Shocking Risk:

Flawed Oncor Buyout Would Harm Texas Electricity Customers

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EXECUTIVE SUMMARY

A consortium led by billionaire Ray L. Hunt has made an offer to acquire Oncor, the state's largest electric transmission and distribution utility. As currently structured, this transaction would harm consumers, enrich utility owners at the expense of ratepayers, and create significant new risk. Regulators should reject this complicated deal.

In this report, AARP examines the proposed acquisition of Oncor from a consumer perspective. Section 1 provides important historical context on the Energy Future Holdings (EFH) bankruptcy, Oncor's parent company. Section 2 explains Hunt's proposal to acquire Oncor. Section 3 spotlights three major areas of concern. This report also includes an executive summary and a timeline.

KEY RISKS FOR ONCOR CUSTOMERS

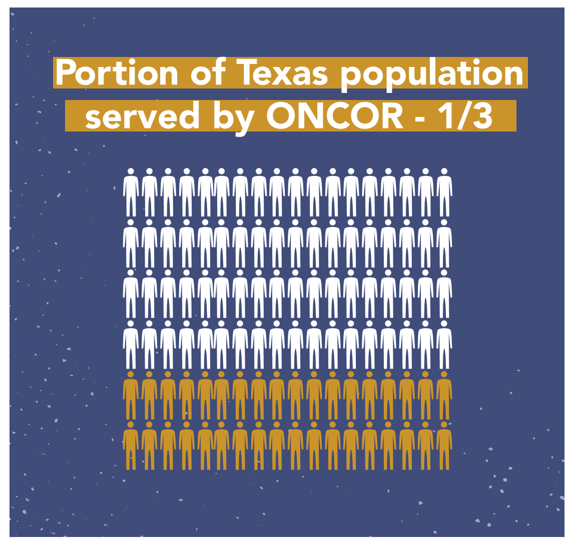
- Under this deal, the utility would collect nearly $250 million from ratepayers each year for non-existent federal income tax expenses, according to estimates.[1] This is an unacceptable wealth transfer from ratepayers to shareholders.
- The exotic financing structure proposed has never been used to acquire a utility of Oncor's size.
- Approximately $5 billion in debt would remain with Oncor, putting continued pressure on rates. Important unanswered questions remain regarding Oncor's debt, the interests of creditors and the proposed restructuring.
- The buyers have no experience operating a utility the size of Oncor. Although the buyers manage one other investor-owned electric utility, it's the smallest in Texas, and customer dissatisfaction with that utility is high.[2]
- Besides Hunt, consortium members seeking to acquire Oncor include investors who lost money on Energy Future Holdings.[3] Such creditors sometimes lack the long-term, patient view of investing that is needed to safeguard ratepayer interests.
- Existing financial protections under the Oncor "ring fence" will be discarded under the Hunt deal.
- The new and unorthodox structure for the utility almost certainly will exacerbate conflicts over its rates and service at the Public Utility Commission (PUC).

RECOMMENDATION

The PUC should reject Hunt's flawed takeover plan.

AARP believes the deal proposed by Hunt to take possession of Oncor is bad for ratepayers. If the utility raises rates, 10 million Texans will feel it. If the utility falters, there's nowhere else for those 10 million Texans to turn. Oncor is a regulated, state-granted monopoly. Its customers—especially older ones—depend on Oncor for their health and welfare. Under state law, the utility must provide continuing and adequate service.[4]

But the Hunt consortium proposes a risky deal that would reorganize Oncor into a corporate structure that is both unorthodox and experimental. Investors who lost money in the massive Energy Future Holdings bankruptcy would become partners.[5] Ratepayers would be forced to pay hundreds of millions of dollars each year for a non-existent federal tax expense. What do ratepayers gain in return? Absolutely nothing of significance.



Because Oncor is a public utility, Hunt and his consortium of investors need pre-approval from state regulators. A PUC hearing has been set, and Texas consumers—particularly older ones—have have a vital interest in its outcome. Although older and younger Americans spend similar amounts on energy, older Americans typically spend a larger percentage of their income heating and cooling their homes.[6] Older Americans also are more susceptible to chronic health problems. Service interruptions—either because electricity has become unaffordable or because of infrastructure failures—can aggravate health problems, spoil food and even lead to death.[7]

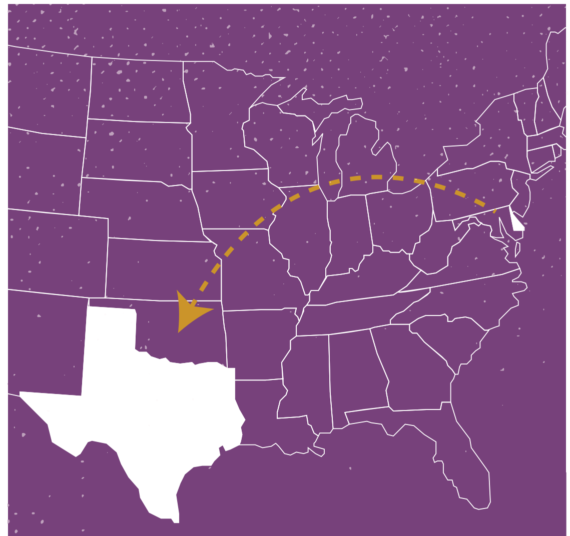
Oncor operates about 120,000 miles of transmission and distribution lines—lines that transport electricity to three million electric meters at homes and businesses across a broad service territory.[8] Oncor is also part of a larger corporation, Energy Future Holdings, which has major retail and wholesale power operations in deregulated parts of Texas. These deregulated business units are free to set their own rates, and they have free-market competitors. Oncor, by contrast, has its rates and services regulated by the Texas Public Utility Commission.

In April 2014, Energy Future Holdings declared bankruptcy. A federal judge in Delaware approved a Chapter 11 plan, albeit one predicated on additional regulatory hurdles, including getting PUC approval for the Hunt transaction.[9]

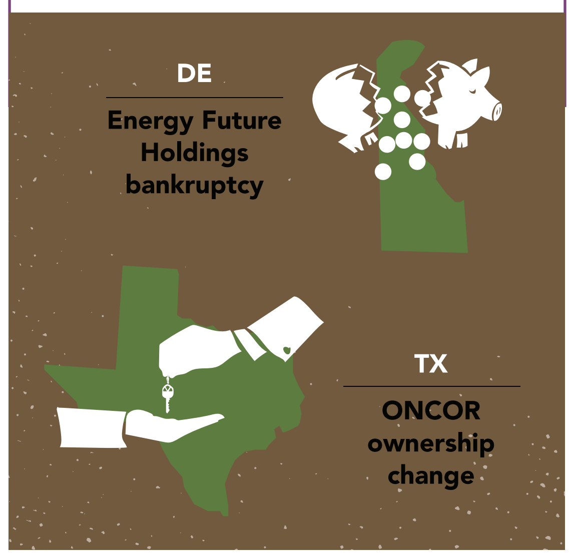
ENERGY FUTURE HOLDINGS' BANKRUPTCY

In 2007, a group of investors (led by New York-based Kohlberg Kravis Roberts)[10] announced plans to acquire TXU Corp., the Dallas-based energy giant. In the largest leveraged buyout in U.S. history,[11] KKR took possession of TXU's retail customers, its wholesale energy business (the largest in Texas), various uranium mines, and Oncor, the transmission and distribution utility. The new company was christened Energy Future Holdings.

The deal was controversial, especially given the approximately $37 billion in borrowed money[12] needed to make it happen. To soften opposition, the purchasers agreed to cut retail electric rates and cancel the development of several coal-fired plants.[13] But AARP found those concessions insufficient.[14] The debt put consumers at risk for higher rates, service cutbacks, and the chaos that would result from a company default. As it turned out, AARP was right to be concerned.



While the Energy Future Holdings (EFH) bankruptcy is in federal court in Delaware, Oncor's proposed change of ownership will be settled in Texas. The PUC must determine if the transaction would serve the public interest.



EFH began posting annual losses almost immediately.[15] Oncor's reliability performance plummeted.[16] Finally, under the weight of its debt and a bad bet it made on natural gas prices (which are closely linked to wholesale electricity prices in Texas), EFH declared bankruptcy.

EFH filed for Chapter 11 protections in April 2014 in federal court in Delaware, far from the company's customers, employees, holdings, and hometown media.[17] The company and its creditors considered several restructuring plans before finally settling on one that would spin its power plants and retail business to creditors and send Oncor to the Hunt consortium.[18] Bankruptcy Court Judge Christopher Sontchi approved the deal on Dec. 3, 2015.

Only a few hurdles remain, and one of the most important is state regulatory approval to transfer ownership of Oncor. Whether or not the Delaware plan succeeds—and EFH exits bankruptcy—depends largely upon the PUC's decision,[19] but the PUC should not let this impact its deliberations. The interests of corporate creditors must not trump the welfare of Texas consumers, especially ones at the mercy of a utility with a monopoly. The PUC must apply a higher standard than the bankruptcy court, one that safeguards the public interest.

AARP urges the PUC to put consumers first and not to get boxed in by the Delaware plan.

TIMELINE: ENERGY FUTURE HOLDINGS' ROAD TO BANKRUPTCY

2007	TXU, the North Texas energy giant, is acquired by a group of investors led by Kohlberg Kravis Roberts & Co. and Texas Pacific Group for about $32 billion and the assumption of about $13 billion in debt. The new company is named Energy Future Holdings.[71]
2008	Natural gas prices begin trending downward, impacting wholesale electricity prices.[72] EFH reports a net loss of $8.9 billion for the fourth quarter.[73]
2009	Natural gas prices fall to $2.843 per million British thermal units in September, less than a fourth of the price recorded a year earlier. EFH begins cutting deals with bondholders to write off debt but has only partial success.[74]
2010	EFH reduces its balance sheet value by $4 billion.
2012	*May:* EFH reports its sixth consecutive quarter of declining revenues.
	August: EFH announces it will terminate pensions for those working for its competitive holdings.
	September: Executives get millions of dollars in incentive bonuses, with CEO John Young receiving $6 million.
2013	EFH discusses a bankruptcy plan with some of its largest creditors.
2014	*April:* EFH starts proceedings under Chapter 11 of the U.S. Bankruptcy Code.[75]
2015	*September 17:* Bankruptcy Court Judge Christopher Sontchi gives initial green light to a plan to breakup EFH and settle its $40 billion in debts. The plan depends in part on the outcome of PUC consideration of Hunt's acquisition of Oncor.[76]
	September 29: A group of investors led by Hunt Consolidated, Inc., files an application to the PUC seeking regulatory approval to buy Energy Future Holdings' ownership stake in Oncor.[77]
2016	Hunt Consolidated, Inc., expects the transaction to close in the first or second quarter of 2016.[78]

THE HUNT DEAL

Hunt's proposal to acquire Oncor involves billions in debt, an unusual corporate structure and an unacceptable multi-million-dollar transfer of wealth from ratepayers to shareholders. The Hunt consortium filed its proposal on Sept. 29, 2015. The PUC has 180 days from that date to consider whether the proposal serves the public interest. If the PUC consents, Hunt could take control by the middle of 2016.[20]

Under terms of the deal, Oncor would be valued between $18 and $19 billion[21] and have approximately $5 billion in debt.[22] Oncor's assets would be placed into a complicated corporate structure known as a "real estate investment trust." This would divide Oncor into two separate businesses—one would own the wires and equipment, the other would lease and operate those assets. This arrangement has not been tried on such a massive scale. Even if it's successful, the setup only benefits Hunt and his investment partners. Ratepayers will unfairly pay for non-existent federal tax expenses.[23] (The real estate investment trust is discussed in greater detail in Spotlight Section One.)

Hunt also proposes the continued use of "ring fence" legal covenants to shield Oncor's assets from outside creditors. This would replace Oncor's existing ring fence, which was created in 2008 as a condition of the original EFH buyout.[24] The ring fence creates legal and financial walls between the regulated utility and unregulated affiliates, and it is meant to protect Oncor and consumers. However, the Hunt plan would abandon key components of the existing ring fence[25] while simultaneously bringing many of EFH's creditors into the Oncor acquisition.[26] This creates untenable risk for ratepayers. (The ring fence is discussed in greater detail in Spotlight Section Two.)

The Hunt family currently operates only one other electric utility, Sharyland Electric. Rates charged by Sharyland are among the state's highest,[27] and customer complaints against Sharyland skyrocketed during 2015.[28] Nothing about Hunt's experience with Sharyland can give consumers confidence that the Hunt consortium can successfully manage the state's largest transmission and distribution utility. (Hunt's Sharyland experience is discussed in greater detail in Spotlight Section Thre.)

DID YOU KNOW?

Energy Future Holdings was born in 2007, the product of a debt-laden buyout by a group of investors in Dallas-based energy giant TXU Corp. The purchasers were New York-based Kohlberg Kravis Roberts, Texas-based TPG Capital, and the private equity arm of New York investment bank Goldman Sachs.

In 2007, AARP warned that the massive debt associated with Energy Future Holdings made the acquisition of Oncor untenable. AARP urged the PUC to reject the transaction.

SPOTLIGHT CONCERN ONE

THE REAL ESTATE INVESTMENT TRUST

- The REIT will lead to a multi-million dollar annual wealth transfer from ratepayers to utility owners.
- The REIT is needlessly complicated, has never before been attempted on a utility of Oncor's size, and will increase the potential for conflicts in future rate cases.
- The REIT offers no offsetting benefits to consumers.

Real estate investment trusts (REITs) are corporate entities that own income-producing real estate, such as shopping malls. REITs typically pay out taxable income as dividends to shareholders. In turn, shareholders pay income taxes on those dividends.

The Hunt consortium wants to place all of Oncor's assets—transmission and distribution lines as well as equipment—into a REIT. The consortium would create a separate operating company to lease equipment from the REIT. Oncor's existing management team and employees would be transferred to the new operating company. Hunt would have control over both the operating company and the (publicly owned) REIT.[29]

This proposed arrangement puts consumers at risk, and it provides no offsetting benefits. The potential problems are many.

First, the structure is unnecessarily complex. It could mean higher than necessary rates for customers. Although the Hunt consortium has said that rates will not increase as an immediate result of this transaction,[30] the sheer complexity of the structure could complicate future regulatory proceedings. Moody's credit rating agency has noted that the REIT plan "will increase the risk of regulatory contentiousness."[31]

Second, some utility experts warn that the proposed corporate structure could lead to a below-investment-grade bond rating, leading to higher borrowing costs "and highly uncertain financial capability to provide safe and reliable service."[32] Economist Carol Szerszen said that "the capital market conditions facing the proposed REIT are unknown, which leaves open the possibility that ratepayers will be facing higher debt and equity costs in the future."[33] Financial analyst Bruce H. Fairchild said that high capital costs would limit the consortium's options, "and it would not be surprising for it to request rate relief in one form or another."[34]

Third, a REIT has only rarely been used in a public utility context—and never before used with a utility the size of Oncor. (REITs more typically involve less substantial real estate holdings, such as shopping centers or hotels.) The only other electric utility that has employed a REIT is Sharyland, also controlled by Hunt. But the Sharyland REIT has one tenth the number of lines as Oncor, one 200th the number of customers[35] and serves a much different customer base.[36]

While the Hunt consortium can claim experience applying a REIT to a public utility, the experience is very limited and applies only to this extremely small utility company. Under Hunt's plan, Oncor ratepayers would become guinea pigs as the consortium works out problems that may follow from its unorthodox financing strategy. Moody's has referred to this corporate structure as a "financial engineering fad."[37]

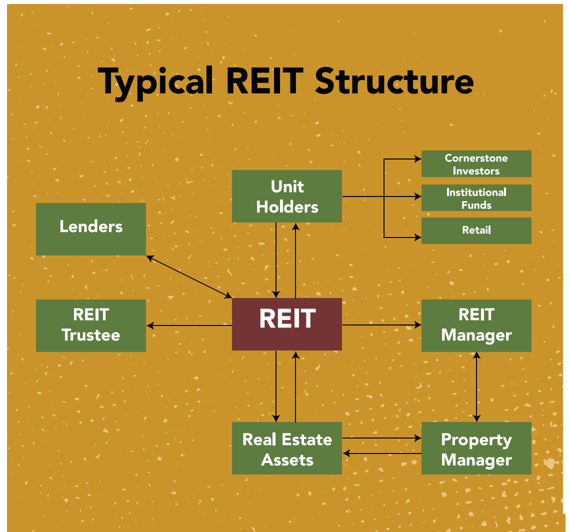
And what do consumers get in return? The Hunt consortium claims their proposal would benefit customers by removing bankruptcy uncertainty,[38] by reducing Oncor's debt, and in various other ways.[39] But these supposed "benefits" don't hold up upon inspection. For instance, any alternative transaction would remove bankruptcy uncertainty. And with regards to the debt reduction: an acquisition proposal made by separate corporate interests would not simply reduce the parent company's debt, it would eliminate it altogether.[40]

The REIT structure has been touted as a superior way to raise capital, in part, because it reduces federal tax liability. Ratepayers should expect to share in that savings through discounted rates. But what makes this deal so attractive to the buyers is precisely the opposite—that is, it theoretically lets the utility overcharge ratepayers for federal taxes.

THE ONCOR REIT AND TAXES

Under regulatory law, public utilities can collect reimbursements from ratepayers for the utilities' federal tax liabilities. In this case Oncor presumably would collect from ratepayers (through charges on monthly bills) an amount that corresponds to a 35-percent federal tax rate on its income. But according to utility expert Lane Kollen, nearly all of the utility's taxable income will be taxed by the federal government at a far lower rate—at 3.5 percent or less. "In other words, the purchasers have valued Oncor based on their ability to recover an excessive income tax expense that neither the utilities nor their first upstream (owner) will ever incur," he wrote.[41]

Moody's Investors Service predicts this "disconnect" between the potential benefit to the utility's investors and the lack of any corresponding benefit to customers could "increase the risk of regulatory contentiousness" both in the short and long term.[42]



Kirk Baker, board chairman of the Sharyland REIT, has been credited with the original idea of employing a REIT in a utility setting.

The PUC's own expert on rate regulation, Darryl Tietjen, has estimated this non-existent tax expense at nearly a quarter billion dollars each year. He said this "substantial transfer of wealth from ratepayers to shareholders" would drive the company's regulated earnings to unacceptable levels. "If the Commission approves the transaction as proposed, other utilities in Texas will be strongly motivated to pursue similar conversions to REIT-based structures because of the tax benefits that will accrue to the utilities' shareholders," Tietjen wrote. For this reason and others, he urged the PUC to reject the Hunt proposal.[43]

AARP agrees. Captive Texas ratepayers should not pay a utility for non-existent federal tax expenses.

SPOTLIGHT CONCERN TWO

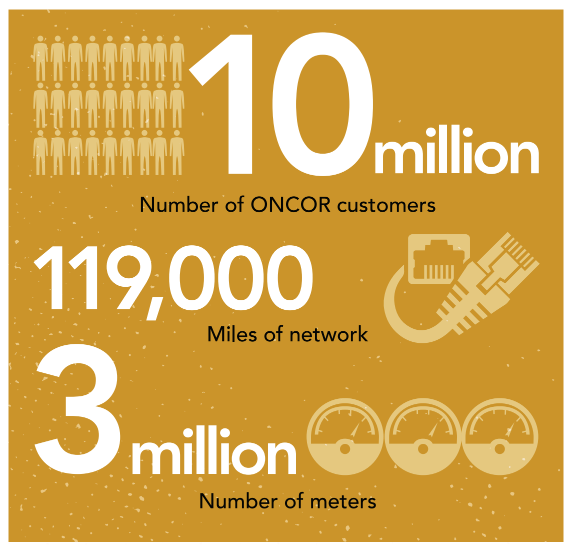
THE RING FENCE

- Billions in debt would remain with a restructured utility, placing pressure on electricity rates.
- The proposed ring fence lacks key protections.
- Creditors associated with the initial Energy Future Holdings bankruptcy would join in control of Oncor.

In the most general terms, "ring fencing" is a corporate strategy where a portion of a company's profits are held separate from the rest of the company—but without necessarily creating a separate corporate entity. Business owners sometimes pursue this strategy for tax purposes. But ring fencing plays a different role when employed by regulated public utilities. Instead of creating a tax shelter, a ring fence may be placed around a regulated utility to protect its captive customers from financial losses incurred by the utility's parent company—especially when those losses are the result of open-market activities.[44]

Such a ring fence was placed around Oncor in 2008, as a condition of the change of ownership during the TXU buyout. The ring fence was intended to protect Oncor and its ratepayers from the financial ups and downs of the utility's new parent company, EFH, and to assuage concerns from ratepayer organizations, municipal groups and others about the massive debt in the TXU buyout.[45] History has shown that those were valid concerns.

As part of the Hunt deal, the consortium would replace the existing Oncor ring fence with a new one. But key components of the existing ring fence would be discarded. Also, many of the same investors who lost money in the original EFH deal could become new owners of Oncor.[46] AARP fears these speculators lack the patience needed for long-term utility ownership,[47] which is all the more reason to maintain strong ring fence provisions.



The existing ring fence provided the utility and consumers important protections despite an otherwise flawed buyout. EFH assumed more than $40 billion in debt in that deal. Without the ring fence, rates could have increased to pay insistent creditors. And when EFH failed, Oncor could have been sold off piecemeal. Less debt is employed in the Hunt proposal, but sources of cash to service the debt also will be reduced.[48] Thus, the challenge Oncor will face servicing debt could increase pressure to raise rates. This is another reason why ring fence protections must remain strong.[49]

A recent U.S. Securities and Exchange Commission report from Oncor enumerates various existing ring fence protections. The first listed is the ownership of a 20 percent share of Oncor by outside investors.[50] According to Moody's Investors Service, the special corporate governance rights granted to these minority investors helped to insulate Oncor from the EFH bankruptcy. This key protection could disappear under the Hunt proposal[51] because the consortium seeks to acquire that outside investor share.[52] Moody's said that would constitute "a material dismantling of the strong suite of ring-fence provisions that helped insulate Oncor from its financially distressed parent."[53]

Economist Craig R. Roach, testifying on behalf of PUC staff, also found the Hunt proposal does not include basic corporate governance requirements included in the original ring fence.[54] He notes that the existing ring fence includes a prohibition against Oncor pledging any assets to support the merger financing,[55] and "this prohibition would be breached fundamentally" in the Hunt proposal.[56]

"The primary reason for restoring the 2008… ring fence provisions is that they worked," writes Roach. "Oncor maintained its investment-grade rating and continued to serve its ratepayers despite the fact that most or all of the other components of the original acquirer fell into bankruptcy… The Applicants have failed to make the case for replacing the Commission's successful protections with... new weaker ones."[57]

In a recent memo, Public Utility Commissioner Kenneth Anderson stressed the importance of a strong ring fence if Hunt takes control.[58] AARP agrees there's a paramount need for a strong ring fence. Unfortunately, the Hunt plan weakens the 2008 ring fence, creating unacceptable risk for ratepayers.

PUC RAISES QUESTIONS

The Real Estate Investment Trust proposal would place Oncor's lines and equipment into one company—sometimes referred to as the "AssetCo"—but leave Oncor's operations to a second company, referred to as the "OperatingCo." Under the REIT structure, the OperatingCo would lease lines and equipment from the AssetCo.

In a Sept. 24, 2015, memo to his fellow PUC commissioners, Kenneth W. Anderson raised a number of important questions relating to the interplay of the Energy Future Holdings bankruptcy, the company's massive debt and the AssetCo and OperatingCo components of the proposed REIT.

For instance, some unsecured EFH creditors likely would become partial owners of the REIT, and some "do not have a reputation of (being) either long-term or particularly patient investors," Anderson wrote.

So what happens if the OperatingCo fails to make a payment to the AssetCo? This could happen, for instance, if major storm damage temporarily interrupts the utility's revenue collections.

Oncor currently has the ability to react to such revenue losses by lowering dividend payments upstream to EFH. But, according to Anderson, it's unclear whether it can pursue that strategy under a REIT structure.

DID YOU KNOW?

The Texas Public Utility Commission has interpreted the public interest standard to require tangible and quantifiable benefits to customers, or at least requires that no harm now or in the future occurs as a result of the proposed Hunt transaction. PUC Commissioner Kenneth Anderson has said that under state law, the burden of proof is on the company. He has stated that the PUC should reject the deal if the company fails to meet that burden.

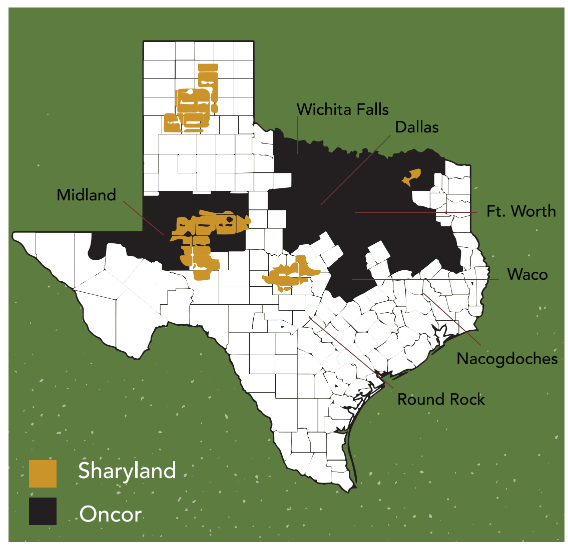
SPOTLIGHT CONCERN THREE

THE SHARYLAND EXPERIENCE

- Hunt has insufficient experience managing public utilities.
- Hunt's only other electric utility holding, Sharyland, charges some of the state's highest rates.
- Consumer complaints against Sharyland increased more than 800 percent during the 2015 fiscal year.

In 1999, Ray L. Hunt's son, Hunter, helped launch Sharyland, a South Texas power line utility. He continues assisting in its operations today.[59] The Hunt family's experience managing tiny Sharyland is insufficient, given the massive size of Oncor.

Sharyland is the state's smallest investor-owned electric utility,[60] while Oncor is the largest. Sharyland operates a power line network that is just one-tenth the size of Oncor's.[61] Its customer base just one-200th the size,[62] unlike Oncor, Sharyland operates in a largely rural area.[63]



The public record also shows deep dissatisfaction with Sharyland under Hunt's management. *The Dallas Morning News* has reported that Sharyland rates, which shot up by an average of 25 percent in 2015, are the highest in Texas.[64] The Texas Coalition for Affordable Power found that complaints against Sharyland rose more than 800 percent during a single year.[65]

State Representative Dan Flynn, in a letter to the PUC, expressed dismay that the state's largest public utility could end up in the hands of a company with a record of significant consumer complaints.

"I represent a large number of Sharyland customers… who are experiencing rate shock, and are having to choose between food and clothes for their families and oppressive rates," Flynn wrote. "The idea of selling Oncor to these same individuals is placing at risk (millions) more individuals … You have seen multiple examples of our concern and quite frankly, Sharyland has done nothing other than blame the Public Utility Commission for these rates."[66]

The mounting complaints prompted the PUC to open a special inquiry, a relatively rare move for the agency. "When you suddenly get 10 emails in a day, and it's just people looking for help, it raises a flag," Public Utility Commissioner Brandy Marty Marquez was quoted in a news article.[67]

The reliability of the Oncor system declined significantly after the EFH takeover in 2007.[68] Given Hunt's experience with Sharyland, Oncor's reliability could fall even further if the consortium takes control. The transaction could result in below-investment-grade credit ratings, a point that has been noted elsewhere. This could make it more difficult for the new owners to maintain safe and reliable service.[69]

Hunt has offered no regulatory commitments or financial assurances that it will maintain or improve reliability.[70] The risk to reliable service is an unacceptable defect in the consortium's takeover proposal

CONCLUSION

Our analysis of the financing structure proposed by investors seeking to acquire Oncor, and a review of the history of Energy Future Holdings, finds an unacceptable level of risk and uncertainty to ratepayers—and to AARP's more than two million members in Texas. These determinations lead to our recommendation that the Public Utility Commission of Texas reject the applicants' proposal, which is not in the interest of Texas electricity customers. Of particular concern to AARP is the vast number of consumers, an estimated 10 million Texans, who could be subject to higher utility rates. Additionally, if the utility monopoly should falter, these individuals could be subject to service interruptions. For older persons, the hazards could result in severe health problems. The applicants have failed to show that consumers will be adequately protected and potential harms mitigated.

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