

# Memorandum

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To: Energy & Telecommunications Interim Committee

From: PSC

Date: October 31, 2003

Re: Ring fencing – statutory authority

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## **Background**

According to Sharon Bonelli of Fitch Rating Service, “ring fencing,” is defined as methods used to separate regulated utilities from the risks of their holding companies and their non-regulated affiliates. These methods include putting limits on dividends, on intercompany loans, and on inter-affiliate transactions. Ring-fencing restrictions can be put in place by utility regulators through a company’s contractual agreement, bank credit agreements or bond indentures, or company policies. The thoroughness of these measures helps determine if various constituents within a corporate group are viewed as one consolidated entity with identical debt ratings for issues of the same seniority or, alternatively, if the ratings for the various constituents within the group are “notched,” (e.g. different ratings are assigned for different issuers in the same group.)

If a company moves down the rating scale, and therefore is viewed as having a higher probability of default, Bonelli noted, the quality of the utility’s ring fence becomes increasingly important. A bankruptcy filing puts these efforts to the test. The lack of an effective fence raises the likelihood of substantive consolidation in bankruptcy.

Bonelli cited Portland General Electric as an example of a company with a strong ring fence in place. Portland General has a senior secured rating of BB+ despite the insolvent status of its derated parent, Enron. This is a nine-notch difference in rating. The Oregon Public Utility Commission used ring-fencing techniques when the commission placed restrictions on Portland General as a condition to approve its merger with Enron. Among other things, the Oregon PUC said that Portland General may not make dividends to Enron that would cause its equity-to-capital ratio to fall below 48 percent. While the PUC’s objective was to protect the ratepayers, a side effect was to protect the creditors of Portland General. Organizationally, Bonelli notes that Portland General did many of the right things: it maintained operations in its own name and was organized as a separate subsidiary of Enron; it maintained separate books and records from Enron; it has its own officers; and it did not commingle cash or assets with Enron. In terms of contractual ring fencing, Portland General has restricted dividends. All these efforts justified a material difference in the ratings of Enron and Portland General. But despite these efforts, as well as Portland General’s healthy earnings and sound operations, the ratings are mostly, but not completely, de-linked. Portland General’s financial flexibility is still constrained by its status as a subsidiary of Enron.

Dynergy is an example of a company cited by Bonelli that lacks an effective ring fence. All the issuers in the Dynergy family have a senior unsecured rating of CCC+. The reason their ratings are equal is that Dynergy has a large inter-company loan with very circuitous repayment among three Dynergy entities: Villanova, Illinois Power and Dynergy Inc. They also have various functional ties. Fiscally, the entities would be difficult to unscramble, so there is no notching among the ratings. This demonstrates how the presence of a single large unifier complicates other ring-fencing efforts that may have been made.

Certain state regulators as well as the Federal Energy Regulatory Commission are becoming more active in making sure ring fences exist for utilities they oversee. In February, the FERC issued a new policy for utilities seeking approval to issue debt that reflects its new focus on protecting the assets and finances of utilities. Basically, public utilities seeking authorization to issue debt secured by utility assets must use the proceeds for utility purposes only. If assets are divested, associated debt, whether it be secured or unsecured, must follow the assets.

### **Montana situation**

At the request of the Montana Consumer Counsel, the PSC opened a docket in August 2003 to investigate NorthWestern Energy's (NWE's) financial and related transactions with NorthWestern Corporation and its affiliates and creditors as those transactions may impair NWE's financial solvency and utility service obligations. As part of the investigation, the PSC will consider imposing these ring-fencing remedies that were proposed by MCC:

- ?? The reversal of such inter-company and inter-affiliate transactions involving NWE or assets of NWE as the PSC may find to have operated, or to be operating, to the detriment of NWE's ability to provide safe, reliable and adequate utility service at just and reasonable rates.
- ?? The incorporation of NWE as a separate, utility-only subsidiary of NorthWestern Corp. in order to facilitate the PSC's oversight of NWE's operations and the prevention of future dissipation of assets dedicated to the public convenience and necessity.
- ?? The adoption of specific cost allocation processes, procedures and manuals for use by NWE.
- ?? The adoption of principles governing current and future financing involving assets of NWE including:
  - Authorization to issue debt that is secured by utility assets must use the proceeds of the debt for utility purposes only;
  - If any utility assets that are pledged or encumbered to secure debt issuances are divested, the debt must follow the assets and be divested as well;
  - If utility assets financed by unsecured debt are divested to another entity, then a proportionate share of the debt also must be divested;
  - If assets financed with unsecured debt are divested, the associated unsecured debt must follow those assets. Specifically, if any of the proceeds from unsecured debt are used for non-utility purposes, the debt likewise must follow the non-utility assets and if the non-utility assets are divested, then a proportionate share of the debt must follow the associated non-utility assets by being divested as well.

In response to the ring-fencing remedies proposed in the PSC investigation, NWE argued that, while the PSC has the authority to supervise and regulate the business of a public utility and may investigate a utility's financial condition, the PSC does not have the authority to order the ring-fencing remedies that are being considered. NWE cited as support for its argument the Montana Supreme Court decision in *Montana Power Company v. Public Service Commission*, 206 Mont. 359, 376, 671 P.2d 604, 613 (1983).

The PSC might respond by pointing to the success of the Kansas Corporation Commission, which ordered a utility in its jurisdiction (Westar) to implement similar ring-fencing methods as are being considered by the Montana PSC in the NWE investigation. The Kansas commission had no express statutory authority to order ring-fencing, but relied instead on its general supervisory powers to take action.

The issue of whether or not the PSC has authority to direct ring-fencing techniques to insulate a regulated utility from the risks of a distressed parent corporation and/or its affiliates would be resolved if express statutory authority was provided. While not a cure for the troubles of the utility industry, ring-fencing legislation could go a long way to keep otherwise financially stable utilities from being dragged down by the financial woes of their affiliated, unregulated companies. If a utility is successfully sheltered from its distressed affiliates, the utility's assets and operations will be preserved for the benefit of its customers and creditors.

#### **Key element of ring-fencing authority**

Express statutory authority should broadly provide that the PSC may, based on a record, establish requirements for the corporate and financial separation of an individual regulated public utility company from businesses that are not regulated public utilities in order to ensure that the actions of corporate affiliates have no material negative impact on the financial integrity of the regulated public utility or its customers.