist in other forums.'

19. Enron and PGE commit to provide guaranteed merger related cost of service reductions of $9 million per year for 4 years for a total of $36 million. PGE will establish a balancing account and credit that account with $9 million per year beginning' on the anniversary of the merger completion date and the three subsequent anniversary dates. The balancing account will accrue interest on the unamortized balance at the then current PGE approved rate of return. Customers will receive the benefit of these cost of service reductions through a tariff that shall reduce the unamortized account. balance. The customer credit will remain in effect for a total of 4 years, or until the effective date of new tariffs following a general rate case, whichever occurs first.

Residual balances in the balancing account, if any, whether debit or credit, will be disposed of only at the discretion of the Commission.

In the event that the actual savings are less than the guaranteed amount of $9 million per year, when determining the new tariffs, PGE will adjust its cost of service to reflect a total merger related cost of service reduction of $9 million in such new tariffs for a period not to extend beyond five years after merger completion. In the event that the new tariffs are a result of PGE disaggregation or divestiture, occurring prior to 5 years after merger completion, the disposition of the $9 million per year for the remainder of the 5 years will be decided in such proceeding.