

# *Public Utility Commission of Texas*

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## **Memorandum**

TO: Chairman Donna L. Nelson  
Commissioner Brandy Marty Marquez

FROM: Commissioner Kenneth W. Anderson, Jr.

DATE: September 24, 2015

RE: **Open Meeting of September 24, 2015, Project No. 42750; Agenda Item No. 20**  
*Matters Pertaining to or Arising Out of the Chapter 11 Bankruptcy of Energy Future Holdings*

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In advance of the September 11, 2015 open meeting, I filed a memorandum in this project raising certain issues related to a proposed change of ownership transaction involving Oncor Electric Delivery Company LLC (Oncor).<sup>1</sup> I explained that two features of the proposed transaction raised particular concern: the continued existence, post-restructuring, of a substantial amount of debt from the 2007 buyout of TXU Corp. (the 2007 Buyout Debt)<sup>2</sup> and the proposal to restructure Oncor so that the reorganized Energy Future Holdings Corp. (EFH) can be taxed as a real estate investment trust (REIT).<sup>3</sup> In light of recent stories in the trade and other press related to my earlier memorandum, I want to make clear what are and what are not concerns to this commissioner.

First, I am not opposed in principle to the continued existence of the 2007 Buyout Debt. Indeed, it is not at all uncommon for utility holding companies to carry debt at the level of a parent company that is not recoverable directly in rates. Neither am I opposed to a REIT structure (or other tax advantageous structure) in and of itself so long as ratepayers either benefit, incur no unrewarded risk, or otherwise suffer no harm. It is the combination of these features in the same transaction that creates issues that will need to be addressed thoroughly in the upcoming change of control proceeding as discussed further below.

### ***I. Ability of Creditors or Equity Owners to Remove Affiliates of Operating Company from Management of REIT or AssetCo***

Absent the 2007 Buyout Debt, the separation of Oncor into an AssetCo and OperatingCo might not be a problem. However, because of the REIT component, the proposal requires a significantly different ownership mix between the two entities. This has the potential to create divergent interests over the medium- and long-run, particularly if the holders of the refinanced 2007 Buyout Debt are or become different from the equity owners of the REIT as would be

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<sup>1</sup> *Matters Pertaining to or Arising Out of the Chapter 11 Bankruptcy of Energy Future Holdings*, Memorandum of Commissioner Kenneth W. Anderson, Jr., Project No. 42750 (Aug. 20, 2015).

<sup>2</sup> *Id.* at note 8 and accompanying text.

<sup>3</sup> *Id.* at 3. This memo presumes the same REIT organization structure that is presented in my August 20, 2015 memo. Accordingly, the terms “OperatingCo,” and “AssetCo” have the same meaning here.

expected after the REIT becomes a public company. Depending upon the terms of credit and indenture agreements between the debt holders and the reorganized EFH as a REIT and the organizational and other management documents of the reorganized EFH and AssetCo, any number of points of conflict can arise that could imperil ratepayers unless the appropriate provisions are included in them along with conditions imposed in an enhanced ring-fence. The issues surrounding REIT rental or other contract obligations and 2007 Buyout Debt may, in turn, affect the relationship between the owners of the REIT and AssetCo and the entity that manages AssetCo. Under the Fifth Amended Plan,<sup>4</sup> a newly formed Texas limited liability company, an affiliate of Hunt Consolidated, Inc. (Hunt), will become OperatingCo, the entity that will lease the Oncor transmission and distribution assets from AssetCo.<sup>5</sup> The Fifth Amended Plan also contemplates that an affiliate of Hunt will serve as the manager of AssetCo, however, the AssetCo management entity will not be the majority owner of AssetCo.<sup>6</sup> This creates some risk of conflict between the owners of AssetCo and its Hunt management entity. Presumably, the AssetCo management entity will be responsible for the day-to-day operations of AssetCo, which will include cooperation with OperatingCo in the administration of the REIT lease agreement and other contractual arrangements. The primary interest of the AssetCo/REIT owners will be to earn a return from their equity interest and the primary interest of the holders of the 2007 Buyout Debt is to receive their principal and interest payments. So the question is what happens if the non-Hunt-affiliated AssetCo owners or creditors become dissatisfied with the AssetCo management entity because of the management entity's interaction with OperatingCo and any coincident impact on the REIT's creditors or AssetCo owners' return? Further, what happens if OperatingCo fails to make a payment obligation relating to the REIT lease agreement or the 2007 Buyout Debt? Will a ring-fence be required to include the AssetCo, including restrictions on management changes and cash distributions upstream unless the applicants can demonstrate that under no realistic and foreseeable circumstances ratepayers can be harmed? Therefore, what additional protections for ratepayers may be required?

Adding to this mix of concerns is the nature of certain parties that are to become the owners of the REIT. While the exact allocation of debt and equity of the REIT remain unclear at this time, what seems apparent is that some of the unsecured creditors of Energy Future Competitive Holdings are going to become equity and debt holders in the REIT. Certain of these investors do not have a reputation as either long-term or particularly patient investors.<sup>7</sup> What would happen if the OperatingCo were required to reduce substantially payments to the AssetCo, either because of storm damage or because of Commission-required investment? This might well be of concern to this Commission, particularly if the OperatingCo is required by circumstances<sup>8</sup> or this Commission to curtail payments upstream in order to fund certain investments or operations. In the usual

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<sup>4</sup> See Energy Future Holdings Corp. Form 8-K Exhibit 99(a) submitted to the United States Securities and Exchange Commission on Sept. 21, 2015. Documents filed in the bankruptcy proceeding describing the Fifth Amended Plan are available at [efhcaseinfo.com](http://efhcaseinfo.com).

<sup>5</sup> Exhibit B to Purchase Agreement and Agreement and Plan of Merger by and among New EFH, OV2, EFH Corp., and EFIH dated August 9, 2015 available at [efhcaseinfo.com](http://efhcaseinfo.com) (Document No. 5248-2).

<sup>6</sup> *Id.*

<sup>7</sup> I do not include affiliates of Hunt Consolidated, Inc. (Hunt), or some of their reported partners such as the Teachers Retirement System of Texas in this category. They are well-known, patient, long-term investors.

<sup>8</sup> For example, see Part II *infra*.

situation the utility would simply reduce dividends. Shareholders might be unhappy, but it would unlikely result in a change in control at least in the short-run. Unlike the more typical utility holding company arrangement, the only source of repayment of the continued 2007 Buyout Debt will be the free cash flow from the OperatingCo via the AssetCo. There are no other operating sources of revenue, at least for the foreseeable future. This means that any disruption in OperatingCo's or AssetCo's revenue stream could also impact the REIT's ability to service that debt. With the proposed REIT structure in place together with the 2007 Buyout Debt, there is the dual problem of the impact on the REIT tax structure and the potential for the REIT to be unable to pay interest or principal on its debt. Unless the proper provisions are in place could the debt holders (or unhappy equity owners) attempt to oust the management either of the REIT or AssetCo through the exercise of various corporate or creditor rights?

Because of the potential conflict in the AssetCo management arrangement, I will expect the following issues/questions to be addressed:

1. Based on applicable state business association laws, under what circumstances, if any, can AssetCo or its majority owners remove the AssetCo management entity? Under what circumstances, if any, can the creditors of the 2007 Buyout Debt remove the AssetCo management entity? Can AssetCo or its creditors remove the AssetCo management entity without the prior approval of the Commission?
2. If OperatingCo is unable to satisfy a lease payment obligation, what rights, if any, will the owners of AssetCo have to control the assets of AssetCo? If OperatingCo is unable to satisfy a lease payment obligation, what rights, if any, will the owners of AssetCo have to remove the AssetCo management entity? If OperatingCo is unable to satisfy a payment obligation related to the 2007 Buyout Debt, what rights, if any, will the 2007 Buyout Debt creditors have to control the assets of AssetCo?
3. What are the AssetCo management entity's statutory and common law duties to AssetCo and its direct or indirect owners? Do those duties conflict with obligations imposed on AssetCo under the Public Utility Regulatory Act (PURA)<sup>9</sup> or obligations under the lease agreement with OperatingCo?

## ***II. Ability of OperatingCo to Fund Operations and Investment Adequately***

Oncor continues to see growth in its service territory. Therefore it will need to continue making significant capital investments to serve new customers while simultaneously replacing parts of its existing system. Under the Fifth Amended Plan's REIT proposal, the OperatingCo will make rent payments pursuant to a lease or other contractual agreement between AssetCo and OperatingCo. Because, at least initially, the OperatingCo is the only source of revenue for AssetCo and the REIT, any disruption in OperatingCo's revenue may have an impact on its ability to make rental payments. Accordingly, a critical aspect of our public interest review will be an analysis of

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<sup>9</sup> Tex. Util. Code Ann. §§ 11.001-66.016 (West 2007 & Supp.).

the lease agreement between AssetCo and OperatingCo (along with any amendments thereto) to determine how lease payments will be made and what will happen if OperatingCo needs to retain funds either to fund unusual capital expenditures or to handle unexpected operational issues. Would it be able to reduce its rental payments to the REIT? As noted above, in the usual corporate structure the utility could simply impose a temporary reduction in dividends.

Storm damage is one example of an event that could affect OperatingCo's free cash flow. Currently, Oncor pays no rent and has the flexibility to adjust upstream dividends as conditions warrant. Because Oncor's service territory covers a section of Texas vulnerable to major storm damage,<sup>10</sup> a major storm (or series of storms) may interrupt Oncor's revenue stream, which could affect the REIT's lease agreement rent obligation or the 2007 Buyout Debt payment obligations. Based on information provided by Oncor, system restoration costs for individual major storm events within the last decade have been substantial. For example, total system restoration costs for three storm events occurring in February of 2010, December of 2013, and October of 2014 were nearly \$120 million, not including the cost of replacement capital items. As the Oncor transmission and distribution system continues to grow so does the potential for more significant storm damage and storm-related costs.

Accordingly, because of the need to ensure Oncor's ability to fund its operations, maintenance and capital expenditures, I will expect the following issues/questions to be addressed:

1. What mechanisms will AssetCo and OperatingCo utilize to protect the utility's financial viability if a major storm requires significant restoration to the transmission and distribution system? Assuming OperatingCo will be responsible for the continued maintenance, operation and restoration of the transmission and distribution system, which entity or other parties will be responsible for securing adequate funds to finance the restoration?
2. If the utility determines it is necessary to utilize PURA's securitization provisions<sup>11</sup> to pay for system restoration costs, how will it endure any lag time between the storm event and receipt of transition bond proceeds necessary to restore the transmission and distribution system? Who will be the recipient of the proceeds when and if they issue? Would OperatingCo or AssetCo even be eligible to use PURA's securitization provisions?
3. A major storm or series of storms could reduce OperatingCo's revenue if significant outages substantially depress electricity consumption. How will OperatingCo meet payment obligations to AssetCo under a lease agreement if a major storm impacts OperatingCo's revenue stream? What financial impacts would a major storm have on any plan to pay down the 2007 Buyout Debt?
4. Among AssetCo and OperatingCo, which entity will own and maintain the self-insurance reserve account permitted under 16 TAC § 25.231(G)? If that account is entirely depleted

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<sup>10</sup> That may be almost an oxymoron as there is no part of the State of Texas that is not subject to severe weather!

<sup>11</sup> PURA §§ 36.401 – 36.406.

because of a storm then what method(s) will AssetCo or OperatingCo utilize to repair and restore damage to the transmission and distribution system?

As with my previous memorandum, I do not propose to discuss the issues in this memo unless my colleagues wish to do so. My primary purpose for this memorandum is to raise these issues for the benefit of the persons preparing any change of control application as well as the parties to the upcoming proceeding.