

1 **Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND**
2 **OCCUPATION.**

3 A. My name is Bryan Conway. My business address is 550 Capitol Street
4 NE, Suite 215, Salem, Oregon 97301-2551. I am employed by the Public
5 Utility Commission of Oregon (OPUC) as the Program Manager of the
6 Economic and Policy Analysis Section in the Economic Research and
7 Financial Analysis Division.

8 **Q. PLEASE DESCRIBE YOUR EDUCATION AND EXPERIENCE.**

9 A. My Witness Qualifications Statement is found on Exhibit Staff/101,
10 Conway/1. In addition, I have completed all of the required and elective
11 coursework for a Ph.D. in economics from Oregon State University. My
12 fields of study were Industrial Organization and Applied Econometrics. I
13 have testified before the Commission in UG 132, UE 115, UE 116, and
14 have been the Summary Staff Witness in UP 158, UP 168, UP 165/170,
15 UX 27, and UX 28.

16 **Q. WHAT IS YOUR ROLE IN THIS DOCKET?**

17 A. I am the Staff case manager in UM 1121. As case manager, I am
18 responsible for Staff's overall recommendation.

19 **Q. WHAT IS THE PURPOSE OF THIS TESTIMONY?**

20 A. I present Staff's summary recommendations, the partial stipulation
21 reached with the Applicants, and provide a historical overview. In
22 addition, I will address issues surrounding the alleged benefits proffered
23 by Oregon Electric Utility Company, LLC (OEUC).

1 **Q. HAVE YOU PREPARED ANY EXHIBITS?**

2 A. Yes. I prepared Staff/101, consisting of one page and Staff/102,
3 consisting of 53 pages.

4 **Q. WHAT DOES THE UM 1121 DOCKET INVOLVE?**

5 A. This docket is OEUC's application to acquire Portland General Electric
6 Company (PGE). Currently PGE is a subsidiary of Enron Corp (Enron).

7 **Q. HOW IS THE STAFF TESTIMONY ORGANIZED?**

8 A. Table 1 presents the Staff Exhibit numbers, major issues identified by
9 Staff, as well as the Staff witness.

10

Table 1

Exhibit Number(s)	Description	Staff Person(s)
Staff/100	Summary Witness, Access to Information	Bryan Conway
Staff/200	Financial Issues, Corporate Strategy/Objectives	Thomas D. Morgan
Staff/300	Cost Savings, Maintaining Infrastructure	Ed Durrenberger
Staff/400	Affiliated Interest Requirements; MSA	Rebecca T. Hathhorn
Staff/500	Tax Issues	Judy Johnson
Staff/600	Service Quality Measures (SQM)	Jerome Murray Robert E. Sipler
Staff/700	New SQM	Clark Jackson

1 **Q. WHAT IS THE STAFF’S ROLE IN THIS DOCKET?**

2 A. Staff’s role in this docket is to review OEUC’s application to determine if it
3 meets the requirements of ORS 757.511. This statute requires the
4 applicant to “bear the burden of showing that granting the application is in
5 the public interest.”

6 **Q. WHAT DOES IT MEAN FOR THE APPLICATION TO BE IN THE
7 PUBLIC INTEREST?**

8 A. This Commission addressed the legal interpretation of the meaning of “will
9 serve the public utility’s customers in the public interest” in Order Number
10 01-778.¹ The key issue the Commission addressed is whether this
11 language means the transaction must hold customers harmless or result
12 in net benefits. The Commission interpreted the meaning of “will serve the
13 public utility’s customers in the public interest” directive to require a two-
14 step assessment of whether the Proposed Transaction will (1) provide a
15 net benefit to the utility’s customers, and (2) impose “no harm” to the
16 public at large.

17 **Q. HOW WAS THE ISSUE OF NET BENEFITS ADDRESSED IN PRIOR
18 ACQUISITIONS?**

19 A. Prior to Order Number 01-778, the Commission did not need to address
20 the issue in the last three acquisition dockets. In the Enron acquisition of
21 PGE, the ScottishPower acquisition of PacifiCorp, and the Sierra Pacific
22 acquisition of PGE the issue of defining what is “in the public interest” was

1 satisfied because the applicants ultimately demonstrated, to the
2 Commission's satisfaction, that the transactions could be expected to
3 result in net benefits to customers.

4 **Q. WHAT DOES OEUC OFFER TO PGE CUSTOMERS IN ITS**
5 **APPLICATION?**

6 A. OEUC's application, dated March 8, 2004, starting at page 23 line 7,
7 states,

8 "The Proposed Transaction offers significant, tangible benefits to PGE
9 customers and the public at large. These benefits include ownership
10 certainty, a strong local voice, a board making thoughtful decisions
11 about strategic direction, long-term resource planning, ongoing
12 investment in the business. [sic] Taken as a whole, these benefits
13 exceed the statutory standard set forth in ORS § 757.511 and provide
14 ample reason for this Commission to find that the Proposed
15 Transaction serves PGE's customers in the public interest."

16
17 **Q. WHAT DOES OEUC'S TESTIMONY IMPLY FOR THIS DOCKET?**

18 A. Staff assumes that OEUC is proposing to show that its transaction results
19 in sufficient economic benefits to PGE's customers to meet the higher of
20 the two standards (net benefits to customers) for what is "in the public
21 interest".

22

23 **Summary Recommendation**

24 **Q. WHAT IS STAFF'S SUMMARY RECOMMENDATION?**

¹ See [UM 1011](#), LEGAL STANDARD FOR APPROVAL OF MERGERS

1 A. At this time, Staff recommends the Commission not approve OEUC's
2 application to acquire PGE. The application, including the recently
3 stipulated conditions, does not demonstrate net benefits to customers. In
4 addition, due to many unanswered questions about relevant issues, and
5 the risks these issues entail for customers, Staff has not been able to fully
6 assess the downside risk to customers of the transaction.

7 **Q. IS THIS STAFF'S FINAL WORD IN THIS DOCKET?**

8 A. No. It is not unusual for Staff to recommend not approving the transaction
9 at this stage of an ORS 757.511 proceeding. In the first round of
10 testimony Staff and other intervenors typically identify issues and
11 concerns. Staff hopes that the OEUC will address and mitigate a number
12 of concerns of Staff and other parties in its rebuttal testimony.

13 **Q. HAS STAFF COMPILED ALL THE INFORMATION IT NEEDS IN**
14 **ORDER TO DEVELOP ITS FINAL RECOMMENDATION?**

15 A. No. We are still conducting discovery and analyzing the proposal. Staff
16 also wants to see other the testimony of other parties who intervened
17 (Intervenors) and the Company's rebuttal testimony. After reviewing
18 responses to additional discovery requests, additional testimonies,
19 Company rebuttal testimony, and discussing matters at settlement
20 conferences, Staff will present its informed recommendation in its
21 surrebuttal testimony.

22 **Q. WHAT ARE THE VARIOUS POSSIBLE OUTCOMES OF THIS CASE?**

1 A. There are several possible resolutions. One possible outcome is that Staff
2 and the Intervenors reach settlement with OEUC on a set of conditions
3 and support the acquisition. Alternatively, Staff could unilaterally propose
4 conditions it believes are necessary to recommend approval of the
5 acquisition, which OEUC or the other parties may dispute. Finally, Staff
6 could conclude that the acquisition should not be approved. In that event,
7 Staff intends, nevertheless, to identify a set of conditions that the
8 Commission should adopt if the Commission ultimately determines the
9 acquisition should be granted.

10 **Q. WHAT ARE THE REMAINING SCHEDULED ACTIVITIES IN THIS**
11 **DOCKET?**

12 A. I identify the remaining scheduled activities in this docket on page 21 of
13 this testimony.

14 **Q. WHAT ARE THE MAJOR TOPICS OR QUESTIONS ADDRESSED IN**
15 **STAFF'S TESTIMONY?**

16 A. In Staff/200, Staff Witness Thomas Morgan raises questions regarding
17 OEUC's ability to acquire PGE without negative financial implications,
18 including the financial pressures PGE might face should the transaction
19 close. Mr. Morgan also raises questions regarding PGE's exposure to
20 liabilities should this deal close.

21 In Staff/300, Staff Witness James Durrenberger raises questions
22 regarding OEUC's cost-cutting plans and its intentions to invest in PGE's
23 infrastructure. Mr. Durrenberger also discusses the inconsistencies

1 between OEUC's statements regarding cost savings and OEUC's
2 responses to Staff Data Requests. In addition, Mr. Durrenberger identifies
3 the Commission's policy regarding acquisition costs, including goodwill.

4 In Staff/400, Staff Witness Rebecca T. Hathorn discusses concerns
5 about the possibility of cross-subsidies and inter-jurisdictional cost shifts.
6 Ms. Hathorn also raises questions about cost allocations between OEUC
7 and PGE, which she believes could be detrimental to customers.

8 In Staff/500, Staff Witness Judy Johnson discusses concerns and
9 questions regarding income tax issues both at the federal and the state
10 level.

11 In Staff/600, Staff Witnesses Jerome Murray and Robert E. Sipler
12 discuss service quality measures and a potential change in the definition
13 of a specific measure so that it conforms to a measure currently applied to
14 PacifiCorp.

15 In Staff/700, Staff Witness Clark Jackson discusses the potential need
16 for an additional service quality measure that tracks issues such as billing
17 accuracy.

18 Partial Stipulation

19 **Q. HAS STAFF REACHED SOME A PARTIAL STIPULATION WITH**
20 **OEUC?**

21 A. Yes. Exhibit Staff/102, Conway/49-53 contains the agreements reached
22 to date. OEUC, PGE, Staff, and ICNU signed the stipulation.

23 **Q. WHAT IS THE PURPOSE OF THE PARTIAL STIPULATION?**

1 A. The partial stipulation helps firm up the commitments OEUC is making in
2 this docket. The partial stipulation does not, however, limit Staff's ability to
3 recommend new conditions even if there is a related condition in the
4 partial stipulation.

5 **Q. HOW DID YOU ARRIVE AT THIS PARTIAL STIPULATION?**

6 A. The parties held a settlement conference on June 8, 2004. As a result of
7 these settlement meetings, Staff and OEUC reached agreement on a
8 handful of conditions. Most importantly, the Company was able to settle
9 with Staff on service quality issues on June 8, 2004 as discussed by
10 Messrs. Sipler and Murray in Exhibit Staff/600.

11

12

Background Discussion

13

14

The Public Interest Standard

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**Q. WHAT IS THE PUBLIC INTEREST STANDARD FOR ORS 757.511 AND
16 WHAT DO YOU UNDERSTAND IT TO BE IN THE CASE OF THIS
17 ACQUISITION?**

18

A. As noted before, ORS 757.511 requires that the acquisition of a public
19 utility be in the public interest. OEUC proposes to satisfy this standard by
20 demonstrating that this transaction provides the following:

1 business.) Some of the due diligence TPG conducted identifies cost
2 savings associated with delaying maintenance on PGE's assets. Cost
3 savings efforts that do not sacrifice service quality and adequately
4 maintain the plants should be encouraged. However, cost savings efforts
5 that threaten current or future service quality should not be considered
6 beneficial reinvestment in the business.

7 Lastly, with respect to alleged benefit No. 6 (simplicity and
8 transparency), the transaction at one level looks simple. OEUC is
9 purchasing PGE with the intent to hold and sell. On the other hand, the
10 purchasers of PGE represent a diverse group of individuals and funds.
11 The local representatives have the majority vote at OEUC but a single
12 TPG member can veto their decisions. With respect to transparency, it is
13 my opinion that TPG is not currently prepared for the level of transparency
14 (e.g., access to information) the Commission should require.

15 Access To Information

16
17 **Q. PLEASE PROVIDE AN EXAMPLE THAT DEMONSTRATES HOW TPG**
18 **IS UNPREPARED FOR THE LEVEL OF TRANSPARENCY THAT**
19 **SHOULD BE REQUIRED.**

20 A. First, OEUC has been unable to provide responses to Staff's data
21 requests in a timely fashion. Staff has submitted 155 data requests. Of
22 those requests, only 14 were answered on time.

1 Secondly, OEUC has filed numerous motions regarding
2 confidentiality. To date, even though the ALJ has ruled that information
3 provided to Staff should be available to all parties, OEUC has yet to
4 provide information that was provided to Staff to some parties. (See
5 Staff/102, Conway/1 (June 17, 2004 e-mail from Ater Wynne)).

6 Lastly, responses to a data request Staff felt was fairly routine
7 based on experiences with other utilities it regulates, was initially objected
8 to on the grounds that it was "overly broad" and "not reasonably calculated
9 to lead to the discovery of admissible evidence." (See Response to Staff
10 Data Request 129, attached as Staff/102 Conway/2-3).

11 **Q. WHY DO YOU VIEW THE APPLICANTS' OBJECTION TO STAFF DATA**
12 **REQUEST 129 AS IMPORTANT?**

13 A. I first want to add that the applicants did eventually respond to DR 129.
14 However, their initial reluctance to do so is troubling. This proceeding is
15 OEUC's first opportunity to make a good impression on the Commission.
16 As such, Staff would expect the applicants would do all they could to
17 cooperate with Staff's investigation. Cast in this light, the Applicants'
18 objecting to routine data requests which Staff issued to evaluate the merits
19 of the application is perhaps an indicator that the Commission may have
20 even more difficulty obtaining OEUC's cooperation should the
21 Commission approve the transaction, removing OEUC's incentive to be on
22 its best behavior.

23 **Q. IS TRANSPARENCY IMPORTANT TO THE REGULATORY PROCESS?**

1 A. Yes. The regulatory process should be a transparent and open one. Lack
2 of access to information will impede public involvement, a tradition in U.S.
3 regulation. Impediments to accessing a utility's (or its affiliates')
4 information could also hinder development of non-regulatory processes,
5 such as open competition if, for example, information on cross
6 subsidization was not available.

7 **Q. DID OEUC PROVIDE OR OFFER ANY CONDITIONS WITH RESPECT**
8 **TO ACCESS TO INFORMATION IN ITS SUPPLEMENTAL**
9 **TESTIMONY?**

10 A. Yes. The following four conditions were offered by OEUC in its
11 supplemental testimony (See Oregon Electric/Exhibit 22, Davis/Page 18 of
12 26.)

- 13 1. The Commission or its agents may audit the accounts of Oregon
14 Electric and any subsidiaries that are the bases for charges to PGE to
15 determine the reasonableness of allocation factors used by Oregon
16 Electric to assign costs to PGE and amounts subject to allocation or
17 direct charges. Oregon Electric agrees to cooperate fully with such
18 Commission audits.
- 19 2. Oregon Electric and PGE shall provide the Commission access to all
20 books of account, as well as all documents, data and records of their
21 affiliated interests, which pertain to transactions between PGE and all
22 its affiliated interests.
- 23 3. PGE and Oregon Electric shall maintain separate books and records.
24 All PGE financial books and records shall be kept in Portland, Oregon.
- 25 4. Oregon Electric shall not subsidize its activities by allocating to or
26 directly charging PGE expenses not authorized by the Commission to
27 be so allocated or directly charged.
- 28
29
30
31

1 **Q. DO THESE CONDITIONS ALLEVIATE YOUR CONCERNS**
2 **REGARDING ACCESS TO INFORMATION?**

3 A. No. However, they are a good start. What is generally missing from these
4 conditions is access to books and records of the affiliates of OEUC and
5 reporting requirements pertaining to the creation of new products and the
6 forming of new affiliates and/or subsidiaries. Staff accepts conditions two
7 and four above and proposes the following revisions to conditions one and
8 three. (See Staff/402, Hathhorn/1.)

9

- 10 1. The Commission or its agents may audit the accounts of Oregon
11 Electric, its affiliates and any subsidiaries that are the basis for charges
12 to PGE to determine the reasonableness of allocation factors used by
13 Oregon Electric to assign costs to PGE and amounts subject to
14 allocation or direct charges. Oregon Electric agrees to cooperate fully
15 with such Commission audits.
16
17 3. PGE shall maintain its own accounting system. PGE and Oregon
18 Electric shall maintain separate books and records and all PGE and
19 Oregon Electric financial books and records shall be kept in Portland,
20 Oregon.
21

22 Ms. Hathhorn proposes additional conditions in this area in Exhibit
23 Staff/400.

24

Rate Commitments

25 **Q. HOW DOES OEUC'S LIST OF BENEFITS COMPARE TO RECENT**
26 **ACQUISITIONS THAT HAVE BEEN APPROVED BY THE**
27 **COMMISSION?**

1 A. A. OEUC's list of benefits in its original application is similar to other
2 recent acquisitions the Commission has considered in that the application
3 contains qualitative benefits. Although net benefits can encompass a
4 variety of factors, the prior acquisitions discussed in this testimony have
5 included qualitative benefits, hold-harmless conditions and rate
6 commitments including, but not limited to, rate credits.

7 **Q. WHAT DO YOU MEAN BY RATE COMMITMENTS?**

8 A. By rate commitments I mean monetary benefits or reductions in rates that
9 either immediately or predictably over time reduce rates from what they
10 otherwise might be.

11 **Q. HAS OEUC OFFERED ANY RATE COMMITMENTS?**

12 A. Not based on Staff's definition of a rate commitment. However, OEUC did
13 propose, in its supplemental testimony, to share any excess profits with
14 customers. (See Oregon Electric/Exhibit 22, Davis/Page 9 of 26.)

15 **Q. DOES STAFF BELIEVE THIS "RATE CREDIT" IS A BENEFIT TO**
16 **CUSTOMERS?**

17 A. No. Staff does not consider this to be an acceptable offer.

18 **Q. PLEASE EXPLAIN.**

19 A. The benefits of a rate commitment or other alternate proposals must be
20 large enough that, after considering measurement difficulty, the
21 Commission can be sure that benefits exist. In other words, the level of
22 benefits Staff assigns to a commitment is directly correlated to the
23 difficulty in measuring the benefits.

1 **Q. WHY ARE EXCESS PROFITS HARD TO MEASURE?**

2 A. First, given the high absolute and relative rates PGE currently charges, I
3 find it difficult to conclude that Staff or Intervenors would not file to reduce
4 rates if PGE's earnings were in excess of its authorized return on equity.
5 Second, OEUC's supplemental testimony provided no details regarding
6 normalization assumptions that would be made. Adjusted results of
7 operations, upon which a potential rate credit is based, would likely be
8 contentious. Nor did OEUC quantify the sharing percentages. Even if
9 these details were provided, it is difficult to determine if this is truly a
10 benefit.

11 **Q. ARE THERE OTHER PROBLEMS WITH THIS APPROACH?**

12 A. Yes. There is a problem with the timing of the approach. Any excess
13 earnings are not likely to be seen until some time in the future. How long
14 in the future depends on various assumptions such as load growth, cost
15 savings realized, etc. However, the risks associated with a highly
16 leveraged holding company occur on day one. The "sharing excesses"
17 proposal asks customers to accept the upfront risks for the potential of
18 some share of excess profits in the future.

19 **Q. DO YOU HAVE ANY OTHER CONCERNS WITH OEUC'S "RATE
20 CREDIT" OFFER?**

21 A. Yes. Although OEUC provides no details on how the sharing would occur,
22 it indicates that this sharing mechanism will "... need to accommodate the
23 asymmetric impact of hydro variability." (See Oregon Electric/Exhibit 22,

1 Davis/Page 9 of 26, footnote 2.) It appears that OEUC's intention is that
2 this mechanism would shift risks due to hydro variability to customers.

3 **Q. DOES STAFF BELIEVE THIS IS A FRUITFUL APPROACH TO**
4 **DEMONSTRATING NET BENEFITS TO CUSTOMERS?**

5 A. No. This approach is fraught with complications and uncertainty. Staff
6 encourages OEUC to look for other methods of providing rate
7 commitments to PGE customers besides "sharing excesses."

8 **Q. WHAT DO YOU RECOMMEND?**

9 A. Immediate rate relief via rate credits would be the most straightforward
10 way of demonstrating net benefits.

11 **Q. PLEASE EXPLAIN YOUR USE OF THE TERM "NET BENEFITS."**

12 A. Any merger or acquisition is likely to produce a combination of results that
13 are positive (benefits) and negative (risks and/or costs) for customers.
14 Staff must be sure that the positive results outweigh the negative results
15 so that, overall, the merger or acquisition produces net benefits for
16 customers (i.e., the benefits outweigh the risks and costs). (See Order 01-
17 778.)

18 **Q. ARE RATE CREDITS A REQUIREMENT FOR APPROVAL?**

19 A. No. However, I believe it is exceedingly difficult to demonstrate sufficient
20 benefits to offset the risks of the transaction without meaningful rate
21 credits.

22 **Q. WHAT DO YOU MEAN BY RISKS?**

1 A. Risk involves the potential for harm or unintended consequences. As
2 noted in my summary remarks, the many unanswered questions
3 stemming from OEUC's proposal to acquire PGE pose risks to PGE's
4 customers. These risks do not exist absent this proposed transaction.

5 **Q. WHY HAVE RATE CREDITS BEEN SUCH AN INTEGRAL PART OF**
6 **PRIOR ACQUISITIONS?**

7 A. First, rate credits are the clearest method of demonstrating benefits
8 sufficient to offset the risks of the transaction. A secondary reason for
9 adopting rate credits in prior acquisitions has been to settle disagreements
10 regarding cost savings.

11 **Q. PLEASE EXPLAIN.**

12 A. If a company wished to show benefits to customers through a method
13 other than rate credits, it could detail cost savings or efficiencies that the
14 acquisition is expected to bring. This could be management expertise,
15 workforce reductions, etc. The difficulty with demonstrating benefits
16 through a plan to reduce costs is that Staff is uncertain that the plan would
17 come to fruition. A second problem is that if the applicants can reduce
18 costs, customers would only see the benefit of those cost reductions
19 through a rate case, which may be a long time coming. Because of these
20 uncertainties, Staff has discounted the benefits resulting from cost-savings
21 plans. In response, past applicants have "guaranteed" the benefit of
22 anticipated cost savings by implementing rate credits.

1 **Q. BASED ON THIS VIEW, DO COST-CUTTING PLANS REDUCE THE**
2 **RATE CREDIT NECESSARY TO DEMONSTRATE NET BENEFITS?**

3 A. Yes. To the extent plans to reduce costs without sacrificing service quality
4 are reasonably certain and there is a mechanism that passes those
5 savings to customers, the cost-cutting plans would reduce the required
6 rate credit, all else being equal.

7 **Q. WHAT IS OEUC'S VIEW ON RATE CREDITS?**

8 A. Mr. Davis states that rate credits are not appropriate in this case because,
9 "[i]n prior proposed mergers involving PGE, the proposed buyers were
10 other energy companies, which meant there would be merger "synergies"
11 resulting in cost savings and benefits to the applicants. These synergies
12 formed the basis for settlements that featured fixed rate credits. By
13 comparison, this is an acquisition by a non-energy related company with
14 no other business. It is not a merger. Oregon Electric has no other
15 holdings and there will be no synergies available to share with customers."
16 (See Oregon Electric/Exhibit 22, Davis/Page 9 of 26, line 22 through
17 Davis/Page 10, line 4.)

18 **Q. DO YOU FIND THIS ARGUMENT COMPELLING?**

19 A. No. As I have discussed, synergies and cost savings, if they are passed
20 through to customers, work to reduce the level of rate credit necessary to
21 meet net benefits, all else being equal. Mr. Davis' argument does
22 however raise an additional concern.

23 **Q. PLEASE EXPLAIN.**

1 A. Mr. Davis' argument could also be read to suggest that TPG is relatively
2 inexperienced with a business such as PGE and this inexperience may
3 cause risks to PGE's customers. Mr. Morgan discusses this issue further
4 in Exhibit Staff/200, Morgan/53 lines 4 through 10.

5

6 **Prior Commission Review of Mergers or Acquisitions**

7 **Q. OEUC IS PROPOSING TO ACQUIRE PGE FROM ENRON. WHEN DID**
8 **ENRON ACQUIRE PGE?**

9 A. Enron filed its application to purchase PGE on August 30, 1996. The
10 Commission approved the application on June 4, 1997, in its Order No.
11 97-196. The Commission also imposed a large number of conditions with
12 its approval. These conditions are presented in Exhibit Staff/102,
13 Conway/4 through 14.

14 **Q. WHEN DID OEUC FILE TO PURCHASE PGE?**

15 A. OEUC filed its application to acquire PGE on March 8, 2004.

16 **Q. BESIDES THIS CURRENT APPLICATION, HOW MANY ENERGY**
17 **UTILITY MERGER OR ACQUISITION APPLICATIONS HAS HE**
18 **COMMISSION DECIDED SINCE ENRON PURCHASED PGE?**

19 A. Table 2 lists the mergers or acquisitions for which the Commission has
20 issued an order approving the acquisition application since 1997.

1

Table 2

Request	Date	Order No.	Conditions Attached as:
Enron acquisition of PGE	June 4, 1997	97-196	Staff/102, Conway/4-14
ScottishPower acquisition of PacifiCorp	October 6, 1999	99-616	Staff/102, Conway/15-25
Sierra Pacific acquisition of PGE	October 30, 2000	00-702	Staff/102, Conway/26-48

2

3

Q. HOW MANY OF THOSE ORDERS INCORPORATED RATE CREDITS?

4

A. All three of these recent Commission orders contained rate credits. I will briefly describe the conditions and rate commitments made in each of these past three acquisitions.

5

6

7

Enron purchase of PGE (1997)

8

Order 97-196

9

- \$36 million in rate credits spread out over four years
- \$105 million to purchase PGE's trading floor
- Limitations on dividends, minimum equity requirements and other financial ring fencing
- Commitment that rates would not be higher due to the acquisition
- Service quality commitments

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Scottish Power purchase of PP&L (1999)

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Order 99-616

18

- \$52 million in rate credits spread out over four years
- Limitations on dividends, minimum equity requirements and other financial ring fencing
- Commitment that rates would not be higher due to the acquisition

19

20

21

- 1 • Commitment of \$6 million a year on conservation programs for
- 2 three years
- 3 • Commitment to develop 50 additional megawatts of renewable
- 4 energy within five years
- 5 • Service quality commitments (Improvements over those approved
- 6 in the Enron PGE merger)
- 7 • Agreed to pay customers \$50 if it missed any of eight customer
- 8 guarantees

9

10 **Sierra Pacific proposed purchase of PGE (2000)**

11 Order 00-702

- 12 • \$95 million in rate credits spread out over seven years
- 13 • Rate freeze and other rate commitments such as rates no higher
- 14 than without the acquisition
- 15 • Limitations on dividends, minimum equity requirements and other
- 16 financial ring fencing
- 17 • Separation of generating and transmission costs to protect Oregon
- 18 customers from higher Nevada rates and a ban on joint ventures
- 19 • Service quality commitments (Matched those implemented in the
- 20 Scottish Power merger).

21

22 **Is OEUC Proposing To Step Into Enron's Shoes?**

23 **Q. IN ORDER NO. 97-196 THE COMMISSION ESTABLISHED**

24 **CONDITIONS FOR APPROVAL OF THE ENRON ACQUISITION OF**

25 **PGE. DOES OEUC PROPOSE TO STEP IN ON BEHALF OF ENRON**

26 **AND ACCEPT THE CONDITIONS AGREED TO BY ENRON?**

27 **A.** No. OEUC did not propose adoption of any of the Enron conditions in its

28 original application. As a result of the June 8, 2004, settlement

29 conference and OEUC's Supplemental Testimony, six Enron-like

30 conditions have been agreed-to in principle.

1 **Q. HOW MANY CONDITIONS DID OEUC PROPOSE IN ITS**
2 **SUPPLEMENTAL FILING?**

3 A. OEUC proposed thirteen conditions that were similar to the conditions
4 imposed on Enron.

5 **Q. HOW MANY CONDITIONS DID THE COMMISSION PROPOSE IN THE**
6 **ENRON CASE?**

7 A. The Commission imposed 22. However, out of the 22 original conditions
8 in the Enron case, only 20 are potentially relevant for this question.

9 **Q. WHY IS THAT?**

10 A. Enron condition number 22 related to the Company's commitment to make
11 an industry restructuring filing within 60 days after closing of the
12 Enron/PGE merger and so is not relevant for the question at hand.

13 Enron condition number 20 was related to compensation to PGE for
14 the trading floor Enron purchased.

15 **Q. PLEASE CONTINUE.**

16 A. So, regarding the remaining 20 conditions imposed on Enron to protect
17 customers, only six have been agreed-to in principle by Staff and OEUC.

18 **Q. WHAT IS THE STATUS OF THE OTHER SEVEN CONDITIONS OEUC**
19 **PROPOSED THAT WERE SIMILAR TO ENRON CONDITIONS?**

20 A. The remaining seven conditions under discussion. Staff's concern is that
21 the parties do not share a common understanding of the meaning of these
22 conditions.

23 **Q. PLEASE EXPLAIN.**

1 A. OEUC made changes to the Enron conditions that now lead Staff to
2 question if the intent of the condition has changed. For example, Enron
3 condition ten states,
4 "Enron guarantees that customers of PGE shall be held harmless if the
5 merger between Enron and PGC results in a higher revenue requirement
6 for PGE than if the merger had not occurred."
7

8 While OEUC's condition eleven states,

9 "Oregon Electric guarantees that the customers of PGE shall be held
10 harmless if the acquisition of PGE directly results in a higher revenue
11 requirement."
12

13 It is Staff understanding that if revenue requirements were higher due to
14 the merger with Enron (e.g., Enron's bankruptcy) that PGE customers
15 would be held harmless by Enron. OEUC's proposed condition could
16 mean that customers are only held harmless due to increased revenue
17 requirements due only to the initial acquisition, not other actions by OEUC.
18 Additionally, Staff is unsure if the condition is limited further due to the use
19 of the word "directly." Staff encourages OEUC to further explain the
20 meaning of the conditions it proposes and any changes it made to the
21 prior Enron conditions.

22 **Q. WHAT DOES THIS LEAD YOU TO CONCLUDE?**

23 A. As it stands, it appears OEUC does not wish to be held to the same
24 standard Enron was held to. In other words, OEUC would provide less
25 assurance that customers will not be harmed.

1 **Q. ASSUMING THE TRANSACTION CLOSES AND OEUC AGREES TO**
2 **ALL OF THE ENRON CONDITIONS, WOULD CUSTOMERS BE**
3 **ADEQUATELY PROTECTED?**

4 A. No. As an example, Enron Conditions seven and ten both made similar
5 commitments. Essentially these two conditions state that neither PGE's
6 cost of capital nor PGE's revenue requirement would rise due to Enron
7 acquiring PGE. However, PGE's bond ratings have been downgraded at
8 least in part due to Enron's demise. This decrease bond rating translates
9 into a higher cost of capital, all else being equal. If PGE were to file a rate
10 case under Enron ownership, Staff would recommend that the increased
11 cost of capital be disallowed based on the merger commitments. Unless
12 OEUC agreed to hold PGE harmless for both its acquisition and Enron's
13 acquisition of PGE, customers would likely be worse off, all else equal.

14 Additionally, as discussed by Staff Witness Thomas Morgan in
15 Staff/200, Morgan/31, it appears the current ring fencing may be
16 inadequate even though PGE has been able to maintain investment grade
17 ratings.

18 Finally, there are unique risks associated with OEUC's ownership of
19 PGE such as the risks associated with OEUC being an LLC and OEUC's
20 apparent lack of experience owning a regulated electric company.

21 **Q. ARE THERE CONDITIONS THAT COULD LESSEN THE UNIQUE RISKS**
22 **AND UNCERTAINTIES ASSOCIATED WITH THIS TRANSACTION?**

1 A. Yes. Conditions that minimize risks to customers by prohibiting some actions
2 and guaranteeing that some risks are borne by the investors, i.e., the equity
3 and debt holders, at OEUC could significantly increase Staff's confidence in the
4 transaction. Some of the overall issues that TPG should address in its rebuttal
5 testimony include the seven following, broad topics:

- 6 1. Ring-fencing measures
- 7 2. Master Services Agreement and affiliated interested issues including
8 services and loans, provisions of guarantees and collateral among
9 affiliates;
- 10 3. Equity ownership or LLC interest dispositions, reorganization,
11 conversion and transfers;
- 12 4. Dividend policy and cash flow sweep;
- 13 5. Hold Harmless clause for revenue requirement and cost of capital due
14 to issues not specific to a "stand-alone" PGE.

15
16 **Potential Benefits to Customers**

17 **Q. DOES THE PROPOSED APPLICATION PROVIDE BENEFITS TO**
18 **PGE'S CUSTOMERS?**

19 A. Yes. We have reached an agreement on a few conditions including
20 service quality measures. In addition, local representation could provide a
21 benefit although it is difficult at the present time to determine how
22 meaningful that benefit is to customers. However, this does not say
23 OEUC has demonstrated net benefits.

1 **Q. DOES OEUC EXPECT TO PROVIDE ANY OTHER BENEFITS SUCH AS**
2 **COST SAVINGS?**

3 A. Yes and no. OEUC claims it has no plans to cut costs since PGE is
4 currently well run but, as Staff Witness Ed Durrenberger points out,
5 OEUC's due diligence identifies millions of dollars of potential cost
6 savings. (See Staff/300, Durrenberger/2, line 19 through Durrenberger/3,
7 line 6.) However, at this point, the only way for the cost savings to benefit
8 customers is through a general rate case.

9 **Q. WHAT BENEFITS DO YOU BELIEVE PGE CUSTOMERS WILL LIKELY**
10 **BE ABLE TO REALIZE BASED ON THE CURRENT PROPOSAL?**

11 A. The most tangible benefit customers will realize compared to current
12 operations is a commitment to extend and improve the current SQM
13 agreement. These changes to the SQM will help ensure PGE maintains
14 the current high level of customer service as measured by the Service
15 Quality Measures (SQM) document. More specifically, the stipulation
16 regarding the SQMs provides benefits to the customers, because it adopts
17 the same improvements in service quality measures that were
18 implemented in the service quality stipulation between ScottishPower and
19 the Commission obtained during ScottishPower's acquisition of
20 PacifiCorp. Specifically, the proposed stipulation between OEUC and
21 Staff adds a new service quality measure and extends the term of the
22 measures to allow a full 10-year extension of the period of protection after
23 the acquisition. Although these changes are minor, they can be

1 considered a benefit to PGE's customers. (See Staff/600, Murray-
2 Sipler/3.)
3

4 **Tax Implications**

5 **Q. ARE THERE ANY OTHER ISSUES YOU WISH TO ADDRESS?**

6 A. Yes. Several parties including Staff have raised questions regarding
7 OEUC's plan for treating PGE's taxes. The primary issue is whether the
8 OPUC should continue to set rates based on the assumption that PGE
9 files its taxes on a stand-alone, normalized basis or if rates should be set
10 on the consolidated company's taxes.

11 **Q. WOULD CUSTOMERS BENEFIT FROM SETTING RATES BASED ON**
12 **A CONSOLIDATED TREATMENT OF TAXES?**

13 A. Staff is unsure. Staff Witness Judy Johnson points out that that tax shield
14 attributable to the interest OEUC will pay on its debt is estimated to be
15 around \$15 million per year. However, Ms. Johnson also points out that it
16 is possible for the consolidated tax burden to be higher than the utility's
17 stand-alone tax burden. If this were the case, rates would be set higher,
18 all else being equal. (See Staff/500, Johnson/8 lines 1 through 12)

19 **Q. DOES STAFF HAVE ANY RECOMMENDATIONS WITH REGARD TO**
20 **THE TREATMENT OF TAXES IN THIS DOCKET?**

21 A. Not yet. Staff is still analyzing the issues surrounding the treatment of
22 PGE's taxes. Staff looks forward to reading other intervenors' testimony
23 on this issue as well as any proposals OEUC may put forward in its

1 rebuttal testimony. Staff will have a recommendation regarding the
2 treatment of taxes at PGE by the conclusion of this case.

3
4 **Future Staff Activities**

5 **Q. WHAT FUTURE ACTIVITIES ARE PLANNED IN THIS DOCKET?**

6 A. Following Staff's direct testimony in this case, other activities in this docket
7 are:

- 8 ▪ Rebuttal Testimony by the Company
- 9 ▪ Settlement conferences
- 10 ▪ Surrebuttal testimony by Staff and Intervenors
- 11 ▪ Sursurebuttal testimony by the Company
- 12 ▪ Additional settlement meetings

13 Therefore, the schedule allows for more opportunities for parties to share
14 concerns and resolve issues. In addition to the above schedule, Staff has,
15 and will continue to be, open to additional settlement meetings. As noted
16 in prior testimony, Staff has many unanswered questions regarding
17 OEUC. The future scheduled events in this docket should aid in
18 answering these questions.

19
20 **Conclusion**

21 **Q. WHAT HAS STAFF CONCLUDED REGARDING OEUC'S**
22 **APPLICATION TO ACQUIRE PGE SO FAR?**

1 A. Staff has concluded that the proposal, as it stands today, falls short of
2 demonstrating net benefits for customers.

3 **Q. DO YOU HAVE ANY RECOMMENDATIONS FOR OEUC?**

4 A. Yes. OEUC should submit a proposal in its rebuttal testimony that honors
5 the commitments Enron made, offers meaningful rate commitments, and
6 proposes conditions that address the additional risks posed the unique
7 nature of the transaction.

8 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

9 A. Yes.

1 **Q. PLEASE STATE YOUR NAME, OCCUPATION, AND BUSINESS**
2 **ADDRESS.**

3 A. My name is Thomas D. Morgan and my business address is 550 Capitol Street
4 NE Suite 215, Salem, Oregon 97301-2551.¹

5 **Q. PLEASE DESCRIBE YOUR BACKGROUND AND WORK EXPERIENCE.**

6 A. I am employed as a Senior Financial Analyst by the Public Utility Commission
7 of Oregon (OPUC or Commission). I have been employed by OPUC since
8 August 2001. I work in the Economic Research and Financial Analysis
9 Division. My Witness Qualifications Statement is found in Staff/201.

10 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

11 A. My testimony addresses certain financial issues relating to the acquisition of
12 Portland General Electric (PGE) by the Texas Pacific Group (TPG), through its
13 subsidiary, Oregon Electric Utility Company, LLC (OEUC). I will describe the
14 findings regarding financial issues that impact the transaction and I will discuss
15 the general strategy and objectives that TPG has represented.

16 My assignment is to develop an opinion on financial and other risks that
17 exist in the proposed TPG acquisition of PGE's equity. I also provide a review
18 TPG's initial Application in this docket and the supplemental testimony provided
19 by Kelvin Davis, a principal with TPG.

20 **Q. DID YOU PREPARE ANY EXHIBITS FOR THIS DOCKET?**

21 A. Yes. I prepared Exhibit Staff/201, a one-page document that provides my
22 witness qualifications and Staff/202, consisting of 609 pages. This exhibit

1 includes supporting material, including responses to data requests, and
2 excerpts from PGE's most recently submitted 10-Q statement to the Securities
3 and Exchange Commission.

4 **Q. HOW IS YOUR TESTIMONY ORGANIZED?**

5 A. In the first section of my testimony, I will discuss the exposure to certain
6 potential liabilities that may impact OEUC, TPG and/or PGE after the close of
7 the transaction. Some of the exposure to liabilities would affect PGE without
8 regard to its ownership or dealings with Enron. Others are a direct result of
9 Enron's actions and ensuing bankruptcy.

10 I will then address the indemnifications that are being provided to PGE
11 and/or OEUC (TPG). I will discuss the due diligence undertaken by TPG to
12 support the investment in PGE's common equity and provide my assessment
13 of the reasonableness of TPG's conclusions and estimates. I will then describe
14 some of the primary ways OEUC will profit from the transaction. Finally, I will
15 detail the numerous risks that are specific to this transaction and offer potential
16 solutions.

¹ My telephone number is (503) 378-4629 and my e-mail address is thomas.d.morgan@state.or.us.

1

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1 **BRIEF DESCRIPTION OF TEXAS PACIFIC GROUP**

2 **Q. COULD YOU BRIEFLY DESCRIBE THE TEXAS PACIFIC GROUP THAT**
3 **IS ORGANIZING OEUC, THE COMPANY THAT DESIRES TO PURCHASE**
4 **PGE?**

5 A. Yes. TPG, with headquarters in Fort Worth, Texas, is a private equity firm² that
6 manages investments from pension funds -- including \$950 million from the
7 Oregon Public Employees Retirement Fund -- and other large investors such
8 as insurance companies. It has invested about \$13 billion in more than 50
9 companies. The \$525 million total equity investment in this transaction
10 amounts to only about four percent of the total capital it has committed since its
11 founding in 1993. TPG will be funding al but about \$100 million of the total
12 equity investment. TPG has an office in San Francisco, out of which the recent
13 deal appears to have been developed.

14 **Q. IS THIS A TYPICAL TRANSACTION OF TPG?**

15 A. No. This would be the first public utility acquisition of the investment company
16 of which I am aware. I have provided excerpts from the FERC filing in
17 Staff/202, that describe in detail the utility-related business lines in which TPG
18 is involved. These mostly include oil and natural gas companies not related to
19 the operations in the region. (See Application for Approval of a Transfer of
20 Control Staff/202, Morgan/509-538.)

² Private Equity generally refers to funds invested in non-public companies, i.e., not publicly-traded. The major capital investments are into venture companies (e.g. start-ups or smaller, high-risk investments) and Leveraged Buyouts (LBOs) in which equity in more mature industries is purchased using a relatively significant amount of debt.

1 Based on my overall review, it is likely that the expected return that will
2 eventually be generated from this investment may be somewhat lower than
3 might be otherwise expected from some leveraged buyout transactions.
4 However, the relative cash flow stability of the utility operations appears to fit
5 TPG's portfolio strategy. According to an article published in the Oregonian
6 when the initial sales agreement was signed, "But PGE, unlike many of the
7 companies Texas Pacific invests in, has a fairly captive audience, so it makes
8 for a stable investment with little chance of going under." (See Staff/202,
9 Morgan/19-21, "Portland General Buyer Texas Pacific Makes Big Turnaround
10 Deals Its Specialty", The Oregonian, Nov 19, 2003.) Mr. Bonderman, a TPG
11 principal, indicated, "This is going to be, for us, a low-return deal."

12 Even though the returns may not be as high as expected in other deals
13 TPG has undertaken, the integration of PGE into TPG's funds should provide a
14 significant overall benefit due to its relatively low risk. "Private equity firms are
15 increasingly seeking out stable investments like PGE to round out their
16 portfolios, said Robert Dunn, associate editor of Private Equity Analyst, a
17 Wellesley, Mass., trade publication. "They're investing in businesses that tend
18 to have sustainable cash flow," he said. In this transaction, TPG is "eschewing
19 a high-growth situation." (Ibid.)

20 According to the article, however, some members of the public hold
21 concerns. There have been overall concerns about cost-cutting measures, the
22 potential impact on customer service and capital reinvestment cuts, for

1 example. Staff shares these concerns and Staff addresses them throughout
2 our testimony. (See generally Staff/300 and Staff/600.)

3 While some argue that the investment company has incentives to slash
4 expenses to maximize returns, others are concerned about a potential speedy
5 re-sale. Mr. Dunn stated, "Because of the low annual returns... Texas Pacific's
6 best strategy is to sell PGE or take its stock public as soon as possible... The
7 quicker they're in and out, the better their return looks." (See Staff/202,
8 Morgan/20.)

9 **Q. WHAT IS THE OVERALL RETURN TO INVESTORS THAT IS EXPECTED**
10 **IN TPG'S ANALYSIS?**

11 A. [CONFIDENTIAL/]
12
13
14
15 [CONFIDENTIAL]

16 Later in my testimony I will detail the sources of profit that will comprise the return
17 to the TPG funds. Prior to discussing the sources of profit, I discuss the risk factors of
18 this transaction.

19

³ The Investment Review Committee is comprised of a group of partners in the TPG funds that review potential investments.

SECTION I: IMPACT OF LIABILITIES AND INDEMNIFICATIONS**LIABILITIES****Q. HOW WILL THE LIABILITIES ASSOCIATED WITH ENRON'S
BANKRUPTCY IMPACT THIS TRANSACTION AND PGE'S ON-GOING
OPERATIONS?**

A. Staff has not been provided complete and clear details pertaining to the contingent liabilities, their valuation and all indemnifications that will be included in this transaction. While there are a few liabilities that currently reside at PGE, such as the impact of Trojan, there are also liabilities that are the result of Enron. It is important to know the degree to which ratepayers are properly protected from Enron and PGE's non-rate-regulated legal problems. At this time, it is not perfectly clear which liabilities will ultimately remain with PGE and which may potentially affect PGE customers. This is an issue that Staff invites the Applicants to further explore in their rebuttal testimony.

Q. WHAT MIGHT HELP MITIGATE STAFF'S CONCERNS?

A. Although there may be no perfect solution to this problem, any purchaser of PGE should expect that it would absorb the liabilities to which PGE might be exposed. Although the liabilities that are a result of PGE's own, completely separate operations may be more appropriately borne by the PGE and its

⁴ An "Exit Multiple" is a relative value metric used to estimate the price when an investment is divested or sold, ergo the term "exit". The term "multiple" relates the price to a financial figure, such as net income (there are a few alternatives and I provide clear descriptions of these alternative multiples further in my testimony.) Building on the net income metric as an example: if a company has a price of \$100 and a net income of \$10, the "net income multiple" would be 10x, i.e., \$100 / \$10.

1 shareholders, none of the exposure that is a result of PGE's involvement with
2 Enron should accrue directly or indirectly to PGE customers.

3 Conditions that protect PGE's customers from any Enron-related liabilities
4 would provide a clear benefit to PGE's customers. Additionally, a complete
5 description and potential valuation of each liability could be provided by TPG in
6 order to assist Staff in determining the potential impact on PGE.

7 **Q. CAN YOU DESCRIBE THE LIABILITIES ASSOCIATED WITH ENRON'S**
8 **BANKRUPTCY AND PROVIDE THEIR POTENTIAL MAGNITUDE?**

9 A. Although there are a few categories where the value of individual liabilities can
10 be estimated with a reasonable range of accuracy, some liabilities could
11 potentially be very large. The degree to which the final impact might affect
12 PGE is not known with certainty. The following details a listing of liabilities for
13 which PGE might face financial exposure. The listing may not be complete,
14 and Staff invites the Applicants to provide complete details or a listing of all
15 potential liabilities in its rebuttal testimony. Staff has recently requested any
16 estimates available to TPG of the valuation of these liabilities.

17 **Q. WHAT ARE THE POTENTIAL CONCERNS ABOUT THE LIABILITIES?**

18 A. The ultimate liability exposure to PGE could be large enough to drain PGE's
19 financial capacity. Additionally, PGE might attempt to recover these costs from
20 its customers. If the impact of these liabilities drains PGE below a reasonable
21 amount of equity, PGE's credit strength could erode.

22 Until the bankruptcy court has made a final decision, there is a potential for
23 PGE to maintain liabilities within its own capital structure that may be viewed

1 by some as belonging to Enron as opposed to PGE. This may weaken PGE's
2 financial performance and ultimately create problems at PGE and OEUC.

3 Access to reasonably priced debt is necessary to maintain ongoing capital
4 investments. Additionally, high-cost debt taken out by PGE now may harm
5 customers for thirty or more years into the future. The degree to which PGE
6 and/or OEUC are responsible for, or protected from, the liabilities associated
7 with Enron is an important factor in Staff's recommendation.

8 INDEMNIFICATIONS

9 **Q. COULD YOU EXPLAIN WHAT THE TERM "INDEMNIFICATION" MEANS?**

10 A. Yes. The term indemnification refers to an agreement that provides for one
11 party to bear the costs, either directly or by reimbursement, for damages or
12 losses incurred by a second party. In this case, Enron agrees to provide
13 compensation for certain liabilities that may reside with PGE or be transferred
14 to OEUC after the finalization of Enron's bankruptcy proceedings. Enron did
15 however limit its indemnification by capping the total dollars to which it can be
16 exposed.

17 **Q. WHAT INDEMNIFICATIONS ARE PROVIDED IN THIS DEAL THAT** 18 **FAVOR PGE AND ITS CUSTOMERS?**

19 A. There are some details pertaining to the indemnifications that have been
20 provided by Enron. These indemnifications would provide cash to offset some
21 of the liabilities that currently are known and that may materialize in the future.
22 Some of the indemnifications for liabilities will be "capped" at a ceiling and
23 OEUC will share others on a percentage-basis. These all relate to protections

1 for the buyers, i.e., TPG/OEUC, and do not provide specific protections for
2 PGE or its customers.

3 **Q. PLEASE DESCRIBE THE ISSUE.**

4 A. The following points detail the indemnification issue as I currently understand
5 it.:**[CONFIDENTIAL/]**

6 [REDACTED]

7 [REDACTED]

8 [REDACTED]

9 [REDACTED]

10 [REDACTED]

11 [REDACTED]

12 [REDACTED]

13 [REDACTED]

14 [REDACTED]

15 [REDACTED]

16 [REDACTED]

17 [REDACTED]

18 [REDACTED]

19 [REDACTED]

20 [REDACTED]

21 [REDACTED]

22 [REDACTED]

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- [REDACTED]

10

[REDACTED] [CONFIDENTIAL]

11
12

- There will be a "crystallization" (e.g., firming up of the issues, such as cost impacts) and final settlement three years after closing.

13
14

SECTION II: PRINCIPLE SOURCES OF INVESTOR RETURNS

15

Q. HOW DO INVESTORS EXPECT TO PROFIT FROM THIS TRANSACTION?

16
17
18

A. There are four primary areas from which OEUC will benefit throughout its holding period. The first is based on overall cost savings. The second is based on the impact of tax savings that will accrue to the OEUC due to the

⁵ [CONFIDENTIAL] [REDACTED] [CONFIDENTIAL]

⁶ The term "HoldCo" refers to the "Holding Company," or OEUC. It is assumed that the name of the holding company had not been identified at the time of the agreement.

1 "Double Leverage"⁷ that will be created. The third is based on the ability for
2 OEUC to resell PGE at a higher price than it is currently paying for it and incur
3 a substantial capital gain. I will describe the each of these issues in more
4 detail.

5 COST SAVINGS

6 **Q. WERE THE COST SAVINGS IDENTIFIED IN THE PRO FORMA**
7 **FINANCIAL STATEMENTS BASED ON DETAILED ANALYSIS AND**
8 **WERE THEY USED TO SUPPORT THE PURCHASE PRICE?**

9 A. Yes. Although it is not clear exactly which scenario cemented the decision to
10 invest in PGE, the sale price that has been agreed upon can be expected to
11 have taken into consideration the requirement of well-reasoned and firmly
12 estimated figures. One could argue that the base case appears to contain
13 some of the more conservative assumptions. After considering the results of
14 the Initial Review Process Plan,⁸ it may be expected that more aggressive cost
15 savings could realistically be identified and quantified. (See Staff/202,
16 Morgan/225.)

17 **Q. HOW WERE THE COST SAVINGS IDENTIFIED?**

18 A. TPG had extensive discussions and interviews with PGE staff and
19 management. They also had physical access to inspect physical plant assets.

⁷ Double leverage is a general term, and is evident due to TPG's purchase of PGE's equity shares by borrowing money. The reference refers to the presumption that the interest rate on the borrowed money is lower than the equity return that it will gain in the regulatory framework.

⁸ The Initial Review Process Plan is designed to "set out the framework for the evaluation of PGE's strategic plan, financial plan, and operating performance." The Plan is expected to be implemented upon closing the transaction.

1 PGE currently uses a cost-plus budgeting model as opposed to a zero-based
2 model. The cost-plus model generally bases future costs on prior year's costs
3 with adjustments due to major projects. The zero-based model explicitly
4 identifies productivity measures that can be developed by deploying plans to
5 reduce capital and business costs.

6 [CONFIDENTIAL/

7 [REDACTED]
8 [REDACTED]
9 [REDACTED]
10 [REDACTED]
11 [REDACTED]
12 [REDACTED]
13 [REDACTED]
14 [REDACTED] [/CONFIDENTIAL]

15 **Q. WHAT TYPES OF COSTS SAVINGS ARE PROJECTED AT PGE?**

16 A. I will provide general details about the cost savings that are anticipated. Staff
17 Witness Ed Durrenberger provides more detailed descriptions in his testimony.

18 (See generally Staff/300.) [CONFIDENTIAL/

19 [REDACTED]
20 [REDACTED]
21 [REDACTED]
22 [REDACTED]
23 [REDACTED]

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[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED] [CONFIDENTIAL]

Q. COULD YOU PROVIDE SPECIFIC EXAMPLES?

A. Yes, I will give specific examples of some cost savings that were identified in TPG's due diligence analysis. [CONFIDENTIAL]

[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]

[CONFIDENTIAL]

Another cost saving includes the tax shield on the interest that will be paid on the debt that will be used to acquire PGE's stock. This component will provide around \$15 million in additional annual savings, at least at the outset.

⁹ I am assuming that the Fixed O&M expenses listed as Production and Distribution, Administrative and Other and Overhead Allocation Charge are those line items included in Mr. Fusco's statement.

1 (See Staff/202, Morgan/184-185.) It is not certain what level of leverage will be
2 maintained at OEUC in the long run, or what the final interest costs will be.

3 **Q. ARE THE COST SAVINGS WELL SUPPORTED?**

4 A. Yes. TPG relies on input garnered from hired experts along with its in-house
5 staff to develop its estimates. It employs the resources of a significant number
6 of its well-trained and seasoned professionals. Further, it has access to
7 excellent corporate advisors.

8 Based on the financial analysis that the company has provided and
9 coupled with the overall historical performance of TPG's funds, TPG may be
10 expected to provide PGE with the corporate focus it requires and to remove the
11 overhang of the Enron bankruptcy.

12 **[CONFIDENTIAL]** [REDACTED]

13 [REDACTED]

14 [REDACTED]

15 [REDACTED]

16 [REDACTED] **[/CONFIDENTIAL]**

17 **Q. COULD YOU DESCRIBE THE TAX SAVINGS SHIELD YOU REFERRED**
18 **TO?**

19 A. Yes. Although I will provide details on the "Double Leverage" issue next, the
20 interest tax shield is due to the fact that operating profits are reduced by
21 interest payments prior to the calculation of income taxes. If OEUC is files its
22 income taxes combined, or consolidated, with PGE, OEUC's income taxes will
23 be reduced by the amount of interest multiplied by the tax rate. Therefore, any

1 debt that is taken on at the holding company can be expected to save OEUC
2 money, all else being equal. In the initial years after the transaction, this factor
3 is expected to save OEUC about \$15 million, as I identified earlier. The
4 amount will vary based on the overall interest rate that is paid on the debt at
5 the holding company and also will vary with principal reductions.

6 **Q. COULD YOU PROVIDE AN EXAMPLE OF THE DYNAMICS OF THIS**
7 **PROCESS?**

8 A. Yes. First, assume that PGE earns \$100 of taxable earnings and that OEUC
9 has no other earnings (on a consolidated basis) than those generated by PGE.
10 Further assume that OEUC would pay a total of \$50 in interest on its debt at
11 the holding company (unrelated to PGE's debt) and that all of this interest is
12 tax-deductible.

13 Assuming a tax rate of 40 percent, PGE as a stand-alone entity would have
14 paid \$40 in taxes. With the additional interest at OEUC offsetting the earnings
15 of PGE, the combined pre-tax earnings would be \$50 (\$100 from PGE less the
16 \$50 in interest at OEUC.) The tax payment, instead of being \$40, is now only
17 \$20. This \$20 amount is the savings due to the tax shield on the added
18 interest from the debt at the holding company.

19 **Q. OTHER THAN THE INTEREST TAX SHIELD THAT YOU IDENTIFIED,**
20 **COULD YOU EXPLAIN HOW ELSE THE INVESTORS IN OEUC WILL BE**
21 **COMPENSATED IF THIS TRANSACTION PROCEEDS?**

22 A. Yes. To begin with, I will provide a little background on the trade-off between
23 risk and return. An appropriate financial return is predicated on the perceived

1 risk of the investment. This concept applies to all classes of investors,
2 including common shareholders and debt holders. A precept of financial theory
3 is that investors expect a higher return as compensation for taking on higher
4 risk on financial assets. Conversely, the lower the risk, the lower the return
5 expected. This guiding principle for determining the appropriate cost of equity
6 for a regulated firm should also be placed in the context of broader cost of
7 capital concepts. Two such concepts are the relationship between operating
8 position, capital structure and bond ratings; and the relationship between
9 capital structure and the cost of equity itself.

10 It is generally understood that common stocks for rate-regulated public
11 utility companies are among the least risky common equity investments. Not
12 only are their dividends more secure, since they enjoy a territorial monopoly
13 and provide a basic and required service, their revenue stream is more
14 assured. They are more stable than many companies both in good times and
15 in bad times.

16 Returns are measured by a "holding-period" measurement unit.¹⁰

$$HPR = \frac{(P_1 - P_0) + D_1}{P_0}$$

17
18 Where: HPR = Holding Period Return
19 P = Price
20 D = Dividend
21

¹⁰ The subscripts refer to period of return, e.g., 0 is present; 1 is at the end of year one, etc.

1 The returns are provided through periodic payments and an eventual
2 capital “reversion” or resale process. OEUC has indicated that it intends to use
3 available cash to pay down debt and its financial models indicate that it expects
4 to provide no dividends to the investment funds. Since OEUC appears focused
5 on extinguishing debt, the effect will be to increase the equity value of the
6 enterprise and, thus, the future resale will provide all its capital investment
7 returns.

8 **Q. IS THERE A REQUIREMENT FOR A CASH FLOW SWEEP?¹¹**

9 A. Not currently. OEUC represents that the banks will require a cash-flow sweep
10 to help ensure that the banks are repaid. However, OEUC makes no
11 agreements on its own regarding a cash flow sweep that would require such
12 debt reduction measures. Therefore, TPG would have the ability to receive
13 dividends from PGE from the funds that could have otherwise be used to pay
14 down debt by passing the dividends through to the underlying private equity
15 funds for reinvestment or other uses.

16 Regardless of the investment strategy, TPG would benefit from the annual
17 income-producing capabilities of PGE. To the extent that it had alternative
18 investments that would provide a more economic use of the capital, OEUC
19 indicates that it will use the current income to accumulate equity (by paying
20 down debt) rather than passing the income through to the funds as immediate

¹¹ A "Cash Flow Sweep" is a provision that requires that all available cash not necessary to operations or financing costs is used for a specific purchase. In this case it is referring to the cash being "swept" to the parent holding company (OEUC) for the purpose of liquidating debt.

1 returns. Additionally, once OEUC has retired or reduced debt, it has made no
2 commitment not to re-acquire debt at OEUC, i.e., re-leverage. Both of these
3 features would provide overall flexibility and security to the lending institutions
4 providing capital for the leveraged buyout, though they provide no offsetting
5 benefits to PGE customers.

6 CAPITAL GAIN AND PRICING COMPARISON OF ELECTRIC COMPANIES

7 **Q. HOW DOES THE PRICE THAT TPG IS PAYING COMPARE TO THE**
8 **PRICES FOR SIMILARLY SITUATED PUBLIC UTILITIES?**

9 A. [CONFIDENTIAL/ [REDACTED]
10 [REDACTED]
11 [REDACTED]
12 [REDACTED]
13 [REDACTED]
14 [REDACTED]
15 [REDACTED]
16 [REDACTED]

17 VALUATION METRICS OF COMPARABLE COMPANIES

18 [REDACTED]
19 [REDACTED]
20 [REDACTED]

¹² The Market-to-Book multiple reflects the market price of equity divided by the book value of equity and is a useful comparison metric to compare pricing among companies.

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[/CONFIDENTIAL] The range of the last three PGE acquisition attempts reflected significantly higher multiples, providing evidence that the current price is reasonable. My observation is that the purchase price is low by comparable, historic standards.

10

11

Q. DOES THE ANALYSIS PROVIDED BY TPG ASSUME A SIGNIFICANT PRICE APPRECIATION AND DOES THIS IMPACT THE OVERALL RETURN TO INVESTORS?

12

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14

A. Yes. Capital gains are assumed in the eventual sale by OEUC for PGE. This is a source of profit for the investors. However, rather than consider the actual price that it is forecasting, it is easier to consider the range in multiples that it has used in its analysis. Because any retention and reinvestment of profits into PGE would be funded by shareholders, considering the aggregate purchase price may be confusing. Price appreciation from this source, by itself, may not

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¹³ EBITDA is financial shorthand for "Earnings Before Interest, Taxes, Depreciation and Amortization". There are a few relative market value multiples that use a measure of earnings as the metric that is being compared to the purchase price.

¹⁴ EBIT is another common financial metric and is shorthand for "Earnings Before Interest and Taxes."

¹⁵ The Net Income multiple reflects price as a multiple of after-tax net income. It may also be referenced a "Price-Earnings" or "earnings" multiple.

1 provide additional benefits to the shareholders. The best source of capital gain
2 is for a "multiple" expansion, meaning that the pricing metrics would increase.
3 In its analysis, OEUC does anticipate that such an expansion will occur.

4 **[CONFIDENTIAL/** [REDACTED]

5 [REDACTED]

6 [REDACTED]

7 [REDACTED]

8 [REDACTED] **[/CONFIDENTIAL]**

9 **DOUBLE LEVERAGE**

10 **Q. CAN YOU SUMMARIZE THE MEANING OF "DOUBLE LEVERAGE"?**

11 A. Yes. First I will define the concept and then I will proceed with an explanation
12 of how it will work in this sales transaction.

13 The concept of Double Leverage can be summarized quite easily. It
14 corresponds to the premise of purchasing equity with borrowed money. As
15 long as the after-tax cost of the debt is less than the return on equity that is
16 expected from the shares that are being purchased, a net benefit it provided to
17 the borrower/investor.

18 **Q. CAN YOU EXPLAIN HOW DOUBLE LEVERAGE PROVIDES ADDITIONAL**
19 **RETURNS TO THE INVESTORS?**

20 A. Yes, I will provide a simple example of the dynamics of this process.

21 If we assume that OEUC borrows \$700 million in funds at 8.0% and pays
22 at a tax rate of 40%, then the after tax cost of the funds is 4.8%, or \$33.6
23 million. Further assume that the borrowed debt capital is invested in the equity

1 of a public utility that is allowed to earn 10.5% ROE. Therefore, the funds
2 could earn \$73.5 million. The difference between these two amounts (\$73.5 -
3 \$33.6 = \$39.9 million) comprises the earnings advantage of the double
4 leverage.

5 To begin a more detailed discussion of Double Leverage, I will need to
6 provide a general background on some key concepts.

7 8 **CAPITAL STRUCTURE**

9 **Q. WHAT IS A COMPANY'S CAPITAL STRUCTURE?**

10 A. The capital structure refers to the relationship among the component sources
11 of debt and equity financing used by a company. On a book value basis, it is
12 typical for utilities to be leveraged, or financed with debt, roughly at a 45-55
13 percent "debt to total capitalization ratio", which is commonly referred to as the
14 "Debt Ratio". This amount of debt would, therefore, make the equity portion
15 also 45-55 percent (to total capitalization.) The capital structure may also
16 include preferred stock, which is a type of equity that enjoys some of the
17 features of debt.

18 **COST OF EQUITY**

19 **Q. WHAT IS THE "COST OF EQUITY" (COE)?**

20 A. A firm's cost of equity is that rate of return on equity which investors require
21 earning on their equity investment given the risk of the investment. An

1 investor's expected return is equally defined as the return on equity that is
2 expected on other investments of similar risk.¹⁶

3 The rate of return on common equity compensates shareholders for the
4 use of their capital to finance the plant and equipment necessary to provide
5 utility service. Investors provide capital only if they expect to earn a return on
6 their investment commensurate with returns available from alternative
7 investments with comparable risks. The appropriate COE is the minimum rate
8 necessary to attract capital on favorable terms. Many concepts are included in
9 this definition.

10 The appropriate COE is a forward-looking concept. It is the *expected*
11 *return*, not the *actual return* that may prevail in some future period.

12 As a measure of opportunity cost, it is the return required to attract
13 investors' funds. As such, a firm must provide a return commensurate with
14 other investments in the market of comparable risk: the return must be
15 sufficient to compensate investors for their foregone opportunities.

16 It is a market-derived return in that it is established in the capital markets
17 where all investments compete against each other for investors' funds. This is
18 an important tenet. If the price for a company's shares do not allow an investor

¹⁶ More precisely, the *marginal* investor determines the firm's cost of capital. The marginal investor will bid the price of the security up to a point that the investor expects to earn the cost of capital and no less. Then, the *security* is in equilibrium. The definition of expected return based on returns on investments of similar risk (the "comparable earnings" standard) also assumes that the alternate security is in equilibrium and the investor does not expect to earn excess profits on that alternate security. For example, assume securities A and B are of similar risk and have a 10 percent cost of equity. Now assume that security B developed an invention such that it will realize a 20 percent return to current investors forever. *However, 20 percent is not security B's cost of equity; nor is it security A's.* The marginal investor will bid up the price of security B's stock (the price will double) until the marginal investor only expects to earn the 10

1 to earn the return required, the market price is expected to fall until the
2 marginal investor is "properly compensated" for his investment. Conversely, if
3 the return provided by a stock is too high, the share price will increase until an
4 equilibrium position is reached.

5 **Q. CAN YOU EXPLAIN HOW THESE RELATE TO THE DOUBLE LEVERAGE**
6 **ISSUE?**

7 A. Yes. First, let me indicate that leverage refers to the amount of debt or
8 preferred equity¹⁷ that exists in a company's capital structure. Use of debt and
9 preferred stock typically requires interest payments and eventually, the debt
10 holders expect to be paid back. As such, they are not shareholders and do not
11 typically share in the profits of the firm.

12 "Double" leverage arises when a subsidiary has debt or preferred stock
13 and is owned by a parent holding company that maintains its own, separate
14 debt or preferred stock. When both the parent company and subsidiary
15 company are leveraged, the company is leveraged twice, hence "double
16 leverage".

17 **Q. CAN YOU PROVIDE AN EXAMPLE OF DOUBLE LEVERAGE?**

18 A. Yes, I will provide a specific example. The following is loosely based on PGE's
19 capital structure and the proposed financing structure of TPG, however, it is
20 meant to be descriptive only. I have made many simplifications.

percent cost of equity in equilibrium on security B. The 10 percent equilibrium rate of return is security B's, and security A's, required (internal) rate of return.

¹⁷ Preferred equity is a hybrid security that has some of the characteristics of debt. For my purposes, I will assume it is a debt-equivalent.

1 In the following table (Table A), I show a stand-alone financing structure of
2 a Utility Company. The percentages to the right reflect the ratio of the debt or
3 equity that comprises the capital structure. As can be seen, the amount of
4 common equity in the company is just under 60 percent. The remaining 40
5 percent or so of capital is financed with either debt or preferred stock.

TABLE A

Utility Company - Stand Alone Balance Sheet				
Assets	\$2,232.2	Liabilities	\$890.2	39.9%
		Preferred Stock	\$22.0	1.0%
		Owner's Equity	\$1,320.0	59.1%
Total	\$2,232.2	Total	\$2,232.2	100.0%

6
7 In the case of a Holding Company that is purchasing the equity in the Utility
8 Company, the only asset it would hold on its balance sheet would be the equity
9 that it is purchasing. The debt at the Utility Company would remain at the Utility
10 Company. The following table (Table B) reflects this purchase as a stand-
11 along balance sheet for the Holding Company. There is a significant amount of
12 debt that is being borrowed to purchase the equity, and it is evident that the
13 equity capitalization ratio is only about 37 percent. It is important to iterate that
14 the 65 percent of debt that is being borrowed is being used to purchase equity
15 with the assumption that the return on equity at the utility company will be at
16 least marginally greater than the cost of the debt to the investor at the holding
17 company. Otherwise a leveraged buyout (LBO) would not be economically
18 feasible.

Table B

19

1

Holding Company - Stand Alone				
Balance		Sheet		
Assets	\$1,320.0	Liabilities	\$860.6	65.2%
		Preferred Stock	\$0.0	0.0%
		Owner's Equity	\$459.4	34.8%
Total		Total		
	\$1,320.0		\$1,320.0	100.0%
			0	

2

3

Now that I have analyzed the stand-alone balance sheets for the subsidiary utility and for the parent holding company, I will provide an example of what the consolidated balance sheet might look like for these two companies. The following table, Table C, reflects the total, combined debt of the two individual entities. Because the only true assets within the company are those from the Utility Company (Table A,) these are the only assets that show up in the consolidated structure. Were we to simply add all the assets, we would effectively be double-counting the true earning-capacity of the entity. As can be seen, the total debt is roughly 80 percent, leaving only 20 percent of "true" equity invested in the combined business.

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Table C

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Consolidated Company				
Balance		Sheet		
Assets	\$2,232.2	Liabilities	\$1,750.8	78.4%
		Preferred Stock	\$22.0	1.0%
		Owner's Equity	\$459.4	20.6%
Total		Total		
	\$2,232.2		\$2,232.2	100.0%

15

1 **Q. HOW DO SHAREHOLDERS BENEFIT FROM DOUBLE LEVERAGE?**

2 A. In this transaction, the shareholders will achieve a greater return on equity
3 (ROE) simply due to the fact that they are able to borrow money, on an after
4 tax basis, at a lower cost than the ROE that they will be able to earn on the
5 equity invested in PGE, as allowed by the Commission.

6

7

SECTION III: RISKS OF DOUBLE LEVERAGE

8 **Q. ARE THERE POTENTIAL RISKS DUE TO THE DOUBLE LEVERAGE**
9 **EXPECTED TO BE EMPLOYED BY OEUC TO PURCHASE PGE?**

10 A. Yes. Assuming consummation of this transaction, OEUC would be a wholly
11 owned company of the TPG funds and the only way one could own an interest
12 in PGE would be by having an ownership interest in the funds that own OEUC.
13 Therefore, one could not invest in PGE and benefit from its relatively modest
14 and "safe" capital structure. If PGE were to have poor financial performance
15 and could not pay sufficient dividends to OEUC to pay its debt service, OEUC
16 would be forced to borrow on its line of credit ---or require PGE to do so to fund
17 its dividend---to make its required payments. This risk could negatively impact
18 PGE's overall creditworthiness. Borrowing funds to pay dividends to
19 shareholders is generally not considered prudent.

20 To the extent that PGE has earnings shortfalls, it may rely on its borrowing
21 capacity on its revolving line of credit (Revolver). However, this would not be in
22 line with applicable laws. This is because short-term borrowing would be
23 authorized under ORS 757.480, which governs long-term borrowing, because

1 of its multi-year commitment. As such, the borrowing is limited to utility uses
2 only. However, the limitations would not preclude PGE from using the
3 Revolver to pay for utility-related expenditures while using other internal funds
4 for dividend payments. This would essentially have the same effect and could
5 occur because the dollars that would be used are not "color-coded", that is, the
6 source of the actual funds cannot be earmarked directly.

7 **Q. WHAT ARE THE RISKS OF HAVING A COMPANY THAT IS HIGHLY**
8 **LEVERAGED?**

9 A. The highly leveraged capital structure presents a significant risk that has not
10 been highlighted or addressed by TPG. (See *generally* Staff/202, Morgan/597-
11 607.) Both OEUC and PGE's weak capitalization at the outset can be
12 expected to limit their on-going access to fresh financing sources, in the event
13 that PGE's operations fall short of TPG's projections. OEUC's access to
14 capital markets in the future is unknown. TPG has indicated that, once debt is
15 partially paid off, it may choose to take on more debt during its holding period
16 of PGE.

17 Not only does the increased leverage highlight the consolidated financial
18 risk, it will impact PGE's overall risk. The credit-rating agency Standard &
19 Poor's, for example, has indicated that the highly-leveraged nature of the
20 proposed transaction is expected to decrease PGE's credit quality. (See
21 Staff/202, Morgan 593) This is due to the increased potential of default at the
22 holding company level. PGE may have already been detrimentally affected

1 regarding its cost of debt because of Enron's demise based on my
2 observations and general statements provided by the credit rating agencies.

3 Further erosion can be expected to increase PGE's cost of debt and its
4 overall cost of equity. Even if OEUC were to agree with a condition to hold
5 customers harmless for this facet of the deal and not increase PGE's cost of
6 capital because of the leverage, which it has not agreed to do, PGE may be
7 impacted in other ways, such as its ability to enter into power contracts or other
8 such deals where credit capacity or collateral are required components.

9 An additional and related concern is the overall interest rate environment
10 and its impact on the financial feasibility of the transaction. A part of the
11 purchase price is being funded by "adjustable-rate" debt and a portion will be
12 funded through fixed-rate debt. None of the specific financing documents have
13 yet been provided, so the exact interest rates will be unknown for some time.
14 As rates increase, the potential for the leverage to create a problem at the
15 holding company increases, and it may increase the pressure on PGE's cash
16 flows.

17 It appears, however, that the financial models have used reasonable
18 interest rates that may be expected to cushion the current movements in the
19 market.

20 **Q. ARE THERE STRATEGIES THAT COULD MITIGATE THIS RISK, SUCH**
21 **AS RING-FENCING MEASURES?**

22 A. Yes. Ringfencing measures can be used to partially offset the risk of heavy
23 leverage. However, it is highly unlikely that "perfect" ring-fencing measures

1 could be developed. However, there are additional ring-fencing measures that
2 OEUC could use to mitigate this concern, such as agreeing to limit PGE's
3 dividends when PGE does not have sufficient earnings to cover its costs. An
4 alternative might be if OEUC agreed to limit PGE's "payout ratio"¹⁸ at some
5 level, such as 75% of earnings. Sufficient ring-fencing measures could be
6 adopted that would require debt pay-down at OEUC rather than dividends
7 being paid to the TPG Funds. I will discuss this potential later, but it suffices to
8 say that such action could be expected to significantly add strength to the
9 capital structure of the holding company, thereby increasing its credit capacity
10 and credit ratings, which would have a spill-over effect on PGE.

11 **Q. DO YOU BELIEVE THAT THE RING-FENCING MEASURES ADOPTED**
12 **WITH ENRON'S ACQUISITION OF PGE WERE ADEQUATE?**

13 A. No. The ring-fencing measures, although some of the best in the nation, were
14 not sufficient to remove the risk of PGE being assigned a non-investment
15 grade debt rating by the credit-rating agencies. The situation during the early
16 months after Enron's bankruptcy was "touch and go." PGE filed emergency
17 financing applications with the PUC to maintain needed liquidity. Further,
18 PGE's cost of debt increased because of its ties with Enron. If there were
19 "perfect" ring-fencing measures, those events in all likelihood would not have
20 occurred. In addition, PGE had to unilaterally provide additional ring-fencing

¹⁸ The Payout Ratio is the ratio of dividends to earnings. That is, if a company earns \$100 and pays out \$60 in dividends, the Payour Ratio would be 60% (i.e., 60 divided by 100).

1 measures as recommended by Standard & Poor's rating agency, indicating that
2 Staff's measures, by themselves, were not sufficient.

3 Perfect ring-fencing measures may not be available that would provide the
4 same protections as if PGE were a stand-alone company. However, if the
5 holding company incurred no additional debt, had no affiliated relationships
6 with PGE and did not enter into any other business activity, PGE might be
7 expected to be influenced very marginally by the holding company.

8

9 **SECTION IV: TPG'S DUE DILIGENCE AND FINANCIAL ANALYSIS**

10 **DUE DILIGENCE**

11 **Q. WHAT WAS THE SCOPE OF THE DUE DILIGENCE¹⁹ UNDERTAKEN BY**
12 **TPG?**

13 A. TPG undertook a process that extended over one year to examine the
14 performance of PGE. [CONFIDENTIAL/]

15 [REDACTED]

16 [REDACTED]

17 [REDACTED]

18 [REDACTED]

19 [REDACTED] [CONFIDENTIAL]

20 Representatives of PGE and Enron appear to have spent considerable
21 time working with TPG and its advisors. The financial analysis that was

1 conducted and reviewed by Staff was based in part on PGE's financial
2 forecasts and the information provided in Enron's Plan of Reorganization. TPG
3 was able to meet with PGE officials and inspect portions of PGE's assets.

4 **Q. WHAT WERE THE OVERALL FOCAL POINTS INCLUDED IN THE DUE**
5 **DILIGENCE?**

6 A. According to the documents that I reviewed, TPG undertook an overall
7 assessment of the operational performance of PGE and produced documents
8 indicating a well-developed (peer) benchmarking analysis. **[CONFIDENTIAL]**

9 [REDACTED]
10 [REDACTED]
11 [REDACTED]
12 [REDACTED]
13 [REDACTED]
14 [REDACTED]
15 [REDACTED]
16 [REDACTED]
17 [REDACTED]
18 [REDACTED] **[/CONFIDENTIAL]**

19 The liabilities issue, as I have discussed, continues to provide many areas
20 of uncertainty. Many of the quantifications, i.e., valuations, of the liabilities and
21 the final disposition and accounting treatment expectations were unavailable to

¹⁹ Due Diligence refers to the investigation undertaken by a potential purchaser to provide sufficient information to make a decision whether to pursue a transaction and at what price and terms.

1 Staff. Although they will be discussed in general, the ultimate impact is
2 unknown.

3 **FINANCIAL MODEL AND ASSUMPTIONS**

4 **Q. DID YOU REVIEW THE FINANCIAL MODELS AND THEIR ASSUMPTIONS**
5 **AND DO THEY APPEAR REASONABLE?**

6 A. Yes. I reviewed generally the models to determine if the overall assumptions
7 appeared supportable. The starting point for the models was based on Enron's
8 Plan of Reorganization, which provided financial forecasts of PGE's operational
9 results. TPG then made assumptions and adjustments that comported with the
10 results of their due diligence. I was favorably impressed with TPG's financial
11 modeling.

12 During the course of their due diligence, TPG was able to make certain
13 financial estimates for use in developing its offering price. These estimates
14 were initially based on input from PGE's management and financial staff. Over
15 a period of months, TPG and its consultants developed a final set of estimates.
16 The primary purpose of the modeling was to allow TPG to determine a value
17 for PGE. The model output appears reasonable and includes a range of
18 assumptions that appear to encompass likely outcomes.

19 In Staff's assessment, the myriad of models that TPG developed to "stress
20 test" the potential performance of PGE, and the residual impact on the finances
21 at OEUC, indicate a high level of sophistication. The model and the runs that

1 were created appear to be high-quality and detailed and the model instills
2 confidence in the overall results.²⁰

3 Staff also requested a few specific model runs with assumptions designed
4 to gauge the impact of poor operating performance by PGE. These model runs
5 assumed that the "earnings before interest and taxes" (EBIT) decreased at
6 rates of 10 percent, 20 percent and 30 percent. Overall, there are no
7 significant weaknesses in the financing structure, although the runs did show
8 that continued operations with EBIT 20 percent to 30 percent lower than
9 "normalized" would increase the pressures faced by both PGE and OEUC.
10 (*See Confidential Staff/202, Morgan/166-168.*)

11 MODEL ASSUMPTIONS

12 **Q. WHAT BASIC UNDERLYING ASSUMPTIONS ARE USED IN THE** 13 **FINANCIAL MODEL?**

14 A. There were 48 individual scenarios (model runs) that were developed by TPG
15 to analyze the robustness of PGE's potential returns. There were several
16 areas of specific cost savings that were considered in the due diligence and
17 were included in varying ways throughout the model runs. These potential cost
18 saving are discussed in more detail in the testimony of Staff Witness Ed
19 Durrenberger. (*See generally Staff/300.*)
20
21

²⁰ The model generally appears to follow the initial framework provided by NW Natural Gas, although the overall development is more complex and appears to be superior.

1 [REDACTED]
2 [REDACTED]
3 [REDACTED]
4 [REDACTED]
5 [REDACTED]
6 [REDACTED]
7 [REDACTED]
8 [REDACTED]
9 [REDACTED]
10 [REDACTED]
11 [REDACTED]

12 **[/CONFIDENTIAL]**

13 **FINANCING COSTS AND TERMS**

14 Other sensitive inputs include the financing costs for the debt that will be
15 used in the acquisition of PGE's stock. TPG has provided the overall mix
16 between invested equity and borrowed debt. It is not known if the capitalization
17 will remain constant at OEUC or to what extent there is flexibility. I will
18 describe the capitalization features in more detail later in my testimony.

19 The actual terms of the debt have not been finalized and it is not known
20 which banks will take part in the loan syndication process, including the extent
21 of public- versus privately-issued debt. One of the presumptions of the deal is
22 that interest rates remain stable for the interim and that the variable interest-
23 rate on such debt may remain relatively low during the holding period of the

1 investment. In my testimony, I will discuss the potential impact of higher
2 interest rates.

3 **PGE'S FINANCIAL PERFORMANCE**

4 **Q. HOW CAN YOU DESCRIBE PGE'S RECENT PERFORMANCE AND ITS**
5 **OUTLOOK?**

6 A. Yes. Even though very recent historic returns have been somewhat
7 disappointing, the company has maintained a strong overall performance that
8 can be expected to rebound. Enron's demise has had some impact on the
9 financial strength of PGE, though PGE has been able to retain sufficient
10 strength. Still, TPG has shown how it could to capitalize on the performance of
11 PGE, including focusing on cost-saving measures to bolster the Company's
12 performance. These savings can be expected to eventually pass through to
13 customers, although the timing would not be certain and could be over several
14 years. This would occur either through subsequent rate cases or, preferably
15 another mechanism that would allow any cost savings to be passed through in
16 a more timely fashion.

17

1 trading activities.²⁴ The SEC denied Enron's request for an exemption under
2 the Act.

3 According to a February 13, 2002 report by by Isaac C. Hunt, Jr., a
4 Commissioner of the U.S. SEC,

5 "For more than sixty years, the SEC has held that as long as the
6 holding company and its utility subsidiaries are all incorporated in the
7 same state and the utility operations are conducted primarily in that
8 state, the holding company is entitled to an exemption. The SEC does
9 not look to where the holding company's non-utility subsidiaries are
10 incorporated or where the non-utility subsidiaries operate."²⁵

11 The manner in which the Commission has administered the
12 intrastate exemption is consistent with its purpose. One of the
13 overriding concerns of PUHCA is to give federal regulators jurisdiction
14 over multistate public utility holding companies that no single state can
15 effectively regulate. In particular, PUHCA is meant to ensure that if a
16 state does not have jurisdiction over both the holding company and the
17 utility that does business in its state — a situation that will occur if the
18 holding company is incorporated in a state different than that in which
19 the utility subsidiary is incorporated — a federal regulator with access
20 to all the holding company's books and records can step in to monitor
21 and police affiliate transactions. In general, the Commission has
22 concluded that, where the holding company and all of its utility
23 subsidiaries are incorporated in the same state, this concern does not
24 arise, and an exemption from PUHCA is warranted. Indeed, Oregon's
25 experience with Enron as an exempt company, at least anecdotally,
26 confirms this — the Chairman of the Oregon Public Utility Commission
27 recently testified that Oregon ratepayers were not harmed by Enron's

²⁴Public Utility Holding Company Act of 1935, Rel. No. 27782 / December 29, 2003 at <http://sec.gov/litigation/opinions/35-27782.htm>

²⁵ See, e.g., In the Matter of Southeastern Indiana Corp., 2 S.E.C. 156 (1937)("[S]uch non-public utility . . . activities of the applicant do not deprive it of its intrastate character so far as the public utility aspect of its business is concerned . . .").

1 collapse and that "this utility [Portland General] is able to function just
2 as well as it did before."²⁶

3
4 PGE is engaged in the generation, purchase, transmission and distribution
5 and retail sale of electricity in Oregon. It also sells wholesale electric energy to
6 utilities, brokers and power marketers throughout the western U.S.²⁷

7 Because the SEC recently decided that PGE's west coast trading activities
8 were of such magnitude that the Company was not "intrastate in nature", the
9 SEC revoked Enron's exemption. [CONFIDENTIAL/

10 [REDACTED]

11 [REDACTED] [CONFIDENTIAL] (See Staff/202, Morgan/590-592.)

12 TPG is now seeking assurance that OEUC will be entitled to an exemption
13 under Section 3(a)(1) upon the transfer of the trading operations to "one or
14 more" subsidiaries after closing. (See Staff/202, Morgan/426-442.) Enron
15 agreed that acquiring this exemption would be a condition to closing. TPG has

²⁶ See Tom Detzel, "Senators Mull Enron, PGE Link," The Oregonian (Feb. 7, 2002) (quoting Roy Hemmingway, Chairman, Oregon Public Utility Commission).

²⁷ Portland General's wholesale electricity sales activity falls into two categories: power procurement related activities (which Enron refers to as its "retail book") and power trading activities (which it refers to as its "non-retail trading book"). Portland General engages in the wholesale activities reflected in its retail book because its owned generation is not sufficient to satisfy the load requirements imposed by Oregon law. To meet these load requirements, Portland General acquires power in wholesale transactions in addition to relying on its owned generating sources. Portland General purchases blocks of power and sells excess power at wholesale in order to manage the cost and volume of the power it purchases to serve retail customers. Wholesale sales generate gross revenue, and net revenue from these sales is sometimes positive and sometimes negative. For its non-retail trading book, Portland General trades or brokers electric power in the wholesale market. This activity, which attempts to take advantage of price differentials in back-to-back purchases and sales, is essentially brokerage activity. Trades are settled financially and seldom result in the transfer of power. See <http://sec.gov/litigation/opinions/35-27782.htm>

1 transaction might be threatened and that this issue would be a condition to
2 closing; without which the deal would terminate.

3 **Q. PLEASE PROVIDE ADDITIONAL DETAILS REGARDING THE PUHCA**
4 **EXEMPTION.**

5 A. **[CONFIDENTIAL]** [REDACTED]
6 [REDACTED]
7 [REDACTED]
8 [REDACTED]
9 [REDACTED]
10 [REDACTED]

11 **[/CONFIDENTIAL]**

12 **Q. DO YOU HAVE CONCERNS ABOUT THE REORGANIZATION OF THE**
13 **TRADING FLOOR?**

14 A. Yes. To date, TPG has not provided a detailed plan regarding the
15 reorganization of PGE's trading floor and the potential impact of removing
16 those activities from PGE. It is not clearly understood what methods will be
17 used to account for costs and conceivably be used to properly allocate costs
18 among the entities.

19 This plan should be addressed in this docket if it is material to OEUC's
20 operational plans for PGE. It is not clear the degree to which this matter has
21 any bearing on the final outcome of the transaction. A letter addressed to the
22 SEC in support of the exemption state that the Commission Staff believed the
23 state was receptive to such a plan. (See *Confidential* Staff/202, Morgan/197-

1 224.) Perhaps OEUC is confusing the Staff's overall general support for a
2 PUHCA exemption for PGE with support for OEUC/TPG's specific plan for
3 obtaining an exemption from PUHCA. In any event, if the exemption impacts
4 this transaction in any way, either through conditions OEUC would agree to or
5 otherwise, Staff recommends the Applicants address the trading floor spin off
6 in this docket.

7 **Q. DO YOU HAVE RECOMMENDATIONS REGARDING THE SEC**
8 **EXEMPTIONS?**

9 Yes. I have two recommendations for OEUC/TPG. Together, these may
10 assist Staff in its determination of the appropriateness of this issue.

11 1. In order to properly analyze the issues surrounding necessary SEC
12 approvals for an exemption of the power trading activities, it is recommended
13 that OEUC and PGE provide complete details surrounding its current trading
14 activities. This information would assist Staff's initial review of the practices
15 currently used and would provide the benchmark for any changes thereto.

16 2. An additional concern is that the SEC may tacitly expect the Commission
17 to provide additional screening of the intra-company activities. An exemption
18 would free PGE from rigorous financial regulation by the SEC. However, the
19 additional oversight from the SEC may provide significant benefits to
20 customers, including increased transparency. Were an exemption to be
21 granted, Staff would need to work with the Company and interested parties to
22 develop a process that would ensure adequate transparency of activities,
23 including appropriate public disclosures. Because of the uncertainties

1 regarding any potential reorganization, TPG should develop that plan in
2 conjunction with this docket or it may risk additional delay.

3 **Q. WHAT WOULD HAPPEN IF OEUC IS NOT GRANTED AN EXEMPTION**
4 **FOR THE TRADING FLOOR REORGANIZATION OR TPG IS NOT**
5 **GRANTED A “NO ACTION LETTER”?**

6 A. The level of consolidated equity in the capitalization would be below 30%, the
7 general limit imposed by the SEC. Even though the SEC has apparently
8 permitted some variations as long as the capital structure would come into
9 compliance in a reasonable timeframe, without a firm agreement, the overall
10 financing plan may come into question. The pledging of PGE’s stock as
11 collateral to support OEUC’s debt may also create conflict with the SEC.
12 Additionally, the SEC would have oversight over the long-term debt issuances
13 of PGE.

14 Ultimately, Staff is unsure of the outcome if PGE is not granted an
15 exemption from PUHCA. However, it does appear that the “no action” letter is
16 a contingency and therefore the transaction would not close without the SEC
17 granting a no action letter. These are on-going issues that I believe are best
18 addressed sooner rather than later and I urge OEUC to address these issues
19 in its rebuttal testimony.

20

21 **SECTION VI: ADDITIONAL RISKS OF OEUC’S ACQUISITION OF PGE**

22 **Q. WHAT OTHER RISKS HAVE YOU BEEN ABLE TO IDENTIFY?**

1 A. Through the course of Staff’s review, we have identified several risks. The
2 following lists concerns, most of which have not been previously identified and
3 others for which I am providing a synopsis.

4 Staff may be able to work with OEUC to develop additional conditions that
5 could alleviate some of these risks. While some of the risks addressed above
6 may have been directly quantifiable, other risks may not be quantifiable.

7 [CONFIDENTIAL/ [REDACTED]
8 [REDACTED]
9 [REDACTED]

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11 [REDACTED]
12 [REDACTED]
13 [REDACTED]
14 [REDACTED]
15 [REDACTED]
16 [REDACTED]
17 [REDACTED]
18 [REDACTED]

19 2. [REDACTED]
20 [REDACTED]
21 [REDACTED]
22 [REDACTED]
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[REDACTED]

[REDACTED] [CONFIDENTIAL]

3. Culture - A problem may be that the culture of a private equity firm can be expected to be significantly different than that of a conventional public utility. Therefore, there is a possibility that TPG's influence over decision-making may create some problems. Highly leveraged, private buyouts of regulated public utilities have historically been very rare. The recent popularity of such transactions may not play out well due to the lack of strategic fit of public utilities within the portfolio firms of private equity funds.

4. Organizational Structure

a. Taxes - Portland General, Enron and other affiliates have filed consolidated tax returns and utilized tax-sharing arrangements that are commonly utilized by affiliated corporations that file consolidated tax returns. OEUC expects, upon its acquisition of PGE, to maintain consolidated filings for tax purposes.²⁹

²⁹ <http://sec.gov/rules/other/35-27809.pdf>; March 31, 2004 10-K. Section J. Tax Allocation Agreements

"Enron has entered into agreements with Portland General...for the payment and allocation of tax liabilities on a consolidated group basis. These agreements generally require the subsidiaries to pay their separate return tax to Enron. In consolidation, Enron offsets the subsidiaries' income with the losses, tax credits and other tax-reducing attributes of Enron and other group companies and pays the resulting lower tax liability amount to the Internal Revenue Service or other taxing authority. Under the agreements, Enron group companies, including Enron, which contributed tax benefits, such as losses or credits, to the consolidated return are paid their proportionate share of the tax reduction resulting from the use of such benefits in the consolidated tax return filing. page... Further, it is contemplated that the existing tax allocation agreement with Portland General may be amended to provide that Enron would pay Portland General for certain Oregon state tax credits generated by Portland General but not used on the

1 b. Conversion of the LLC – One potential uncertainty that Staff
2 continues to explore is the matter of a potential business conversion
3 between PGE and OEUC. Although there has been no information
4 that would indicate that TPG may plan for such an occurrence, the
5 potential may create issues that have not been addressed.

6 c. Due to the private equity nature of the underlying funds that are
7 providing equity to this transaction, it is unclear the ease or speed
8 that additional equity could be accessed, were it necessary.

9 5. Access to information - TPG has indicated that the reason it does not
10 maintain a website is that it wishes to maintain secrecy surrounding the
11 core of its operations. For this reason, along with the lack of formal filing
12 requirements by the SEC, for instance, the ability for important information
13 to be made available to Staff or others is limited. This lack of transparency
14 may create a negative perception by other parties throughout OEUC's
15 investment horizon.

16 6. Additionally, Staff is concerned about some limitations that have been
17 placed on information provided to Staff in this docket. There have been
18 confusions over redactions and other information that has been limited to
19 either Staff or to other parties involved in the case. Utilities regulated by the
20 Commission should be prepared for a high degree of transparency.

consolidated Oregon tax return. Enron and Portland General also seek authorization to amend the Portland General tax allocation agreement accordingly."

- 1 7. Uncertainty and Stable Ownership - Because PGE has been for sale for
2 the past the few years, there has been a lot of uncertainty surrounding it.
3 The exact impact on employee morale is unclear. Based on the turnout of
4 PGE personnel at the UM 1121 Open Houses, it appears as if the
5 Company's employees generally favor this buyout. Notwithstanding any
6 immediate desire among PGE's employees to "get out from under the
7 overhang of Enron," this transaction would bring with it uncertainty as well.
8 TPG has expressly stated that it would likely not hold onto PGE for more
9 than a few years. The Company has existed for only about a decade, so
10 any analysis of the holding period for other companies would not be
11 meaningful. TPG may not hold onto PGE for more than three or four years.
12 Therefore, the eventual and ultimate disposition of PGE is not clear. The
13 nature of the investment fund would not likely create a very long-range
14 planning horizon for PGE.
- 15 8. Leverage – The risks associated with the use of leverage by OEUC has
16 already been detailed. One problem Staff has is analyzing the overall
17 transaction is because the company has not yet provided clear or exact
18 debt amortization or terms. Without precise details, the overall effect of the
19 leverage cannot be known.
- 20 9. Lack of Final Details – Financing – There has not been a firm commitment
21 yet from banks. TPG has only provided a “Highly Confident Letter.” Until
22 the final terms are available and detailed for consideration, it is unknown
23 what potential risks may materialize. TPG provided a response to a Data

1 Request in which an excess cash flow sweep is anticipated that would
2 require all available cash to be used to pay down the debt at the holding
3 company, until such time that a "key" credit, maximum leverage test is met³⁰
4 and OEUC is at least investment grade.³¹ (See Staff/202, Morgan/186-
5 187.) Such a clause coupled with a condition preventing re-leveraging at
6 OEUC would increase Staff's comfort with the leveraged transaction.

7 10. Credit Rating - PGE could and should be rated A as a stand-alone utility
8 and without the Enron overhang. According to most current 10-Q SEC
9 filing,³²

10 "PGE continues to serve its customers effectively and operate well.
11 Earnings in the first quarter of 2004, compared to the prior year, were more
12 typical of the Company's historical levels. It is expected that the effects of a
13 suppressed economy and recent years' financial reserves related to Enron's
14 bankruptcy and the 2000-2001 West Coast energy crisis will have less
15 impact on PGE's future earnings. PGE continues to maintain investment-
16 grade ratings on its secured debt, has adequate liquidity, and stable
17 operating cash flow."
18

19 The OEUC deal will effectively erode PGE's ability to regain its footing, at
20 least in the near term. (See TPG's presentation to Standard & Poor's,
21 Staff/202, Morgan/383-425.) Because of the pressures placed on PGE due to
22 Enron's bankruptcy and this deal, PGE's credit rating would reflect an increase
23 in financing costs. Port Westward is an example of how customers might be
24 impacted by higher financing costs.

³⁰ The credit metric is described generally, but it is not specific.

³¹ i.e., at least BBB- or Baa-, as reflected by Standard & Poor's and Moody's, respectively.

³² An excerpt of the 10Q is included in Exhibit Staff/202, Morgan/1-18. The full filing can be found at: <http://www.sec.gov/Archives/edgar/data/784977/000078497704000014/fm10q331.htm>

1 [CONFIDENTIAL] [REDACTED]
2 [REDACTED]
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5 [REDACTED]
6 [REDACTED]
7 [REDACTED]
8 [REDACTED]
9 [REDACTED]
10 [REDACTED]
11 [REDACTED]
12 [REDACTED] [/CONFIDENTIAL]

13 **Q. ARE THERE OTHER AREAS THAT WILL REQUIRE MORE DETAIL**
14 **PRIOR TO MAKING A FINAL RECOMMENDATION TO THE**
15 **COMMISSION?**

16 A. Yes. Other than the issues already identified, I will list several ongoing
17 concerns about which Staff has been awaiting more details. There is still a
18 good deal of overall uncertainty over the PGE transaction.

- 19 1. An Operating Agreement³³ that will govern OEUC has not yet been
20 completed. Without being provided the operational agreement that the
21 participants of the LLC would be required to follow, there are questions

³³ Limited Liability Companies are generally organized under an Operating Agreement that specifies the responsibilities of the parties and other important issues.

1 about the level of control that will be retained by TPG. The Consent Rights
2 appear to provide an overwhelming level of control at TPG. Because of the
3 level of sophistication that exists at TPG, there is little reason that this
4 feature would undermine the performance of PGE. However, until we are
5 given more concrete information on the contractual structure, it is
6 impossible to address potential problems. An ultimate agreement on the
7 "No-Action Letter" issue that is pending before the SEC may be required
8 prior to the final drafting of an Operating Agreement.

9 2. Final debt agreements with the banks with which TPG is working will be
10 necessary prior to any final Staff conclusion. Because the agreements will
11 provide valuable details regarding the structure of the debt financing for the
12 transaction, it is important to know what potential impacts may relate
13 directly to PGE and its stock, which will be the underlying collateral for the
14 loans. These agreements will also help to clarify the required debt
15 amortization at OEUC.

16 3. The LLC nature of the buyer, and its highly-leveraged financing from private
17 venture capital sources and investment banks, will increase the perception
18 of risk. This risk is due not only to the leverage, but also due to the lack of
19 transparency that OEUC would provide regarding future decisions.

20 Because OEUC is not expected to be required to be registered by the SEC,
21 limited public information will result. This increased risk should result in a
22 larger benefit to ratepayers than those offered by other potential PGE
23 acquirers, such as those proffered by Sierra Pacific and NW Natural.

- 1 4. The private nature of the Texas Pacific Group may limit the ability to attract
2 fresh financing. PGE, at present, has adequate liquidity and access to
3 capital. The initial debt financing at OEUC will be in the form of non-
4 investment grade capital. Its access to increased debt loads can be
5 expected to be poor, at best.
- 6 5. From a credit perspective, the experience of the TPG investors in the
7 regulated energy markets is not extensive. Since PGE will be going to
8 private owners without significant regulatory oversight, it may adversely
9 affect the company from a credit perspective. TPG does not appear to be a
10 particularly conservative venture firm. Any highly leveraged deal presents
11 significant downside risk, as compared to "normally-capitalized" public utility
12 companies.
- 13 6. Because PGE will be initially drained of any surplus capital due to the
14 dividend payout that is anticipated at closing, its access to the debt markets,
15 at that time, would be strained, notwithstanding the limits on PGE's equity
16 capitalization that may be expected at the consummation of this deal.

17 **Q. WHAT RECOMMENDATIONS DO YOU HAVE THAT ADDRESS YOUR**
18 **CONCERNS?**

19 A. OEUC should provide a formal copy of its Operating Agreement and final
20 financing agreements for Staff's review prior to filing its rebuttal testimony. In
21 addition, OEUC should agree to provide additional filings that would address
22 the absence of formal public filings. OEUC should also be prepared to make
23 the Affiliated Interest filings that would be required by the Commission.

1 philosophy. Simply, PGE is seen as a company that produces steady cash flows
2 and not one with high growth potential. As such, *some investment advisors say*
3 *that the new owners might want to sell their stake outright or to take the entity*
4 *public in the near term to maximize their returns."* (emphasis added)
5

6 The uncertainty surrounding the future state of PGE is difficult to address
7 at this time, as TPG has not indicated what strategy it may employ. The fund
8 prospectus indicates that TPG's investment horizon for any of its investments
9 is no greater than 12 years. Based on the excerpt above, a holding period of
10 five years or less cannot be ruled out. This represents an unknown for
11 customers due to the company's acquisition of PGE.
12

13 **SECTION VII: PROBABLE ALTERNATIVE IF THIS DEAL IS NOT CONSUMMATED**

14 **Q. WHAT DO YOU BELIEVE IS LIKELY TO HAPPEN SHOULD TPG'S** 15 **ACQUISITION OF PGE NOT CLOSE?**

16 A. Based on the testimony of Robert Bingham on behalf of Enron Corp, the most
17 likely scenario would be continued ownership by Enron with an eventual share
18 "spin-off", or distribution, to creditors.

19 **Q. ARE THERE POTENTIAL BENEFITS ASSUMING CONTINUED ENRON** 20 **OWNERSHIP?**

21 A. Yes. Customers would benefit because the conditions that were put into place
22 during Enron's purchase of PGE would remain in place. Specifically, Enron
23 agreed to no increases in either revenue requirement or cost of capital

1 because of its acquisition. Additionally, the gamut of conditions coupled with
2 adequate cash reserves appear to have adequately protected customers.

3 Considering PGE's stand-alone operating and financial strengths, it may be
4 expected to operate over the foreseeable future without problems, barring any
5 erosion to its current balance sheet. This is especially important in light of the
6 fact that, without paying the initial dividend to OEUC at the consummation of
7 the transaction, more than \$300 million would remain on PGE's balance sheet,
8 which provides needed liquidity.

9 **Q. WOULD THE BENEFITS REMAIN IF A STOCK SPIN-OFF OCCURRED?**

10 A. I believe so. According to Enron's witness, Robert Bingham, this scenario
11 would require Commission approval under ORS 757.480 and 757.511 because
12 a new issuance of shares would be required and there would be a change in
13 control of the company. (See Enron/Bingham/4 of 8.)

14 **Q. COULD THE STOCK STILL BE SOLD TO A THIRD PARTY?**

15 A. With the approval of the bankruptcy court, Enron could have the authority to
16 enter into an agreement to sell the PGE shares prior to the "effective date" set
17 by the court and subject to certain conditions and actions, etc. After the
18 Effective Date, the shares could be sold upon a vote of PGE's shareholders,
19 that would be the creditors to whom the shares were distributed and the
20 Overseer, to the extent that all shares have not been fully divested. This
21 transaction too would require Commission approval under ORS 757.511 and
22 would be expected to benefit customers.

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CONCLUSIONS

Q. WHAT IS YOUR OVERALL CONCLUSION?

A. I recommend TPG continue to address the issues identified in this testimony.

The details of the transaction and financing should be developed further.

However, based on the quality of TPG's due diligence, it is likely that this transaction could be structured in a way that—with appropriate conditions—could protect ratepayers and provide investment returns to TPG.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes.

1 **Q. PLEASE STATE YOUR NAME, OCCUPATION, AND BUSINESS**
2 **ADDRESS.**

3 A. My name is James E. (Ed) Durrenberger. My business address is 550 Capitol
4 Street NE, Suite 215, Salem, Oregon 97301-2551. I am employed by the
5 Public Utility Commission of Oregon (OPUC) as a Senior Revenue
6 Requirement Analyst in the Revenue Requirement Section in the Utility
7 Program.

8 **Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND WORK**
9 **EXPERIENCE.**

10 A. My Witness Qualification Statement is found in Exhibit Staff/301,
11 Durrenberger/1.

12 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

13 A. The purpose of my testimony is to summarize the results of my investigation
14 into cost saving measures that have been proposed for Portland General
15 Electric (PGE) by the applicant Oregon Electric Utility Company (OEUC) and
16 by its major investor Texas Pacific Group (TPG). I will comment on the
17 implications these proposals can have on service quality and the long-term
18 viability of the utility.

19 I will also examine the treatment of acquisition adjustments and goodwill and
20 transaction costs resulting from the proposed transaction.

21 **Q. DID YOU PREPARE AN EXHIBIT FOR THIS DOCKET?**

22 A. Yes. I prepared Exhibit Staff/301, Durrenberger, which contains my Witness
23 Qualification Statement consisting of one page. I have also included Exhibit

1 Staff/302, containing responses to Staff and ICNU Data requests and other
2 supporting documents, which consists of 241 pages.

3 **Q. HOW IS YOUR TESTIMONY ORGANIZED?**

4 A. My testimony is organized as follows:

5 Issue 1: Cost Saving Measures proposed by OEUC in its application;

6 and

7 Issue 2: Treatment of Acquisition Adjustment and Transaction Costs.

8

9

10 **Issue 1: Cost Saving Measures:**

11 **Q. WHAT COST SAVING ANALYSIS DOES OEUC HAVE?**

12 A. OEUC has a number of reports that evaluate PGE's operation, physical assets
13 and financial health and include detailed cost savings proposals.

14 **Q. WHERE DO THE COST SAVINGS PROPOSALS COME FROM?**

15 A. The cost savings proposals are detailed in a series of reports produced by
16 industry experts hired by TPG as part of the due diligence investigation into
17 PGE. These reports are marked confidential and were provided in response to
18 Staff's data requests to OEUC.

19 **Q. HOW MUCH IS PROJECTED TO BE SAVED?**

20 A. In rough numbers, the reports identified a range [CONFIDENTIAL/]

21 [REDACTED]

22 [REDACTED]

23 [REDACTED]

1 [REDACTED]

2 [REDACTED]

3 [REDACTED]

4 [REDACTED]

5 [REDACTED]

6 [REDACTED] [/CONFIDENTIAL].

7 **Q. WHY ARE THESE REPORTS IMPORTANT?**

8 A. OEUC has made a specific operational commitment to maintain PGE's
9 customer service record at a level that exceeds national and regional averages
10 (See Oregon Electric/Application/Page 20 of 26 lines 21-24) yet

11 [CONFIDENTIAL/] [REDACTED]

12 [REDACTED]

13 [CONFIDENTIAL].

14 Additionally, OEUC has offered reinvestment in the business as a significant
15 tangible benefit of the sale for PGE's customers (See Oregon
16 Electric/Application/Page 24 of 26 lines 20-23) yet [CONFIDENTIAL/]

17 [REDACTED] [/CONFIDENTIAL].

18 [CONFIDENTIAL/] [REDACTED] [/CONFIDENTIAL]

19 could adversely affect the basic utility infrastructure and long-term reliability of
20 the generation and distribution assets,

21 **Q. CAN YOU ELABORATE ON THESE POINTS?**

22 A. The reports contained detail that included:

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[CONFIDENTIAL]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

iii. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[CONFIDENTIAL] (See Response to Staff Data Request 73
attached as Staff/302, page 238).

[CONFIDENTIAL]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

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4 [REDACTED]
5 [REDACTED]
6 [REDACTED]
7 [REDACTED]

8 [REDACTED]
9 [REDACTED]

10 2. [REDACTED]
11 [REDACTED] **[/CONFIDENTIAL]**.

12 **Q. WHO GENERATED THE REPORTS YOU REVIEWED?**

13 A. The cost savings reports were generated by a variety of consultants hired by
14 TPG. Each consultant had a different area of expertise and knowledge and
15 examined a different area of PGE's current operation. **[CONFIDENTIAL]** [REDACTED]

16 [REDACTED]
17 [REDACTED]

18 **[/CONFIDENTIAL]** and there is no reason for Staff to doubt the credibility of the
19 industry expert's findings. A list of the advisors and their general area of
20 expertise is included below:

- 21 Boston Consulting Group – General Consultants
- 22 Jack Fusco – Corporate Advisor
- 23 Tom Bullis – Transmission and Distribution Advisor

1 completed. [CONFIDENTIAL] [REDACTED]

2 [REDACTED]
3 [REDACTED] [/CONFIDENTIAL] those savings will benefit the new owners and
4 not the customers, in the absence of a general rate case. As previously stated,
5 these benefits have been forecasted to range from [CONFIDENTIAL] [REDACTED]

6 [REDACTED] [/CONFIDENTIAL].

7 **Q. WILL THE SERVICE QUALITY MEASURES (SQM), IMPLEMENTED AS A**
8 **CONDITION OF THIS ACQUISITION, ASSURE SERVICE AND RELIABILITY**
9 **FOR CUSTOMERS?**

10 A. Although the package of SQMs proposed by Staff as a part of this transaction
11 are excellent and set a high standard for customer service, it is by no means
12 comprehensive enough to cover everything PGE does to service its customers
13 and maintain its standing as a good local and regional corporate citizen. PGE
14 has historically been involved in a variety of civic and charitable endeavors in
15 the region and sponsors its employees in community volunteer programs.
16 Customers are accustomed to services from their utility that surpasses the SQM
17 performance metrics. If service quality were to slip to mid-quartile levels, as
18 measured by the SQM, [CONFIDENTIAL] [REDACTED]
19 [REDACTED] [/CONFIDENTIAL] customers would not be satisfied. Nor is it Staff's
20 intention to allow service quality to decrease as a result of this acquisition.

21 **Q. IS THE LEVEL OF CAPITAL SPENDING IMPORTANT TO THE LONG-TERM**
22 **VIABILITY OF PGE?**

1 customers would not benefit until a general rate case was filed where the cost
2 reductions could be incorporated into the rate base.

3 **Q. DO YOU EXPECT, UNDER OEUC'S PROPOSAL, CUSTOMERS WILL BE**
4 **SUBJECT TO GREATER RISKS TO SERVICE QUALITY AND RELIABILITY?**

5 A. Yes. Although OEUC does not report savings as a result of this acquisition, its
6 investigation into PGE has indicated that OEUC can [CONFIDENTIAL/]
7 [] [CONFIDENTIAL] two areas
8 that increase risks to ratepayers in service quality and long-term reliability.

9 **Q. PLEASE SUMMARIZE YOUR OBSERVATIONS ON THE ISSUE OF OEUC'S**
10 **COST SAVING PROPOSAL.**

11 A. OEUC's proposal presents little or no benefit to customers through a cost
12 savings and increases the potential for significant risk in service quality and
13 long-term reliability.

14 In-so-far as:

- 15 • Consultants performing due diligence reports have identified cost
16 savings.
- 17 • Shareholders would benefit to the detriment of customers if the
18 acquisition takes place and imprudent cost-cutting measures are
19 adopted.
- 20 • Reducing [CONFIDENTIAL/]
21 [] represents new risks to the customers as a result of
22 the acquisition.

1

2 **Issue 2: Acquisition Adjustment, Goodwill and Transaction Costs:**3 **Q. WHAT IS AN ACQUISITION ADJUSTMENT?**

4 A. An acquisition adjustment is an accounting adjustment made into the books of
5 an acquired company to account for the difference between (1) the cost of
6 electric plant acquired as an operating unit or system by purchase, merger,
7 consolidation, liquidation, or otherwise, and (2) the original cost, estimated, if
8 not known, of such property, less the amount or amounts credited by the
9 accounting utility at the time of acquisition to accumulated provisions for
10 depreciation and amortization and contributions in aid of construction with
11 respect to such property (See Code of Federal Regulations excerpt attached
12 as Staff/302 pages 239-240). Simply stated, an acquisition adjustment is
13 accounting for the difference between the purchase price and the net book
14 value (or fair market value) of the assets being acquired.

15 **Q. WHAT IS GOODWILL?**

16 A. Goodwill typically represents a premium value represented in the purchase
17 price for a company over the "Net Book Value " of the company's assets. The
18 premium is an intangible asset that represents the acquired company's ability
19 to generate additional profits or value that cannot be assigned to a tangible
20 asset (See Fourth District Conditions attached as Staff/302 page 241).

21 **Q. IS AN ACQUISITION ADJUSTMENT THE SAME AS GOODWILL?**

22 A. Typically, these terms can be used interchangeably and are frequently used in
23 this manner. However, specifically the term "acquisition adjustment"

1 represents the actual accounting adjustment that takes place where "goodwill"
2 typically represents the premium value above the book value or fair market
3 value of the assets being acquired. This premium value, or "goodwill" can be
4 represented by such things as: employee talents, growth opportunities, value of
5 customer base or other intangibles that would not appear on the balance sheet.
6 The "acquisition adjustment" is the recording of the goodwill that takes place on
7 the books.

8 **Q. IS IT OEUC's INTENTION TO BOOK GOODWILL IN PGE's FINANCIAL**
9 **STATEMENTS?**

10 A. In OEUC's response to Staff's Data Request OEUC 28; Oregon Electric states:
11 "...customers will not pay for any goodwill [acquisition adjustment] created by
12 this transaction" (See Response to Staff Data Request 28 attached as
13 Staff/302, page 230). However, in a response provided to ICNU's Data
14 Request OEUC 3.9, (See Response to ICNU Data Request 3.9 attached as
15 Staff/302, page 231) the applicants state that Oregon Electric does not *intend*
16 (emphasis added) to adjust PGE's financial statements to reflect the acquisition
17 unless PGE is subject to certain Security and Exchange Commission (SEC)
18 reporting requirements.

19 **Q. WOULD REQUIREMENTS IMPOSED BY SEC IMPACT THE REGULATORY**
20 **ACCOUNTING REQUIRED BY CODE OF FEDERAL REGULATIONS (CFR)?**

21 A. No. SEC requirements would not be reflected in the regulatory accounts but
22 would be accounted for separately following Generally Accepted Accounting
23 Principles (GAAP). In other words, a separate accounting system exists to

1 conform with regulations imposed by SEC. These transactions are kept
2 separate from the regulatory accounting system that exists for ratemaking
3 purposes. Therefore, requirements imposed by SEC would not be reflected in
4 the books for regulatory accounting and would not be included in rate recovery
5 during a rate proceeding.

6 **Q. WHAT IS THE PROPER METHODOLOGY REQUIRED BY THE FEDERAL**
7 **RULES TO ACCOUNT FOR AN ACQUISITION ADJUSTMENT?**

8 A. According to 18 CFR § 46.6 Subchapter C Part 101, Electric Plant Instructions
9 (5): electric plant acquisition adjustments require the following accounting
10 procedures (See Code of Federal Regulations excerpt attached as Staff/302
11 page 240):

- 12 1. The original cost of plant, estimated if not known, shall be credited to
13 Account 102, Electric Plant Purchased or Sold, and concurrently
14 charged to the appropriate electric plant in service accounts and to
15 Account 104, Electric Plant Leased to Others, Account 105, Electric
16 Plant Held for Future Use, and Account 107, Construction Work in
17 Progress—Electric, as appropriate.
- 18 2. The depreciation and amortization applicable to the original cost of the
19 properties purchased shall be charged to Account 102, Electric Plant
20 Purchased or Sold, and concurrently credited to the appropriate
21 account for accumulated provision for depreciation or amortization.
- 22 3. The cost to the utility of any property includible in Account 121,
23 Nonutility Property, shall be transferred thereto.

1 4. The amount remaining in Account 102, Electric Plant Purchased or
2 Sold, shall then be closed to Account 114, Electric Plant Acquisition
3 Adjustments.

4 **Q. DO YOU BELIEVE PGE SHOULD BE ALLOWED TO RECOVER GOODWILL**
5 **OR AN ACQUISITION ADJUSTMENT IN A FUTURE RATE CASE**
6 **PROCEEDING?**

7 No. Past Commission practice has been to exclude any goodwill that results
8 from system mergers or acquisitions from rate recovery. I recommend that (a)
9 if OEUC is required to record an acquisition adjustment in PGE's regulatory
10 accounts, that it be accounted for in a manner that clearly isolates the values
11 from the original cost of the assets and, (b) any premium attributable to the
12 purchase or acquisition not be included by PGE into any request for rate
13 recovery, earnings review or results of operation. That is, the acquisition
14 adjustment should be clearly separable from the original cost values
15 attributable to PGE's regulatory assets, and any goodwill or acquisition
16 adjustment resulting from this proceeding be excluded from future rate
17 recovery.

18 **Q. WHAT ARE TRANSACTION COSTS?**

19 A. Transaction costs are the fees and costs associated with a purchase or
20 acquisition, such as loan fees, appraisal fees, escrow fees, banking fees, etc.
21 OEUC estimates its transaction costs for the purchase of PGE to be
22 approximately **[CONFIDENTIAL]** [REDACTED]

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[REDACTED]

[/CONFIDENTIAL].

Q. WHO DOES OREGON ELECTRIC PROPOSE SHOULD BEAR THE BURDEN OF TRANSACTION COSTS IN THIS PROCEEDING?

A. In Oregon Electric's application (See Oregon Electric/Exhibit 3, Davis/ Page 20 of 22, lines 6-8) Kelvin L. Davis states, "Neither PGE nor its customers will bear the costs of the acquisition..." He further testifies that acquisition costs "...will be funded by the members of Oregon Electric and excluded from PGE's utility accounts." This is the correct treatment for the transaction costs and I concur with this proposal.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes.

1 **Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS, AND**
2 **OCCUPATION.**

3 A. My name is Rebecca T. Hathhorn. My business address is 550 Capitol Street
4 NE Suite 215, Salem, Oregon 97301-2551. I am employed by the Public Utility
5 Commission of Oregon (OPUC) as a Program Manager of the Corporate
6 Analysis and Water Regulation Section in the Economic Research and
7 Financial Analysis Division.

8 **Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND WORK**
9 **EXPERIENCE.**

10 A. My Witness Qualification Statement is found in Exhibit Staff /401.

11 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

12 A. The purpose of my testimony is to address affiliated interest issues related to
13 Oregon Electric Utility Company's (OEUC) proposed acquisition of Portland
14 General Electric (PGE). In addition, I will discuss the importance of a master
15 service agreement and Staff's proposed conditions related to affiliated
16 interests.

17 **Q. DID YOU PREPARE AN EXHIBIT FOR THIS DOCKET?**

18 A. Yes. In addition to my witness qualification exhibit, I prepared Exhibit Staff/402
19 Hathhorn/1.

20 **Q. HOW IS YOUR TESTIMONY ORGANIZED?**

21 A. My testimony is organized as follows:
22 • Issue 1 – Affiliated Interests
23 • Issue 2 – Master Service Agreement

- Issue 3 – Proposed Conditions

ISSUE 1 – AFFILIATED INTERESTS

Q. WHAT ARE YOUR MAIN CONCERNS REGARDING THE PROPOSED ACQUISITION?

A. OEUC, which is comprised of the Local Applicants, TPG Applicants (TPG), and Passive Investors, will have numerous affiliated interests if the application is approved. TPG will own 80 percent of the economic interest in OEUC and has hundreds of subsidiaries. Staff is concerned with: (1) the potential for cross subsidization by PGE customers of other OEUC affiliates; and, (2) fair and reasonable cost allocation methods to apportion costs, if any, between TPG and its affiliates, including PGE.

ISSUE 2 – MASTER SERVICES AGREEMENT

Q. WHAT ARE YOUR MAIN CONCERNS REGARDING A MASTER SERVICES AGREEMENT?

A. As of the writing of this testimony, OEUC has not yet submitted a proposed Master Services Agreement (MSA). Staff believes it is essential, from a risk basis, that an MSA be thoroughly reviewed prior to approval of the merger.

Q. WHY IS REVIEW OF A MSA ESSENTIAL IN EVALUATING RISK?

A. A MSA would detail the specific relationships and transfer pricing policies agreed upon between OEUC and PGE. Absent this agreement, PGE may be exposed to the risk of inappropriate cross subsidization of OEUC and any non-regulated affiliates and subsidiaries. Staff believes it is critical to review and approve a MSA prior to any approval of an acquisition. Even if OEUC has no

1 other subsidiaries other than PGE, customers should be assured of a fair and
2 reasonable allocation of costs between PGE and OEUC.

3 **ISSUE 3 – PROPOSED CONDITIONS**

4 **Q. HAVE YOU DEVELOPED PROPOSED CONDITIONS TO ADDRESS**
5 **CONCERNS REGARDING AFFILIATED INTEREST ISSUES RELATED TO**
6 **THIS PROPOSED ACQUISITION?**

7 A. Yes. Staff has proposed conditions relating to this testimony (See Staff/402
8 Hathhorn/1).

9 **Q. DO THE STATED CONDITIONS ELIMINATE ALL RISKS ASSOCIATED**
10 **WITH AFFILIATED INTERESTS?**

11 A. No. Staff believes that in addition to the stated conditions, as noted above,
12 review of a MSA prior to conclusion of this docket is also critical to ensure fair
13 and reasonable cost allocations between PGE and OEUC.

14 **Q. HAVE THE PARTIES AGREED TO THE STATED CONDITIONS IN EXHIBIT**
15 **STAFF/402?**

16 A. No. OEUC is expected to provide revised wording to the stated conditions but
17 as of the writing of this testimony nothing has been submitted. In addition,
18 Staff will continue to explore additional conditions related to affiliated interests
19 based on OEUC's responses and other materials gathered in the course of this
20 investigation.

21 **Q. PLEASE SUMMARIZE CONDITION NUMBER ONE AND STATE WHY IT IS**
22 **IMPORTANT.**

1 A. Condition Number 1 (See Staff/402 Hathhorn/1) states that the Commission
2 has the right to audit the accounts of OEUC and any OEUC affiliates and
3 subsidiaries that are the basis for charges to PGE. It is important that the
4 Commission receive full cooperation from PGE and OEUC so that the
5 Commission can ensure that any allocation factors used, or direct charges, are
6 reasonable in assigning such costs to PGE.

7 In addition, ratepayers should be assured that they are not subsidizing any
8 non-regulated business ventures that OEUC may decide to develop or that are
9 currently in existence.

10 **Q. PLEASE SUMMARIZE CONDITION NUMBER TWO AND STATE WHY IT IS**
11 **IMPORTANT.**

12 A. Condition number two states PGE and OEUC must first receive Commission
13 authorization before any charges accrue to PGE. This condition helps assure
14 that OEUC and its affiliates are not subsidized by PGE.

15 **Q. PLEASE SUMMARIZE CONDITION NUMBER THREE AND STATE WHY IT**
16 **IS IMPORTANT.**

17 A. Condition number three states that PGE should maintain its own accounting
18 system and PGE and OEUC should maintain separate books which should be
19 kept in Portland, Oregon.

20 Ratepayers should be assured that they are not paying for an accounting
21 system that would be beneficial to OEUC rather than PGE ratepayers. In
22 addition, the separate accounting makes a clear distinction between the two
23 companies and provides an audit trail. Finally, maintaining the records of these

1 companies at their headquarters in Portland, Oregon will assist Staff in its
2 auditing efforts.

3 **Q. PLEASE SUMMARIZE CONDITION NUMBER FOUR AND STATE WHY IT IS**
4 **IMPORTANT.**

5 A. Condition number four states any new subsidiary, affiliate, or partnership
6 arrangement developed by PGE or OEUC must be reported to the Commission
7 within 30 days of its formation. In addition, for subsidiaries of PGE and OEUC,
8 the business plan and capitalization strategy should be provided.

9 The Commission needs to know of any businesses related to OEUC or
10 PGE in order to conduct meaningful audits. If the Commission does not know
11 about a particular business venture, it would be difficult to ascertain any
12 significant risk to ratepayers.

13 **Q. PLEASE SUMMARIZE CONDITION NUMBER FIVE AND STATE WHY IT IS**
14 **IMPORTANT.**

15 A. Condition number five states for any new product or service or change in terms
16 or conditions of an existing product or service, that is not related to energy
17 service under Chapter 757, offered by PGE or OEUC, should be reported to the
18 Commission within 30 days of its offering.

19 It is important to have knowledge of any business ventures that could
20 potentially impact PGE customers.

21 **Q. PLEASE SUMMARIZE CONDITION NUMBER SIX AND STATE WHY IT IS**
22 **IMPORTANT.**

1 A. Condition number six states the Commission must have access to all books
2 and records of any affiliates that pertain to transactions between PGE and all of
3 its affiliates.

4 The Commission is responsible for ensuring that proper charges are
5 allocated to PGE.

6 **Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?**

7 A. Yes.

1 **Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND POSITION.**

2 A. My name is Judy Johnson. My business address is 550 Capitol Street
3 NE, Suite 215, Salem, Oregon 97301-2551. I am the Program Manager
4 for Electric & Natural Gas Revenue Requirements in the Utility Program of
5 the Public Utility Commission of Oregon (OPUC). My qualifications are
6 shown in Exhibit Staff/501, Johnson/1.

7 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

8 A. I am responsible for covering the issue of state and federal corporate
9 income taxes.

10 **Q. WHAT ARE THE ISSUES SURROUNDING STATE AND FEDERAL**
11 **INCOME TAXES IN THIS DOCKET?**

12 A. The primary issue is whether the OPUC should continue to set rates
13 based on the assumption that PGE files its taxes on a stand-alone,
14 normalized basis.

15 **Q. PLEASE EXPLAIN.**

16 A. From 1997 to May 2001, Enron filed consolidated tax returns that included
17 PGE's income and expenses. During that period, PGE calculated its
18 federal and state income tax liability on its results of operations and
19 forwarded to Enron those amounts. From May 2001 through 2002, while
20 Enron was unconsolidated, PGE made its income tax payments directly to
21 the taxing authorities. Enron and PGE reconsolidated for filing income
22 taxes in December 2002.

23 When Enron filed on a consolidated basis, it owed little or no income

1 taxes because of losses in other areas of its operations. Several persons
2 have recently asserted that the money for taxes PGE paid to Enron should
3 be refunded to ratepayers if Enron did not use the money to pay taxes.
4 This docket allows parties to explore alternative methods for the
5 ratemaking treatment of federal and state taxes which could potentially
6 avoid the "Enron situation" if Oregon Electric Utility Company (OEUC)
7 were to purchase PGE.

8 **Q. DO OEUC AND ENRON HAVE SIMILAR STRUCTURES?**

9 A. No. Enron had multiple subsidiaries. At this point, OEUC is proposing
10 that its only subsidiary would be PGE. Absent conditions agreed to
11 otherwise, there is nothing to prevent OEUC from purchasing or creating
12 other subsidiaries.

13 **Q. WHAT HAS BEEN THE DIFFERENCE BETWEEN THE COMMISSION'S**
14 **PAST PRACTICE REGARDING HOW INCOME TAXES ARE**
15 **CALCULATED FOR SETTING RATES COMPARED TO HOW UTILITIES**
16 **CALCULATE INCOME TAXES FOR TAX RETURNS?**

17 A. There are two primary differences. For ratemaking purposes, the
18 Commission has set utilities' rates on a "stand-alone" basis, reflecting the
19 costs of the company's regulated operations. That is, in a rate
20 proceeding, a utility's rates would be set based on its own revenues, costs
21 and rate base for a given test year. Income taxes would be calculated
22 using the utility's net operating income. For tax returns, corporations
23 typically file on a "consolidated" basis, so that the tax liability is calculated

1 using the revenues and expenses of the parent company and all
2 subsidiaries, regulated and non-regulated.

3 The second difference is that the Oregon Commission has used the
4 "normalization" method for calculating tax expense for setting rates, while
5 the utilities have used the "flow-through" method for calculating their tax
6 return liability.

7 **Q. WHAT IS THE DIFFERENCE BETWEEN THE NORMALIZATION AND**
8 **FLOW-THROUGH METHODS WITH REGARDS TO TAX EXPENSE?**

9 A. Normalization or "deferred tax" accounting is the process of recognizing
10 timing differences when transactions affect taxable income for "book" and
11 "tax" purposes. The most common example is depreciation expense,
12 where book and financial reporting depreciation is typically lower in the
13 early years of an asset's life than the accelerated tax depreciation that the
14 IRS allows as a deduction for calculating "current" income tax expense.
15 All else equal, actual taxes paid will be lower in the earlier years for the
16 utility's tax return than is calculated for book purposes, which recognizes
17 an additional "deferred tax" (based on the difference each year between
18 book and accelerated depreciation). This timing difference turns around in
19 the later years of the asset's life so that the total tax deduction over the life
20 of the asset is the same. Meanwhile, the customers are compensated for
21 the time value difference for the additional tax they pay early, because
22 these amounts are recognized as "accumulated deferred taxes" that

1 reduce the utility's rate base and the return on investment included in
2 rates.

3 The flow-through method for calculating income tax expense records
4 and passes through all timing differences, such as, accelerated
5 depreciation, and underlying the tax expense actually paid (current tax).

6 **Q. WHAT ARE THE ARGUMENTS FOR USING FLOW-THROUGH**
7 **VERSUS NORMALIZATION ACCOUNTING FOR CALCULATING**
8 **INCOME TAXES?**

9 A. Proponents of flow-through accounting for income taxes argue that
10 income taxes in rates should reflect more closely what is paid each year,
11 and that normalization is more complex.

12 Normalization accounting, on the other hand, tends to dampen
13 potentially large swings in net income (and customer rates). Also, using
14 depreciation expense as an example, normalization provides
15 intergenerational equity because it spreads the tax benefits more evenly
16 over the life of an asset providing service.

17 Most importantly, Staff's understanding is that IRS and accounting
18 rules require normalization. The Internal Revenue Code provisions
19 mandate the use of normalization, and if the provisions are violated, the
20 right to elect accelerated depreciation is not allowed.¹ In other words, in
21 order for public utility property to be eligible for the more favorable

¹ Normalization requirements are contained in Internal Revenue Code Sections 167 and 168. Both the Economic Recovery Act of 1981 and the Tax Reform Act of 1986 required that the difference be-

1 depreciation allowances available for federal income tax purposes
2 (relative to the book depreciation used for ratemaking or financial
3 statement purposes), the tax benefits of accelerated depreciation must be
4 "normalized" in setting rates charged by utilities to customers and in
5 reflecting operating results in regulated books of account.

6 **Q. ARE THERE ANY RULES OR STATUTES THAT DICTATE WHETHER**
7 **TAXES SHOULD BE CALCULATED ON A STAND-ALONE OR**
8 **CONSOLIDATED BASIS FOR RATEMAKING?**

9 A. No. However, Section 17.04[3] in Accounting for Public Utilities
10 (Publication 016, Release 19, November 2002) states, "Non-utility
11 operations involve financial risks that are different from a utility's regulated
12 operations. When these risks are not borne by the ratepayers, it is unfair
13 to make use of the business losses generated in those nonregulated
14 entities to reduce the utility's cost in determining the rates to be charged
15 for utility services. By the same token, when a company's
16 nonjurisdictional activities are profitable, the ratepayers have no right to
17 share in those profits, but neither are they required to pay any of the
18 income taxes that arise as a result of those profits. Thus, a "stand-alone"
19 method (as opposed to a consolidated effective tax rate method) for
20 computing the income tax expense component of cost of service is the
21 proper and equitable method to be followed for ratemaking purposes."

22 **Q. WHICH UTILITIES IN OREGON HAVE TAXES SET ASSUMING THEY**

tween accelerated depreciation and book depreciation had to be normalized. Statement of Account-

1 **OPERATED ON A STAND-ALONE BASIS EVEN THOUGH THE TAXES**
2 **ARE FILED ON A CONSOLIDATED BASIS?**

3 A. All six of the regulated energy utilities (Idaho Power Company, PacifiCorp,
4 Avista Corporation, Portland General Electric, Cascade Natural Gas, and
5 NW Natural) file on a consolidated basis but have taxes set for ratemaking
6 on a stand-alone basis.

7 **Q. WILL OEUC BE STRUCTURED ANY DIFFERENTLY THAN THE**
8 **UTILITIES YOU JUST LISTED?**

9 A. Yes. OUEC is proposing that its only subsidiary would be PGE.

10 **Q. IS OEUC REQUIRED TO FILE A CONSOLIDATED RETURN WITH**
11 **PGE?**

12 A. In response to Staff Data Request No. 128, OEUC states "Consolidated
13 filing is elective under federal law, but is consistent under normal business
14 practice. Virtually all corporate groups elect to file consolidated federal
15 income tax returns. Consolidated filing is mandatory in Oregon, because
16 Oregon is a 'unitary' state that requires including the income items of all
17 members of a unitary group in calculating Oregon taxable income." (See
18 Exhibit 502, Johnson/1)

19 **Q. IS IT YOUR OPINION THAT OEUC WANTS TO FILE CONSOLIDATED**
20 **RETURNS WITH PGE?**

21 A. Yes. In response to Staff Data Request No. 128, OEUC states "PGE and
22 Oregon Electric intend to file consolidated income tax returns for both

ing Standards (SFAS) 109, Accounting for Income Taxes, requires recording of deferred taxes.

1 federal and state purposes. One reason for this is that unless Oregon
2 Electric and PGE file consolidated tax returns, the interest expense at
3 Oregon Electric will result in a tax loss for which no tax benefit could be
4 obtained." (See Exhibit 502, Johnson/1)

5 **Q. HOW MUCH IS THE TAX BENEFIT THAT OEUC IS REFERRING TO?**

6 A. In response to Staff request No. 102, OEUC states, "Assuming a 40% tax
7 rate at Oregon Electric, the interest expense creates an annual reduction
8 in income taxes of approximately \$15 million versus the taxes that would
9 otherwise be paid if the debt at Oregon Electric were not issued." (See
10 Exhibit 502, Johnson/2)

11 **Q. CAN THE COMMISSION ASSURE THAT RATEPAYERS WOULD PAY
12 ONLY WHAT THE TAXING AUTHORITIES ACTUALLY RECEIVED?**

13 A. That is uncertain. Under one approach, the Commission could order that
14 customers' rates be set using the consolidated basis, or at least imputing
15 OEUC's interest expense, for calculating income taxes instead of the
16 stand-alone basis currently being used. Another approach would be to
17 refund to ratepayers the difference between PGE's and OEUC's taxable
18 income either through a deferred account, which is trued up to actual
19 taxes paid or an up-front rate credit based on estimations. However, this
20 "true-up" approach could constitute a violation of IRS normalization rules
21 because rates would be based on actual taxes calculated using flow-
22 through accounting.

23 **Q. WHAT IS THE PRIMARY ADVANTAGE AND DISADVANTAGE TO**

1 **SETTING CUSTOMERS' RATES BASED ON A CONSOLIDATED**
2 **BASIS RATHER THAN STAND-ALONE?**

3 A. The primary advantage to setting customers' rates on a consolidated basis
4 rather than stand-alone is that -- if based on flow-through accounting --
5 customers would then be responsible for only what was actually paid in
6 income taxes. The problem with this approach is that it may not be
7 allowed by the IRS. Even if it were allowable, taxes might not always be
8 lower, but may actually be higher, depending on the profitability of other
9 subsidiaries, if applicable. In addition, in the case of PGE, calculating
10 PGE's costs, including income taxes, on a stand-alone basis protected
11 PGE's customers from the financial difficulties experienced by Enron's
12 other subsidiaries.

13 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

14 A. Yes.
15

1 **Q. PLEASE STATE YOUR NAME, OCCUPATION, AND BUSINESS**
2 **ADDRESS.**

3 A. We are:

4 Jerome Murray, Senior Utility Analyst in the Safety and Reliability Section of the
5 Public Utility Commission of Oregon. My Witness Qualification Statement is
6 attached as Staff Exhibit 601, pg.1.

7 Robert Sipler, Senior Utility Analyst for the Safety and Reliability Section of the
8 Public Utility Commission of Oregon. My Witness Qualification Statement is
9 attached as Staff Exhibit 601, pg.2.

10 Our business address is 550 Capitol Street NE Suite 215, Salem, Oregon
11 97301-2551.

12 **Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND WORK**
13 **EXPERIENCE.**

14 A. Our Witness Qualification Statements are found in Exhibit Staff/601, pages 1
15 and 2.

16 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

17 A. We will cover the basic package of Service Quality Measures (SQMs) that
18 Portland General Electric (PGE) would operate under, should the purchase by
19 Oregon Electric Utility Company, LLC be approved.

20 **Q. DID YOU PREPARE AN EXHIBIT FOR THIS DOCKET?**

21 A. Yes. we prepared Exhibit Staff/602, consisting of 22 pages.

22 **Q. ARE THERE OTHER SQMS THAT ARE NOT INCLUDED IN THIS "BASIC**
23 **PACKAGE"?**

1 A. Yes, another measure is being proposed and is discussed in Staff Witness
2 Clark Jackson's testimony in Staff Exhibit 700.

3 **Q. WHAT ARE YOUR BACKGROUNDS RELATED TO ELECTRIC SQMS IN**
4 **OREGON?**

5 A. We have been involved, starting in 1996, with the original concept
6 development, negotiation, adoption, and ongoing administration of the SQMs
7 for both PGE and PacifiCorp.

8 **Q. HAVE THE PARTIES REACHED AN AGREEMENT FOR THIS SPECIFIC**
9 **SQMS PACKAGE THAT WILL BE INCLUDED AS A STIPULATED**
10 **AGREEMENT IN THE CASE?**

11 A. Yes, at the settlement meeting held June 8, 2004, a specifically designated
12 SQMs document, with specified modifications and term, was agreed to by the
13 parties. One subsequent proposal for modification to the R4 measure,
14 included in that agreement, was proposed by OEUC and was considered
15 acceptable by Staff and ICNU (the parties primarily involved in the settlement
16 discussion). A Stipulated Agreement was signed for this SQMs Package. The
17 final SQMs document is included as Staff Exhibit 603.

18 **Q DID THIS PGE PROPOSAL TO MODIFY THE R4 MEASURE MATERIALLY**
19 **CHANGE THE SQMS THAT WERE AGREED TO?**

20 A. Staff believes the change is minor and will actually improve the SQMs
21 Package.

1 **Q. HOW WILL THE SQMS PACKAGE BRING VALUE TO THIS CASE?**

2 A. The existing SQMs adopted in UM 814, which PGE is presently operating
3 under, is a regulatory agreement that provides incentives to continue service
4 quality at equal or improved levels after the Enron purchase. Items covered
5 are customer relations, reliable service, safety, personnel levels, and the
6 continuation of many basic maintenance programs.

7 The agreement package in this docket is an improvement in two areas.

8 First, a new measure, R4, will monitor the effectiveness of PGE in the
9 restoration of service to customers who experience extended outages.

10 Secondly, the term of the SQMs will be extended for ten years after the present
11 measures would have ended. This will extend this important regulatory tool
12 through the end of 2016.

13 **Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?**

14 A. Yes.

1 **Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS, AND**
2 **OCCUPATION.**

3 A. My name is Clark Jackson. My business address is 550 Capitol Street NE,
4 Suite 215, Salem, Oregon 97301-2551. I am employed as the Program
5 Manager for the Consumer Services Section at the Public Utility Commission of
6 Oregon (OPUC or Commission).

7 **Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND WORK**
8 **EXPERIENCE.**

9 A. My qualifications are listed in Exhibit Staff/701, Jackson/1.

10 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

11 A. I have reviewed Oregon Electric Utility Company's (OEUC) application for
12 authorization to acquire Portland General Electric Company (PGE) with the
13 specific purpose of addressing the need for a new Service Quality Measure
14 (SQM) related to billing accuracy.

15 **Q. HAVE YOU PREPARED ANY EXHIBITS?**

16 A. Yes. I prepared Staff/701, consisting of one page and Staff/702, consisting of
17 6 pages.

18 **Q. HOW IS YOUR TESTIMONY ORGANIZED?**

19 A. My testimony is organized into three major areas: (1) my summary
20 recommendation; (2) a brief discussion of the need for the billing accuracy
21 SQM; and (3) the current billing accuracy SQM proposal.

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Summary Recommendation

Q. WHAT IS YOUR SUMMARY RECOMMENDATION REGARDING IMPLEMENTATION OF A SERVICE QUALITY MEASURE FOR BILLING ACCURACY?

A. I recommend that the Commission implement a billing accuracy SQM as a condition of approval of the application by OEUC to acquire PGE. Staff's proposed billing accuracy SQM is discussed further in this testimony.

Q. WHY IS STAFF PROPOSING AN SQM FOR BILLING ACCURACY?

A. Customers expect their bills to be accurate, and while the Commission's rules do not explicitly require accurate bills [OAR 860-021-0120 provides only the requirements for meter readings and bill forms], they do include the requirements for a utility to notify its customers when an underbilling or overbilling occurs [in OAR 860-021-0135]. There has been a troubling increase in the number of billing problems, leading to highly publicized remedial actions by several of the largest utilities the Commission regulates. The Commission promised to review the need for an SQM to address this issue and to ultimately provide assurances that customers are getting the accurate bills that they are paying for in their rates. (See Exhibit Staff/702, Jackson/6.)

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Q. HAS BILLING ACCURACY BEEN AN ISSUE WITH PORTLAND GENERAL ELECTRIC?

3

4

A. Yes. In 2003, the company issued inaccurate bills affecting over 78,000 customers for a single error.

5

6

Q. WHY ARE YOU PROPOSING A BILLING ACCURACY SQM IN THIS DOCKET?

7

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A. I am concerned that OEUC will, in an attempt to cut costs, either neglect or attempt to change the PGE billing system. These cost-cutting measures could cause a decrease in customer services, including a decline in the accuracy of PGE's billing system.

9

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Q. HOW WOULD A BILLING ACCURACY SQM BENEFIT CUSTOMERS?

13

A. An SQM on billing accuracy will encourage PGE to render accurate and reliable billings for their customers. Customers will benefit because they will have a greater assurance of accurate bills.

14

15

- 1 A. Inclusions are PGE bills that have been rendered inaccurate, but where the
2 error in the bill amount was not adjusted by the rendering of a separate bill in
3 either the current or a subsequent month.

4 **Q. WHEN WOULD AN INCLUSION-TYPE ADJUSTMENT OCCUR?**

- 5 A. A customer's bill would be inaccurate in one month, but the amount of the error
6 would be added to or subtracted from a subsequent month's bill without PGE
7 ever issuing a revised or adjusted bill specifically for the error that occurred.

8 **Q. HOW IS THE PERFORMANCE CALCULATED?**

- 9 A. The performance is calculated as follows:

10
$$\frac{\text{Number of inaccurate bills to customers for the billing month}}{\text{Total number of bills for the billing month}}$$

11
12
13 or

14
15
$$\frac{\text{Number of bills adjusted less exclusions plus inclusions for the billing month}}{\text{Total number of bills for the billing month}}$$

16
17
18 **Q. HOW IS THE COMMISSION STAFF NOTIFIED OF INACCURATE BILLS?**

- 19 A. Notification of inaccuracy can originate from either the customer through PGE's
20 own customer service, as a complaint through the Commission's Consumer
21 Services Section, or by notice of the company's efforts or the Commission
22 Staff's efforts.

23 **Q. WHEN WOULD PGE BE REQUIRED TO NOTIFY THE OPUC OF A**
24 **BILLING ERROR?**

- 25 A. Notification of an error would be required if the error affected 50 or more
26 customers of a single billing cycle or a total of 500 or more customers of the
27 combined billing cycles for the billing month. Immediately upon discovery of the

1 error, PGE would notify the Commission's Consumer Services Section either by
2 telephone, facsimile, electronically (e-mail) or in person.

3 **Q. DOES STAFF PROPOSE A REMEDY FOR BILLING INACCURACY?**

4 A. Yes. Staff proposes that the Commission impose revenue requirement
5 reductions for billing inaccuracy, and that these reductions be capped at
6 \$500,000 in the initial calendar year and \$1,000,000 in each subsequent
7 calendar year, if billing accuracy is not improved. Staff proposes that the
8 performance measure be quantified on a monthly basis; however, the remedy
9 would accrue on an annual basis and be capped at 1/12th of the revenue
10 requirement reduction amount or a maximum of \$42,000 per month, in the
11 initial year. Each subsequent year the remedy shall be capped at \$84,000 per
12 month. For a description of how PGE, as well as PacifiCorp and the three
13 Oregon natural gas utilities would have been assessed revenue requirement
14 reductions over two 12-month periods beginning in March 2002 under the
15 proposed SQM see Exhibit Staff/702, Jackson/5.

16 **Q. WHAT WOULD THOSE REVENUE REQUIREMENT REDUCTIONS HAVE**
17 **TOTALED FOR PGE?**

18 A. With the performance measure at 0.6% as Staff has proposed, for the period
19 March 2002 through February 2004, PGE would not have been required to
20 reduce their revenue requirement in any month. If the errors that did occur
21 happened in a subsequent year with the performance measure at 0.4%, the
22 monthly remedies would have totaled \$168,000 for the first year, and \$84,000
23 for the second year.

1 **Q. HAS STAFF PROPOSED A BILLING ACCURACY SQM FOR OTHER**
2 **UTILITIES?**

3 A. Yes. As I discussed earlier, the Commission is reviewing the need for service
4 quality measures to address concerns that customers are not getting the
5 accurate bills they pay for in their rates. At this time, Staff is working with NW
6 Natural on a billing accuracy SQM.

7 **Q. IS THE PROPOSED BILLING ACCURACY SQM FOR NW NATURAL**
8 **SIMILAR TO THE ONE PROPOSED BY STAFF IN THIS DOCKET?**

9 A. Yes. Exhibit Staff/702, Jackson/1-5 is the draft proposal currently being
10 reviewed by NW Natural and its stakeholders. Staff proposes that any billing
11 accuracy SQM negotiated in this docket be similar to an SQM negotiated with
12 NW Natural.

13 **Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?**

14 A. Yes.

CERTIFICATE OF SERVICE

UM 1121

I certify that I have, this day, served the foregoing document upon all parties of record in this proceeding by mailing a copy properly addressed with first class postage or first class equivalent prepaid to all parties or attorneys of parties.

Dated at Salem, Oregon, this 21st day of July, 2004.

Mike Weirich
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Of Attorneys for Public Utility Commission's Staff
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