Rocky Mountain Power
Exhibit UIEC-_____ (JRM-2)
Docket No. 10-035-124
Witness: J. Robert Malko

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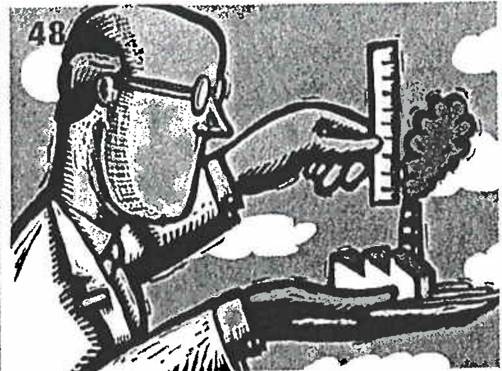

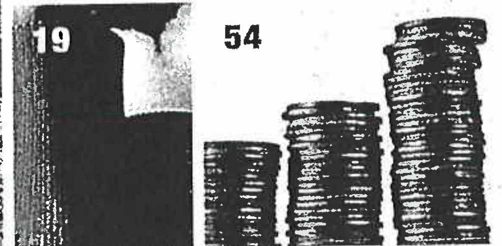

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Commission Watch

Ring Fencing In Utah

Regulatory structures protect ratepayers in geography-spanning utility mergers.

BY CHARLES E. PETERSON AND J. ROBERT MALKO

Corporate restructurings of electric utilities in the United States have become a significant and controversial issue during the past thirty years.[1] The controversy is caused by differing perspectives among electric utility executives and regulatory commissioners relating to corporate restructurings associated with mergers, diversification, and functional separation of generation, transmission, and distribution.

Electric utility executives generally view corporate restructuring as a potential source of economic value and a potential partial solution to financial problems that reflect changing business risks. On the other hand, regulatory commissioners attempt to insulate and regulate the utility component of the restructured energy business and to protect the public interest, including reliability of service at reasonable costs.

A prime example is the Utah Public Service Commission, which is applying ring-fencing conditions and tools to utility PacifiCorp. The geographic diversity of PacifiCorp poses regulatory problems to its new owner, MidAmerican Energy, which may require solutions similar to approaches that have been applied to the legal, financial, and economic issues related to ring-fencing of energy utility companies.

Restructuring Framework

A workable framework for protecting ratepayers in electric utility corporate restructurings must address a hierarchy of significant issues from a public-policy perspective. This framework extends a hierarchy developed initially in the early 1980s in order to address and analyze electric utility diversification activities.[2]

At the apex in this framework are regulatory issues of important concern to regulatory commissions regarding electric utility corporate restructurings and related effects on the broad public interest. Examples include roles and relations between federal and state regulatory agencies, and potential financial agency problems among economic stakeholders, such as managers, share owners and bondholders. Regulatory issues focus on addressing and analyzing electric utility corporate restructuring activities that affect the ability to provide adequate electricity service at reasonable prices to customers.

> Standby support from Berkshire Hathaway is seen as significant support for PacifiCorp's financial situation.

In this framework, four subsidiary categories of technical issues address financial, economic, accounting and legal concerns.

Financial issues concern the implications of an electric utility corporate restructuring on valuation and financing. Significant types of financial issues that emerge are changing business and financial risks, relative financial health of the restructured business, and reactions of investors to restructuring activities.

Economic issues concern the allocation of limited resources in providing electricity service in an atmosphere of electric utility corporate restructurings. Significant types of economic issues that emerge are market structure and powers; pricing policies, practices and associated customer choices; and utility management incentives.

Accounting issues primarily concern affiliate interest issues, including transfer pricing practices, and the allocation of common costs.

Legal issues relating to electric utility corporate restructuring activities concern regulatory authority over the electric utility and its corporate restructuring activities. For example, the entity's selected corporate structure, such as a parent holding company or a wholly-owned utility subsidiary, affects the needs and interests of utility management, shareholders, bondholders, utility customers, and regulators. Additionally, relatively complex corporate restructuring activities and policies have implications for regulatory authority.

Ring-Fencing PacifiCorp and MidAmerican

In May 2005, PacifiCorp announced it was being sold to MidAmerican Energy Holdings Co. (MEHC). ScottishPower had purchased PacifiCorp in 1999 when interest in deregulating electric utilities was near its peak. Subsequent events, such as the California energy crisis in 2000 and 2001, convinced Scottish Power that its expectations for PacifiCorp probably never would be fully met, and so it decided to sell

PacifiCorp Ring-Fence Structures

	Scottish Power	MidAmerican Energy
Regulatory	• PacifiCorp agreed to certain customer service and performance standards. • PacifiCorp will notify the commission of material acquisitions.	• MEHC committed to interpret Utah statute (Utah Code Annotated 54-4-28) to require Utah regulatory approval of a merger of PacifiCorp with any other public utility, whether or not that utility provides service in Utah. • MEHC committed that PacifiCorp will not directly own equity shares of either MEHC or Berkshire Hathaway. • PacifiCorp will file semi-annually a report on its service performance and customer guarantee commitments. • PacifiCorp will maintain "sufficient operations and front line staffing to provide safe, adequate and reliable service in recognition of the level of load and customer growth in Utah."
Accounting	• PacifiCorp will maintain its own separate books and records and will make them available to inspection by regulators. • PacifiCorp will file an affiliate interest report, an organizational chart, and a narrative description of each affiliate. • PacifiCorp and its parent will not cross-subsidize between regulated and non-regulated businesses.	• MEHC and PacifiCorp committed to provide to Utah regulators their Board of Director's minutes, committee minutes and internal audits. • MEHC filed with regulators its intercompany administrative services agreement (IASA) for review by regulators and, also will file if necessary in a particular jurisdiction for approval. (The IASA governs MEHC and affiliate cost allocation methodologies.)
Financial	• PacifiCorp will maintain separate debt and preferred stock, as well as debt and preferred stock ratings. • Regulators will have unrestricted access to all written communications with rating agencies. • PacifiCorp will not make loans to, or be a guarantor of, any debt security or transfer funds to its parent or any other affiliate of its parent.	• PacifiCorp will not pay any dividends if "PacifiCorp's unsecured debt rating is BBB- or lower by S&P or Fitch (or Baa3 or lower by Moody's), as indicated by two of the three rating agencies." • PacifiCorp will not pay dividends or make any other distribution to its parent if PacifiCorp's common equity falls below 40 percent. • MidAmerican Energy created a subsidiary, PPW Holdings, LLC (PPW), to hold the common stock of Pacificorp. MidAmerican Energy committed PPW to having no debt at the time of closing of the acquisition. If it ever were contemplated that PacifiCorp would acquire debt, then regulators would be given 30 days notice and the commission may impose additional ring-fencing provisions.
Legal	• Any new non-utility or foreign utilities will not be held by PacifiCorp.	• MEHC organized a wholly owned company, PPW Holdings, LLC (PPW), for the purpose of holding the common stock of PacifiCorp. • A special PPW independent director will have veto power over any voluntary bankruptcy filings of PacifiCorp or any attempts by MEHC or PPW to place PacifiCorp in a bankruptcy proceeding. • Any diversified holding of the parent will not be held by PacifiCorp. PacifiCorp will be separated financially from diversified holdings of the parent and will be protected from financial distress of the parent or its other holdings. • MEHC disclosed its documents describing the PPW ring-fencing commitments.

the company. In 1999 regulators had required a number of ring-fencing-related structures be put in place as a condition for approval of PacifiCorp's acquisition (*See sidebar, "PacifiCorp Ring-Fence Structures"*).[3]

In its acquisition, MEHC adopted or otherwise agreed to continue and extend these conditions. For example, MEHC committed to give regulators access to all documents related to affiliate transactions with PacifiCorp; this commitment even was extended to Berkshire Hathaway, MEHC's ultimate parent, with Berkshire's approval. Additionally, customer service guarantees and performance standards were extended to at least 2011. Several specific customer service guarantees and performance standards negotiated in Utah for the Scottish Power purchase

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expired five years after the closing of that transaction.

Additional relevant commitments were offered by MEHC or were negotiated by the Utah parties.[4] So far, there have been few actual tests of the ring-fencing structures put in place. However, PacifiCorp has continued to maintain its own separate debt and preferred stock. The company has conducted several debt financings or restructurings in its own name and independently of MEHC debt. MEHC has made equity capital contributions to PacifiCorp totaling several hundred million dollars that have helped keep PacifiCorp's debt-to-equity ratios stable as PacifiCorp has borrowed heavily to fund its capital expenditure programs.

So far, credit rating agencies have seemed satisfied with PacifiCorp's activities since PacifiCorp has maintained its A- rating on its secured debt. However, the rating agencies continue to note that on a stand-alone basis, PacifiCorp would merit a lower debt rating of, perhaps, BBB. The financial support from MEHC and standby support from Berkshire Hathaway are seen as significant support for PacifiCorp's financial situation.

PacifiCorp or MEHC have delivered on the commitments promised as part of the acquisition to the extent the commitments required certain actions within specified time frames. However, PacifiCorp's performance has not always been satisfactory in the opinion of some parties. For example, advocates for low-income rate payers were dissatisfied with PacifiCorp based on the arrearage economic study produced under an acquisition commitment.

Utah regulators have not yet tested the availability and cooperation of MEHC or Berkshire Hathaway regarding the audit or other examination of their books and records with respect to any issues related to PacifiCorp. Further, there have not been events that would trigger other ring-fencing structures such as major acquisitions or divestitures. Fortunately, of course, regulators have not been faced with the bankruptcy or potential bankruptcy of MEHC or any of its subsidiaries.

Geographic Diversity Challenges

While there is some regulatory confidence that the near future will continue to be similar to the recent past with respect to MEHC's financial support to PacifiCorp, the longer term view necessarily is cloudy.

> States may find themselves increasingly implementing ring-fencing strategies around PacifiCorp to protect themselves from **other states.**

A change in management at MEHC and Berkshire Hathaway eventually may result in a change in the treatment of PacifiCorp away from the current management philosophy. For example, in the acquisition process, MEHC emphasized it was able to take a long view in terms of planning and financing, and was not constrained by short-term stockholder expectations of one quarter or one year. That could change in the future, and regulators may find themselves dealing with a utility operated by a parent that is looking for short-term benefits.

Another type of problem is evolving that may affect PacifiCorp more than some other integrated utilities: geographic diversity. PacifiCorp operates across six western states. These states have significant differences including climate, local resources, economy, and political philosophy. Roughly, PacifiCorp can be divided between its Pacific Northwest service territories (California, Oregon, and Washington) and its inland Rocky Mountain service territories (Idaho, Utah, and Wyoming). The climate in the populated areas of the Pacific Northwest can be generalized as cool, wet, and mild. The Rocky Mountain region can be characterized as dry, with hot summers and cold winters. Further, Utah and Wyoming have significant coal resources and consequently coal has been, and continues to be, the primary fuel source for electric generation; Wyoming recently has been seeing the development of significant wind resources. The Pacific Northwest is blessed with hydro and is developing wind resources. The economies and electric demand of PacifiCorp's Utah and Wyoming service areas are growing rapidly and this growth is expected to continue. PacifiCorp's territories in the other states are growing slowly or not at all.

While geographic diversity is often seen as beneficial, the contrasts outlined above create a situation of obvious tension. The Pacific Northwest, which is experiencing slow growth, does not want to pay for the construction of additional power plants to serve Utah. Oregon currently is investigating a proposal that would encourage PacifiCorp not to build by allowing the utility to capitalize purchased power to rate base and earn a return on that purchased power. This proposal also may affect the way PacifiCorp evaluates power bid proposals versus self-build options.[5] People in other states may be concerned that this proposal would have the effect of raising costs and putting system reliability at risk.

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An additional difficulty associated with this geographic diversity includes the current concerns with carbon dioxide emissions and climate change. California, Oregon and Washington have enacted renewable portfolio standards (RPS). To date, Idaho, Utah, and Wyoming do not have such standards, and currently there is no national RPS, although that might change. Even among states that have an RPS, there are differences that may cause frictions among the states. For example, a request for proposal for new generation resources may result in two different "lowest-cost" or "optimal" resources that must be chosen under the laws and regulations of two different states in PacifiCorp's region. This potential situation creates difficulties for the company to develop an integrated resource plan that satisfies the laws in all of the states it operates in.

With further merger and acquisition activity in the electric utility industry, geographic diversity issues may become more prevalent than they are today. David Sokol, MidAmerican Energy chairman and CEO, noted last year, "I don't think there is a substantial benefit [to combining] neighboring utilities [compared to] ones that are separate. It really comes down to [whether] the operations are as efficient as can be in dealing with the requirements and the demands of their state and their customers. In this business all states don't view the requirements the same. So, the fact you might have two different utilities neighboring, if the preponderance of their customers are in different states they still have to be run to the constituents [they serve]."[6]

As geographic differences evolve, states may find themselves increasingly implementing ring-fencing strategies around PacifiCorp to protect themselves from other states.

But in the current environment, geographic diversity raises concerns that are implicitly understood by PacifiCorp's parent company. Geographic diversity often is seen as a benefit in that it may smooth out cash flows over time. However, there may be downsides to geographic diversification wherein the costs are greater than the benefits.

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Coal: Inconvenient Truths

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and transportation prices will translate into continued pressure on the delivered price of coal. While the PRB has low FOB mine prices, the coal produced is transported great distances and in great quantities because of its low heat content. Eastern regions (Southeast and Northeast) have high delivered coal costs because of higher Eastern mining costs or very high transportation rates for cheaper western coal. Colombian imports also keep Eastern prices high due to high transportation costs. For Western coal consumers, lower prices and short hauls equates to retaining the lowest burner-tip price of coal, even with considerable inflation over the forecast period (*see Fig. 4*).

While the North American coal industry is experiencing anxiety attacks today, mostly over the uncertainty of CO_2 emission reduction requirements and the rising costs of new plant construction, the long-term prospects for coal remain solid based upon fundamentals.

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Note: Global Energy Decisions and New Energy Associates were both acquired by Vista Equity Partners, a private equity fund, in 2007, and rolled up along with Indus International and Mobile Data Solutions Inc. into a new company called VENTYX. Together Global Energy and New Energy Associates comprise the Ventyx Energy Group

Ring Fencing in Utah

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corporate finance at the Jon M. Huntsman School of Business at Utah State University.

Note: This article reflects the views of the authors and does not necessarily reflect the views of the Utah Public Service Commission or the Utah Division of Public Utilities.

Endnotes

1. *Public Utilities Fortnightly's* parent company, Public Utilities Reports Inc. (PUR), has published several of the co-author's books on corporate-restructuring topics, including: Faruqui, Ahmad and Malko, J. Robert, editors, *Customer Choice: Finding Value in Retail Electricity Markets,* 1999; Enholm, Gregory B. and Malko, editors, *Reinventing Electric Utility Regulation,* 1995; and Enholm and Malko, editors, *Electric Utilities Moving Into The 21st Century,* 1994.
2. York, Stanley and Malko, J. Robert, "Utility Diversification: A Regulatory Perspective," *Public Utilities Fortnightly,* January 1983; Malko and Edgar, George R., "Energy Utility Diversification: Its Status in Wisconsin," *Public Utilities Fortnightly,* August 1986; and Malko, "Assessing Corporate Restructurings In The Electric Utility Industry: A Framework," *NRRI Quarterly Bulletin,* vol. 17, No. 4, Winter 1996-97.
3. "Stipulation between PacifiCorp, ScottishPower, the Division of Public Utilities, and the Committee of Consumer Services," Docket No. 98-2035-04, approved by the Utah Public Service Commission on November 23, 1999.
4. Docket No. 05-035-54, "In the Matter of the Application of MidAmerican Energy Holdings Co. and PacifiCorp dba Utah Power & Light Co. for an Order Authorizing Proposed Transaction," Second Amendment to Stipulation, April 20, 2006.
5. Oregon Public Service Commission, Docket No. UM 1276: "Staff's request to open an investigation regarding performance based rate making mechanisms to address potential build vs. buy bias."
6. *Public Utilities Fortnightly,* June 2006, p. 45.

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