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Docket No. UE-051090
Witness: Kenneth L. Elgin

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION
COMMISSION

IN THE MATTER OF THE JOINT
APPLICATION OF MIDAMERICAN
ENERGY HOLDING COMPANY AND
PACIFICORP DBA PACIFIC POWER
& LIGHT COMPANY FOR AN
ORDER AUTHORIZING PROPOSED
TRANSACTION

DOCKET NO. UE-051090

EXHIBIT TO
TESTIMONY OF

Kenneth L. Elgin

STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

*Article: Taking Utilities Private: Return of the Barbarians
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Business & Money

Taking Utilities Private: Return of the Barbarians

Experts debate whether KKR's leveraged buyout of UniSource Energy is right for the industry.

BY RICHARD STAVROS

WFrom a public policy standpoint, should a utility that provides a vital public good be owned by a private group that gains ownership by taking on a high degree of debt (risk)?

Mark T. Williams, executive-in-residence at the Finance & Economics Department at Boston University, identifies the quintessential issue that will no doubt be heatedly debated in boardrooms and commissions as more utility CEOs are tempted to become private utilities through a leveraged buyout transaction.

And tempted they will be.

Morgan Stanley estimates that the top 10 largest private equity groups seeking to invest in the sector have a total buying power of \$198 billion (*see chart 1, p. 25*). While this amount is for total investment in all business sectors, many experts say billions are being earmarked for utility industry investment even as significant amounts of private equity investment already have been spent (*see chart 2, p. 25*).

Moreover, Williams says, given that interest rates are currently at 40-year

lows, and utility sector debt spreads over risk-free treasuries have declined in recent months makes highly leveraged transactions more attractive.

In a typical leveraged buyout (LBO) a small group of investors, usually including current management, acquires a firm in a transaction financed largely by debt. The debt is serviced with funds generated by the acquired company's operations, and in some cases, by the sale of some of its assets. In other instances, the LBO firm plans to sell off divisions to other firms that can gain synergies. The acquiring group expects to make a profit from the LBO, but the inherent risks can be great due to the heavy use of financial leverage, according to a textbook definition. LBO specialists are quick to point out that the amount of financial leverage in recent deals has been much lower than in the past.

Putting it another way, leveraged buyers in the last few years have faced less-favorable terms. For example, in the last three years LBO firms parted with equity worth an average 41 percent of the deal price, according to a Standard & Poor's report. This is a significant change from the 10 percent equity that defined the typical 1980s LBO.

Certainly, many industry insiders disagree over whether the heavy use of financial leverage would pose any risk to utilities, which as a matter of historical record have always been highly leveraged, capital-intensive businesses. Furthermore, they say the capital structure of a utility is but one of many considerations a regulator makes to determine if an acquisition is in the public interest.

But other criticisms come down to trust. Can the so-called "barbarians at the gate" be trusted?

Some utility executives have raised concerns over the possibility of holding-company abuses by private equity groups that haven't been raised since the 1930s,



when such abuses were terminated by the passing of the 1935 Public Utility Holding Company Act (PUHCA). Conversely, proponents of LBOs say that private or public ownership has little to do with corporate abuse, pointing out that corporate scandals in the last few years came largely from publicly traded companies such as Enron.

Moreover, other critics heatedly complain that private equity firm support for a utility could dry up after privatization when interest rates increase, causing a liquidity crisis. "While existing company debt will have been refinanced at lower rates in conjunction with the LBO, private equity firms will be harder pressed to raise more money as interest rates rise and thus will constrain the utility's access to capital," says one analyst. Private equity proponents respond, "We always have access to public equity markets and can take the company public again in order to raise capital in the public markets." Furthermore, "The company will continue to have access to public debt markets and can go back to their private equity sponsors for additional equity if needed," argues another LBO expert.

So why a private equity investor in a high-interest-rate environment would continue to leverage its acquisition or provide equity at a higher cost of capital, when such an investment fails to outperform treasuries is anybody's guess, queries one.

Fairly or unfairly, private equity investors using heavy financial leverage to acquire companies have raised debate in almost every industry where such transactions have been introduced. The focus of the concern has always centered on implementation. The utility industry is no different. If anything, experts say, private equity groups will be more heavily scrutinized because of the high degree of regulatory oversight over utilities involved in protecting the

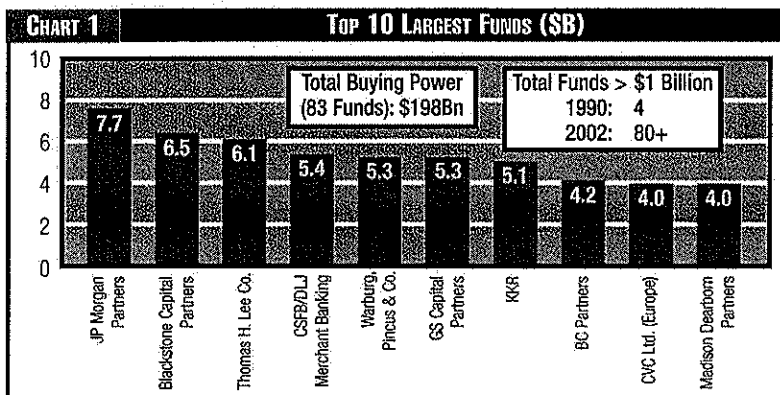


CHART 2 PRIVATE EQUITY INVESTMENTS IN INTEGRATED UTILITIES

Transaction	Agg.	Equity
KKR, JPM, Wachovia / UniSource (2003)	\$2.9Bn	\$0.8Bn
TPG / Portland General (2003)	\$2.4Bn	-
KKR / DPL Inc. -19.9% Stake (2000)	-	\$0.5Bn
Laurel Hill Capital Partners / TNP (1999)	\$1.1Bn	\$0.6Bn
Berkshire Hathaway / MidAmerica (1999)	\$9.0Bn	\$2.0Bn

public interest.

That is why the LBO by Kohlberg Kravis Roberts & Co. (KKR) and its investor group purchase of Arizona-based UniSource Energy, parent company of regulated utility Tucson Electric Power, is a good test case to debate whether, and in what circumstances, the LBO structure may or may not be appropriate for the utility industry from a business and policy perspective.

The KKR Deal: The Art of Going Private

On Nov. 24, 2003, the board of UniSource Energy accepted an offer to acquire the company from a private investor group that includes KKR, J.P. Morgan Partners LLC, and Wachovia Capital Partners as limited partners, plus general partner Sage Mountain L.L.C, an Arizona company owned and managed by Frederick B. Rentschler, a former corporate CEO. The approximate \$3 billion transaction would leave UniSource Energy's senior management team in place, and the company's headquarters would remain in Tucson. This transaction will be financed with

approximately \$560 million of partner equity and \$660 million in new debt. The leverage added to UniSource from the deal causes the company's debt on a consolidated basis to exceed 80 percent, according to analysts.

"Ironically, while other industry players such as Duke Energy and El Paso are shedding debt as quickly as possible, here is an example of a strategy that embraces debt to achieve an objective," says Boston University's Williams. A private equity specialist adds that an appropriate level of debt can impose a discipline on companies to remain more focused on their core business rather than divert capital and management resources into unrelated businesses.

Still, Williams says the real test will be how this company will be able to become profitable, given that it is financing \$970 million, including new debt of \$660 million.

"While the purchase price is approximately \$885 million in cash to shareholders plus assumed debt, total consolidated debt will exceed \$2 billion. To meet these debt payments, any additional income generated will have

to come from the cost side, not the revenue side, as utility rates are highly regulated. Additionally, costs related to plant and line maintenance are closely scrutinized to ensure that adequate capital is spent for reliability.

"In a sense, the fact that existing management has not been successful in turning this company around, as measured in stock performance, the LBO is at least acknowledgement that radical changes needed to occur. Shareholders are now able to cash out at a premium and reinvest their money elsewhere," Williams says.

Daniel More, head of utility M&A at Morgan Stanley, who advised Unisource Energy on the deal, says it was precisely because the company was not being paid attention to in the public equity markets that privatization is a compelling alternative.

"Let's face it; Wall Street research is getting to be harder and harder to come by. Mid-size to smaller utilities are often not covered by any sell-side analysts. It's also difficult to have adequate trading liquidity in the stock of such companies, both of which contribute to lack of institutional investors' interest. With lack of interest in your stock, if you don't have clear avenues for growth, you start to think about the world out there and potential pools of capital. There is public equity and there is private equity," More says.

Furthermore, many advocates of the deal point out that it strengthens the capital base of the company's regulated utility. But opponents point out that the leverage is moved from the utility subsidiary to the holding company. "KKR is not putting equity into the utility out of the goodness of their hearts. They're providing that equity to overcome restrictions on the dividend amount paid to the holding company to further leverage the holding company," says another.

The equity that will be attributed to Tucson Electric Power Co. (TEP) is \$260 million, including the retirement of a \$95 million inter-company loan from TEP to UniSource Energy. According to Kevin P. Larson, vice-president, CFO, and treasurer of UniSource Energy, "The Arizona Corporate Commission limits dividends (from TEP to UNS) to 75 percent of TEP net income if TEP equity is less than 40 percent of total capitalization (excluding leases). Today TEP's equity represents approx 25 percent of capitalization per Arizona Corporation Commission calculation. Following the merger it is anticipated that TEP equity will be equal to or greater than 40 percent. At that point, TEP could pay 100 percent of net income as a dividend, provided no other restrictions exist," he says. At press time, the application to the Arizona Corporate Commission for the acquisition of UniSource Energy by KKR had not been filed, neither had the proxy statement, but both were expected sometime in early February. However, a notice of intent has been filed, and the company said all documents would be available on the UniSource Energy Web site (www.unisourceenergy.com).

KKR executives say the deal is predicated on no change to UniSource Energy's current business model or rate structure, and KKR does not intend to make any changes that jeopardize reliability or its relationship with regulators.

"Our business model is not in this context to cut costs. You don't make any money at a utility by cutting some costs around the edges. For us, this is all about putting a large amount of capital to work for a long period of time at a reasonable rate of return. The reasonable rate of return comes from just earning your regulated return and then putting an appropriate financial structure in place," says Marc S. Lipschultz, partner at KKR.

"I think the only risk is that we as investors do not make an acceptable return. There is no downside for the customers of this company because as part of this transaction we are actually infusing equity in TEP for them to pursue their goals in providing good customer service and reliability. And they have a rate freeze, so there is no change to rates. There is only an upside for customers and ratepayers," he says.

Furthermore, Lipschultz adds that KKR will not be a fly-by-night operation, which buys out the company, carves up the pieces, and sells the parts for more than the whole.

"Our average hold period is seven to eight years. We have held some businesses as long as 15 years. We think a portion of our portfolio can be in lower risk and lower return utilities. ... If one takes a very long and steady view and really understands the sector, we think there is really good fit between our kind of capital, which is long-term patient capital, with the needs of the energy sector," he says. But while no one may doubt KKR's good intentions, some regulators, who asked to remain anonymous, are concerned over whether the amount of leverage being used is appropriate, even as other regulators say ring-fencing laws make the question irrelevant.

Leveraging Up to the Nose: The Great Debt Debate

Even as KKR presents a very conservative approach in its future ownership of the utility, the company's use of heavy financial leverage still leaves many regulators and financial analysts uneasy. One banker, using public data, forecasts KKR's levered return on total invested capital to be as high as 18 percent (*see Box, p. 27*). While a private equity specialist familiar with the deal says the base-case return will be 16 percent.

Some argue that the forecast of almost 16 to 18 percent return that

THE KKR/UniSource ENERGY LBO:

THE FIVE POINTS OF THE DEAL

An anonymous Wall Street investment banker breaks down the important points of the deal for *Fortnightly* readers and analyzes how much KKR stands to gain. A source close to KKR confirms his analysis (see box).

1. On Nov. 23, 2003 UniSource announced that it had agreed to sell to an investor group (a partnership called Saguario Acquisition Corp.) including KKR 62 percent, J.P. Morgan Partners 31 percent and Wachovia Capital 7 percent. The General partner is Sage Mountain LLC, owned by Frederick Rentschler, a long time KKR associate formerly associated with Armour-Dial, Beatrice and Northwest Airlines.
2. The transaction is priced at \$25.25 per share, for a total equity value of \$880 million and assumed debt of approximately \$2.1 billion. Total enterprise value is approximately \$3 billion. KKR's motivation for the deal was, among others: (i) the company was a small-cap utility with no research coverage and limited public market support; (ii) Arizona is a good load growth region; (iii) TEP has balanced, low-cost generation; (iv) there was significant noise around the Millennium investment; (v) the markets appear receptive to the transaction.
3. The sources of capital for the \$880 million of equity will be \$557 million of equity from the sponsors and the balance new notes (\$300 million) and bank debt (\$360 million). The balance of the debt will be used to fund a contribution of \$260 million of equity capital to TEP, which will be used to repay an intercompany note and bring the equity ratio of TEP to 40 percent, which is the target set by the ACC. This is intended to attract support from the regulators. This also will result in incremental leverage at the holding company while de-leveraging the utility.
4. The transaction is subject to a number of closing conditions including, among others: (i) ACC approval (apparently the standard is no adverse impact to customers); (ii) no material adverse change, which includes a significant adverse rate case; and (iii) obtaining the incremental holding company financing. The rate case and ACC approval are expected to be taken together in June. There is a \$25 million breakup fee.
5. The acquisition is at a trailing multiple of 8.6x EBITDA. However, the run rate multiple of EBITDA is closer to 6.5x, representing a run rate EBITDA of approximately \$400 million to \$425 million, versus LTM EBITDA of \$313 million as of 9/30/03. The variance is largely a result of the synergies associated with Citizens acquisitions, which continue to come

SHEDDING LIGHT ON THE BLACK BOX: KKR RETURN ON INVESTMENT

	Run Rate Numbers	LTM Numbers
Income Statement		
EBITDA	\$410	\$313
Depreciation	(151)	(151)
EBIT	259	162
Interest Expense*	170	170
Pretax Income	89	(8)
Taxes	35	3
Net Income	54	(5)
Cash Flow		
Net Income	54	(5)
Depreciation	151	151
Capex	(101)	(101)
Cash Flow	104	45
KKR Equity Investment	557	557
Run Rate Cash/Cash Return	18.6%	8.1%

*assumes 7% on incremental \$660 million

- on line. The Springerville plant also represents \$0.30 per share of upside, but it will not be on line until 2006. There are some cash and financial assets on the balance sheet which reduce the effective debt by \$200 million to get to the 6.5x.
6. Holding Company Leverage - While there is an additional \$660 million of holding company leverage, half of which is being contributed to TEP as equity and the other half used to acquire the public equity, the Partnership acquiring the entity is not expected to itself be leveraged. While this would increase the equity returns, there is a perception risk that would have a negative impact on the regulatory oversight/approval process, which will include both FERC and the ACC. Given KKR's commitment to the utility sector, they would have a lot to lose by hiding leverage on the structure.
 7. There are several sources of upside that KKR will rely on: (i) additional leverage on the structure; (ii) the realization of cost savings initiatives from the Citizens deal; (iii) savings from the elimination of public company costs; (iv) synergistic add-on acquisitions; and (v) a very good load growth region in Arizona.
 8. The existing \$2 billion of debt - The debt is expected to be rolled. There is not a change of control at the utilities. Therefore, the utility debt (which is currently where the debt resides) is not implicated. Only this transaction is putting debt at the holding company.
 9. Return analysis - The returns don't appear to be as poor as one might think. If the run rate EBITDA is really over \$400, it appears that the cash on cash return to the equity, including the benefit of the holding company leverage, could be close to 20 percent without the benefit of any acquisition vehicle back leverage.

KKR will receive could be a "windfall." Others point out that the returns forecasted are not guaranteed, and that KKR will always live with regulatory risk.

Branko Terzic, global regulatory policy leader for Energy & Resources at Deloitte and a former FERC and Wisconsin state commissioner, says that

the regulator always has the ultimate regulatory tool: the power to reduce rates if he or she feels there is abuse. Furthermore, he believes that regulators should

be primarily focused on the regulated utility. "Most LBO entities are not expert operators: They are financial investors. The regulator doesn't care if you mortgaged your house to buy shares in the regulated utility, or whether you inherited your stock from your grandfather Rockefeller. How you financed the stock that you purchased is irrelevant to the regulator as long as the equity structure of the [regulated] utility is appropriate," he says. "There is, of course, the issue of 'control' when a single stockholder owns the utility, but once again the regulator in most states has a full array of regulatory tools to protect the public interest."

Jim McGinnis, managing director at Morgan Stanley, says that targeted returns in the order of 20 percent are anything but guaranteed, especially as there is more to worry about than just the regulator.

"The regulator might be motivated by perceived excess leverage to reduce rates, but negative regulatory impact can come from other sources: a serendipitous change of rulemaking framework on the timing of recovery of fuels, the pricing of fuel inputs, the willingness to extend rate freeze agreements or engage in prospective rate stabilization discussions. So, regulatory rate actions are not only linked to excess leverage," he says.

Furthermore, debt is not necessarily a bad thing, McGinnis says, explaining that regulators often encourage added leverage at the regulated utility level in an effort to lower the cost of delivering electricity to customers who otherwise might have been charged a higher amount.

"The concern dating back to the 1930s was that if a holding company used excessive leverage, there was the potential for undue risk being shared by the utility that was not apparent to the local regulator. And this heightened risk of financial distress at the parent was a

burden that the utility was inherently bearing, completely outside the scope of regulation. This extra-jurisdictional risk was one of the primary reasons why the federal government began regulating

If anything, say experts, private equity will be more heavily scrutinized. But others fear what may happen when interest rates rise.

holding companies. In today's market, we have effective structuring techniques applied to today's ring-fenced utilities that are protective and which ensure against that kind of credit deterioration from above, and investor constituencies—lenders and shareholders—who carefully monitor these inter-creditor issues," McGinnis says.

Some regulators council that if KKR or any other highly leveraged company is perceived to be taking advantage of the regulated utility and earning a "windfall," the double leverage standard may be applied. Double leverage is the use of debt by both the parent company and the subsidiary, in combination with the company's equity capital, to finance the assets of the subsidiary. The purpose behind the double leverage adjustment is to account for the parent's accessibility to lower cost debt to purchase equity in its subsidiary, upon which it may earn a higher rate of return than it pays for the debt.

Alliant Energy's Interstate Power & Light and MidAmerican Energy, which itself was taken private, recently protest-

ed the use of double leverage by the Iowa Utilities Board. Nevertheless, the board agreed with consumer advocates that it is the best approach to recognize the true capital structure at the subsidiary level, and to prevent the parent company's stockholders from earning a "windfall," or excessive returns at the expense of ratepayers. "The Board sees no reason on this record to disavow the application of double leverage in all instances. Double leverage is one regulatory tool to help protect the utility from abuse by its parent company," the Iowa Utility Board wrote recently. But the use of double leverage has always been a source of controversy in regulatory circles.

Additionally, many have pointed out that the KKR deal with UniSource Energy has a material adverse change (MAC) clause, which nullifies the deal if there is a change to the business or to rates. This result may not be likely to occur.

Heather Murphy, public information officer at the Arizona Corporation Commission, says as far as TEP's rates are concerned, "the commission's decision on electric competition and subsequent settlement with Tucson Electric Power ushered in a two-step rate decrease—one percent in 1999 and one percent in 2000. Thereafter, TEP's rates are locked in at the current tariff levels until after Dec. 31, 2008. If the company seeks a change in rates or rate structure to take effect after Dec. 31, 2008, TEP would have to file a rate case in late 2006 or early 2007."

Of course, the KKR MAC clause expires when the deal is consummated. "Regulatory risk will be a part of their life," says one. Of course, some regulators say there may be benefits to dealing with one owner.

"A rational, individual regulator might well decide that it is preferable to be negotiating with one rational, economically motivated counterpart,

rather than a board and management team working on behalf of 10,000 disparate shareholders. But regulatory bodies are groups of individuals, and these groups have their own historic, institutional biases. It's harder to apply the Rational Man rule. These institutional relationships are difficult to suddenly change in a dramatic way," says McGinnis. As such, he says, LBOs will not be for every utility, and the relationship with regulators may be at the heart of any deal.

"Companies that are weaker candidates for an LBO include some utilities that have relatively uncertain regulatory horizons, and, in particular, utilities that have had a difficult relationship with regulators. On the other hand, under some circumstances, utilities that are in the midst of difficult regulatory relationships can improve their circumstances through the introduction of new senior management that may be able to adopt a fresh perspective and do a better job of interacting with regulators in a constructive way than past management. It's not a forgone conclusion that weaker regulatory relationships would rule out an LBO, but it is certainly the first touch point," McGinnis says.

Can 'Ring-Fencing' Protect Ratepayers From Risk?

Some believe that regulators should not concern themselves with the leverage at the holding company, and instead operate on the assumption that the regulated utility is ring-fenced and thus, perfectly insulated from the troubles at a holding company. Many often point out that the bankruptcy of Enron did not have a significant impact on utility subsidiary Portland General Electric because of tight ring-fencing measures.

But credit rating agencies caution regulators from overconfidence in the structural separation at the utility.

Fitch Ratings, in a meeting with state regulators last year, said there is no perfect ring-fence that can completely insulate a utility. According to Fitch, companies have an inalienable right to force a subsidiary into bankruptcy. A company cannot waive this right, according to the general counsel at Fitch. The National Association of Regulatory Utility Commissioners' (NARUC) Subcommittee on Accounting and Finance last year investigated the issue of ring-fencing in an attempt to identify best practices.

According to its analysis, the NARUC subcommittee found that "the regulator might also be proactive in encouraging a properly structured package of ring-fencing enhancements in any acquisition. That is to say, the regulatory entity might require the insertion of a special purpose entity between the utility and the holding company, structured in a way that reduces the risk to the utility... This could also require tightly drafted set of covenants subject to commission review."

Moreover, according to a presentation to the NARUC subcommittee, Standard & Poor's named three states that they believe have adequate regulatory insulation mechanisms. Of those states, Wisconsin, Oregon, and Virginia, the report noted that the first two rely upon state statutes for their regulatory insulation. The third relied on conditions in a merger that indirectly is dependent upon state authority over mergers.

The NARUC subcommittee suggests several ring-fencing measures (some are more strenuous forms of others):

1. Commission authority to restrict and mandate use and terms of sale of utility assets. This includes restriction against using utility assets as collateral or guarantee for any nonutility business.
2. Commission authority to restrict

dividend payments to a parent company in order to maintain financial viability of the utility. This may include, but is not limited to maintenance of a minimum equity ratio balance.

3. Commission authority to authorize loans, loan guarantees, engagement in money pools and large supply contracts between utility and affiliate companies.
4. Commission authority over the establishment of a holding company structure involving a regulated utility.
5. Expand commission authority over security applications to include the ability to restrict type and use of financing.

Panos Ninios, associate principal at consultants McKinsey & Co., says, "Whether a regulator should approve an LBO transaction really depends on the company he or she is dealing with. An LBO is valuable only if the regulator and the company can negotiate an equitable distribution of value creation between customers and shareholders."

As far as the capital structure at the utility, Ninios says, "There is no magic debt/equity ratio for regulated businesses. What is appropriate is defined by the risk/return of the regulator and the shareholders. Assuming you know what this ratio is, you need to review the balance sheet and you also need to look at the contractual obligations of the regulated utility. You need to know how it buys and sells power and fuel. Furthermore, you need to evaluate its industrial customers, which could go bankrupt. Regulators really need to understand commodity exposure because that drives how you want to structure your balance sheet." □

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