

The Financial Impact on the Regulated Utility From the Activities of Unregulated Affiliates

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PURPOSE

- The purpose of this paper is to examine the financial impact on regulated utilities from the businesses of affiliated marketers and generators.
- Concerns about diversification into unregulated business are not new.
- In modern times, the debate of diversification (or not) started in the early '80's and has been addressed by the then (and still) utility luminaries.
- The problems of Pinnacle West, and others, kept the debate going.

Generic Regulatory Concerns Regarding the Financial Distress of an Affiliate of a Regulated Utility

- The financial distress of an affiliate may significantly and adversely affect the parent's financial integrity.
- The financial distress of the parent may:
 - affect the regulated utility's ability to borrow and its cost to do so;
 - provide an incentive to divert resources (cash) to the parent which would, over time, reduce quality of service;
 - reduce expected and future equity infusions for the present thus negatively impacting the utility's debt/equity ratio and ability to undertake needed construction/maintenance.
- The financial distress may give the supervising Commission a Hobson's Choice in ratemaking-- if it disallows the utility's actual cost of money, it may exacerbate the utility's financial condition.

Scope of Review

- The rapid decline of the Generating and Marketing businesses had its start with the bankruptcy of Enron.
- Since it is so recent, the true impact may not be seen for some time. In order to determine whether there has been a near-term impact, we have reviewed:
 - Selected financial data of the parent and regulated utility
 - Net income, cash flow, dividends, debt/equity ratio
 - Ratings from rating agencies
 - Analyses from stock analysts
- We have also reviewed selected state regulatory decisions and filings before and after the Enron bankruptcy and their effectiveness in “ring-fencing” the regulated utility.

Companies Reviewed

- With the exception of Westar, all of the companies reviewed are (or were) engaged in businesses which were in their area of expertise (generation and marketing in the United States and abroad).
- Marketers/Generators With Regulated Subsidiaries
 - AES - IPALCO/Indianapolis Power & Light
 - Dynegy - Illinois Power
 - Enron - Portland General Electric

continued

Companies Reviewed

- Utilities Directly Engaged in Unregulated Activities
 - Aquila
 - Westar
- Public Utility Holding Companies with Regulated Subsidiaries
 - AEP
 - Allegheny
 - Xcel
 - Constellation
 - Dominion
 - PSEG

continued

AES

Overview

- AES has been spending significantly more than its internally generated cash over the last two and one-half years.
- Its equity has declined from December, 2001 to September 30, 2002 by over 50% from \$5,542B to \$2,413B.
- Its equity ratio (not including non-recourse debt) has declined from 35% to 30%.
- Its ratings have dropped significantly below investment grade from BB in 2000 to a B+ in 2002.
- Indianapolis Power and Light (“IPL”) is the regulated utility acquired in 2000 when AES purchased IPL’s parent, IPALCO.

INDIANAPOLIS POWER & LIGHT

Overview

- Since January 2000, IPALCO (the immediate parent of IPL) has sent over \$990m to AES in dividends and distributions.
- IPALCO's capital structure is 96% debt, 4% preferred stock and a negative <\$7M> equity balance; IPL is truly leveraged.
- For the two years 2000 and 2001 (2002 not available), IPL's dividends to IPALCO of \$277m exceeded its earnings of \$174m.
- IPALCO's ratings have dropped from AA- to BB since 2001.
- IPL is at the lowest Fitch investment grade.

AES/IPL

State Regulatory Review

- No jurisdiction by the Indiana Utility Regulatory Commission (IURC) to approve AES' acquisition of IPALCO (IPL).
- Indiana Legislature debating giving the IURC jurisdiction over the acquisition of a holding company with utility subsidiaries.
- No reports of any IURC investigation of IPL/AES – but

Dynegy Overview

- As with AES, Dynegy investments have greatly exceeded its internally-generated cash flow over the last two and one-half years.
- Its combined equity/preferred ratio to debt has declined from 52% to 42% over that same period, mainly due to a \$2.165B loss in the nine months ending September of 2002.
- Its ratings have dropped from BBB+ in 2001 to B in 2002.

Illinois Power Overview

- Illinois Power's dividends to AES have been in line with its earnings during 2000 and 2001, and have been minimal for 2002.
- Its Common Equity ratio has increased from 36% at year 2000 to 41% at 9/30/02.
- IP's bond rating has fallen from BBB+ to B (S&P) and Baa1 to B3 (Moody's).
- Illinois Power has been affected by Dynegy's financial difficulties.
- "Due to our relationship with Dynegy, adverse developments or announcements concerning Dynegy have affected and could continue to offset our ability to access the capital markets and to otherwise conduct our business." *3rd Quarter 2002, 10Q*

Illinois Power Overview

- Issued \$550m of mortgage bonds yielding approximately 11.8% in December 2002.
- Dependent on an unsecured note from direct parent Illinova of approximately \$2.3B resulting from transfer of generating assets. There is a resulting mismatch between Illinois Power's capitalization of \$3,329m and its net utility plant of \$1,940m.
- Selling transmission assets for approximately \$180m subject to regulatory approval -- will use proceeds to pay down debt.

DYNEGY/ILLINOIS POWER

State Regulatory Review

- After Dynegy's financial difficulties, ICC approved a netting agreement between IP and its affiliates, the potential repurchase of IP preferred stock from Illinova and a restriction on the payment of dividends until it achieves investment grade ratings. (ICC Order, October 2002)
- IP's consent to restrictions appears to have been driven by prospective bond holders.

PORTLAND GENERAL

Overview

- The dividends paid to Portland General are within an appropriate payout ratio given its earnings. In fact, this year (9/30/02) its dividends to Enron are negligible.
- Its equity ratio has held over the last two years, dropping only from 55% to 52%.
- PGE's S&P ratings have remained at investment grade while Enron's are at the lowest end of junk (D-). PGE's most recent 8-K discloses a rating downgrade to "negative," with the market increasingly concerned about its role in the Western Markets investigations.
- PGE is being sold.
- What is remarkable is that it has been able to maintain an investment grade rating.

ENRON/PORTLAND GENERAL

State Regulatory Review

- Enron's acquisition of Portland General was approved by the Oregon PUC with significant conditions:
 - Must maintain LTD and preferred stock ratings;
 - Must maintain a common equity ratio of 48% or more;
 - Must notify Commission of dividends and distributions to Enron;
 - Must maintain service quality.
- Oregon PUC retains on-going oversight of PGE's activities.

AQUILA Overview

- The consequence of Aquila's rapid expansion into, and attendant losses from, unregulated energy trading operations were profound. In June 2002, Aquila announced it was abandoning entirely its energy trading operations, and launched an aggressive asset divestiture program with a goal of raising \$1B to reduce debt and ease its access to capital.

continued

AQUILA Overview

- The rapidity of Aquila's financial decline is worthy of note:
- Return on Average common equity for 2001 was 11.7 percent ... 2001 was one of our two best years in the past ten. *Annual Report to Shareholders 2/28/02 ("AnRep")*
- Our expectations for performance both internally and externally have never been better. **(AnRep)**
Versus
- Earnings for the nine months ending 9/30/02 were negative \$1.097B. *(3rd Quarter 10Q 2002 ("10Q"))*

continued

AQUILA Overview

- Our credit rating remains at investment grade. We are firmly committed to keeping that way. *(AnRep)*

Versus

- Further downgrades of our credit ratings (Moody's downgrade was in September) below investment grade will increase our interest costs and adversely affect our liquidity. *(10Q)*
- *Several days later the downgrades occurred; there may be more.*

continued

AQUILA Overview

- Our systems and procedures for monitoring and controlling risk are recognized as among the best in the business. *(AnRep)*

Versus

- Our commitments under long-term gas delivery contracts will generate significant losses and negative cash flows for their term. *(10Q) and*
- Based upon current power prices our obligations under contracts will result in significant losses and negative cash flows for an extended period of time. We are not anticipating improvements in power prices for at least three years. *(10Q)*

continued

AQUILA Overview

- Our fundamental strategy is to manage our risk and transfer it to the capital markets. *(AnRep)*

Versus

- We are exposed to market risk on open positions on trading contracts, which may cause us to realize gains or losses. *(10Q)*

continued

AQUILA Overview

- Our acquisition of Midlands Electricity in England (expected to occur in late March) will make this a very different company. *(AnRep)*

Versus

- We may not be able to obtain attractive prices for planned asset sales (including Midlands which is on the block). *(10Q)*

continued

AQUILA Overview

- About two-thirds of our projected earnings this year will be from energy merchant and risk management activities and from international network operations. **(AnRep)**

Versus

- Aquila has written off most of its merchant business and is exiting the trading business to return to a traditional utility. **(10Q)**

continued

AQUILA Overview

- Aquila is ideally situated to take advantage of today's increasing convergence of the capital, commodity and insurance markets. *(SL)*

Versus

- Our ability to access the capital markets is substantially curtailed. *(10Q)*

continued

AQUILA Overview

- At the end of December 2001, Aquila's ratings were:

| | |
|---------|------|
| Moody's | Baa3 |
| S&P | BBB |
| Fitch | BBB |
- February 2002, Fitch downgraded Aquila to BBB-.
- September 2002, Moody's downgraded Aquila to Ba2. Aquila had to pay \$192 associated with financial triggers. Interest rate on \$500m of senior notes due 2012 increased from 11.875% to 13.125%. Interest on \$250m of senior notes increased from 7.95% to 8.70%.

continued

AQUILA Overview

- November 19, 2002, S&P downgraded Aquila to BB from BB-. The interest rate on the \$500m of senior notes increased from 13.125% to 14.375%. The interest rate on the \$250m senior notes increased from 8.70% to 9.45%.
- Credit ratings were:

| | |
|---------|-----|
| Moody's | Ba2 |
| S&P | BB |
| Fitch | BB |
- Further downgrades would increase interest rates.

continued

AQUILA

State Regulatory Review

- The Kansas Corporation Commission opened an investigation regarding its concerns about Aquila's financial difficulties.
- The KCC Staff noted concerns regarding Aquila's the operational structure and requested quarterly updates.
- Minnesota Public Utility Commission has opened an investigation. Its Staff report concludes:
 - Since Aquila is an operating utility, not a holding company, its credit ratings are based on a blending of all its activities.
 - Aquila did not file for approval of its most recent debt issuance. Aquila responds that Minnesota property was not used to secure the debt – the notes were unsecured.

continued

WESTAR Overview

- Net income declined from \$136m in 2000 to a loss of \$694m through the third quarter of 2002.
- Cash invested has been less than depreciation, but can't tell if it is because there is less investment in Protection One.
- Total equity has declined over the period by almost 50% to \$1,089b.
- Equity ratio has declined from 36.6% to 17.8%.
- Ratings have been below investment grade consistently since 2000.

WESTAR

State Regulatory Review

- After investigation, the Kansas Corporation Commission ordered Westar to:
 - Submit a corporate restructuring plan to separate the utility into its own subsidiary;
 - Reduce debt (sell assets, dividends).
- The Company just announced that its Board of Directors is discussing how to maximize Protection One so it can be sold.

AEP Overview

- AEP just announced a 4th Q write-off of approximately \$1b on top of the \$0.5b write-off in prior quarters. These write-offs result in a loss of \$519m for 2002.
- It is “committed to strengthening its balance sheet” by:
 - Reducing O&M costs and capital expenditures;
 - Revising its dividend policy;
 - Systematically reducing non-core assets.
- AEP plans to return to the more traditional utility business with a small commercial cell.
- The WSJ reported that AEP was considering selling or closing 2 plants in England that it had bought from Edison International in June 2001 for \$960m. (Edison had paid \$2B two years earlier.)

AEP Overview

- Even with its 2002 loss, AEP should maintain an equity ratio over 35%.
- The utility subsidiaries are maintaining equity ratios of approximately 50%.
- AEP's bond ratings have slipped from A- to BBB+ as have the utilities. Moody's ranks the subsidiaries slightly higher, as does Fitch (A-).
- It is now on credit watch.

AEP

State Regulatory Review

- In approving AEP's application for conversion of its generation to EWGs and for FUCO investment authority, the Public Utilities Commission of Ohio (PUCO) required:
 - Quarterly reports on the aggregate amounts of investments in FUCOs and EWGs;
 - Reports of any decline in senior bond rating by a major credit rating agency including explanation and plans to restore the credit rating;
 - If senior bonds fall below investment grade, identification of steps that will be taken to restore them to investment grade and a commitment to take such actions.

AEP

State Regulatory Review

- In a recently-opened investigation by the PUCO to assess the financial condition of Ohio utilities, AEP not only endorsed the conditions set on it but went further saying the Commission should evaluate each company's risk management policies and procedures.

ALLEGHENY ENERGY

Overview

- Allegheny Energy's cash expenditures for investments and acquisitions over the last two years have greatly exceeded its internally-generated cash.
- Allegheny Energy still has not filed its 3rd Quarter 10Q due mid-November 2002.
- Its equity ratio is now only at 30%.
- Its bond ratings have deteriorated in 2000 from A+ to BB.

MONONGAHELA POWER

Overview

- Allegheny subsidiary Monongahela Power dividends of \$187m to its parent have exceeded its income over the period from 2000 through the third quarter (\$23m).
- It incurred a \$200m goodwill writedown in 2002.
- Its equity ratio has fallen from 46% at the end of 2000 to 37% at the end of the 3rd quarter of 2002.
- Its S&P rating has fallen from A+ to BB, while Fitch is still investment grade.

ALLEGHENY ENERGY

State Regulatory Review

- We have been unable to find any investigations specific to Allegheny's financial condition opened by state regulators in the jurisdictions in which the Allegheny subsidiaries operate.
- News reports and anecdotal evidence strongly suggest various commissions may take investigatory action, but no details are available.

XCEL Overview

- Xcel's investments have averaged two to three times its internally-generated cash flow over the last two and one-half years.
- The write-off of NRG resulted in a \$1,883b loss for the period ending September 30, 2002.
- Xcel's equity ratio has fallen from 40% to 23.5% and it has had to ask for an "exception" to the SEC's 30% guideline.
- Its ratings have dropped below investment grade.

continued

Northern States Power (Minn) Overview

- Capital contributions from parent since January 1, 2000 have exceeded dividends to parent by \$200m.
- Internally-generated cash has exceeded investments.
- Common equity ratio has risen from 42% at year-end 2000 to 44% at the end of the 3rd Q, 2002.
- Numbers for Xcel's utility subsidiaries are similar.
- All of the utility subsidiaries are one step above investment grade.

continued

XCEL

State Regulatory Review

- The Minnesota Public Utilities Commission (MPUC) regulates the capitalization and the capital structure of NSP-Minn.
- In reviewing the financial problems of Xcel, it has limited the total capitalization of NSP-Minn to \$4.2b and required it to maintain an equity ratio of between 43.74% to 53.46%.

continued

XCEL

State Regulatory Review

- The staff of the MPUC raised a number of concerns regarding the impact of NRG financial difficulties on Xcel and on NSP-Minn.
 - Strong incentive to divert utility resources to Xcel reducing maintenance and service quality.
 - Restrictions on access to and/or higher costs of long-term capital could negatively impact long-term reliability.
 - NRG's and Xcel's financial difficulties could significantly reduce expected and future equity infusions from Xcel.

continued

XCEL

State Regulatory Review

- In response to Staff concerns, NSP and Xcel committed to:
 - Not seek a rate increase until 2006;
 - Not encumber Minnesota property other than for NSP;
 - Not seek recovery from ratepayers for costs and expenses from EWGs or FUCOs;
 - Fund an independent audit of its service quality;
 - Permit no intercompany loans to Xcel or NRG.

continued

PSEG

Overview

- 70% of income is unregulated.
- Going forward, Global will limit its spending to contractual commitments and refocus its direction from one of accelerated growth to one that places emphasis on increasing the efficiency and returns of its existing assets.
- Reduced capital expenditures after this year, projected cash flow should cover investments plus dividends.

PSEG

- For the last several years PSEG's investments and acquisitions have substantially exceeded its internally-generated cash flow.
- It has had to take write-downs in 2002 because of foreign investments (\$662m).
- Its equity and preferred ratio have stayed relatively constant for the last two and one-half years.
- Its ratings have held at investment grade.
- Its 4th Q earnings, released Tuesday, were strong.
- Since Labor Day, it has issued \$1.1b in equity and equity-linked securities.

PSEG Overview

- Investments for the regulated utility have been lower than internally-generated cash flow.
- Total dividend payments to parent for last year and one-half have been below earnings.
- It is A-rated by the rating agencies.

PSEG

State Regulatory Review

- NJ Board of Public Utilities (Board) requires PSE&G to certify that the members of the Board of the parent company are different from those sitting on the Board of the unregulated subsidiary.
- The Board also requires all utility holding company investments that can potentially affect the financial health of the regulated utility to conform to sound and prudent business investment criteria. (1992)

continued

PSEG

State Regulatory Review

- The Board has restricted investments of PSEG Energy Holdings to 20% of consolidated assets. This restriction may be reviewed because of Energy Competition Act.
- PSE&G's Board of Directors must certify annually that activities of Energy Holdings will not adversely affect PSE&G.

continued

CONSTELLATION

Overview

- Constellation is a registered public utility holding company with regulated gas and electric distribution operations and unregulated energy marketing and trading interests.
- Constellation's principal utility subsidiary is Baltimore Gas and Electric Company, a Maryland electric and gas utility serving approximately 1.7 million customers.
- In 2002, Constellation considered spinning off its unregulated entities into a separate company, but later decided to keep the holding company structure including unregulated affiliates.

CONSTELLATION

- Its unregulated businesses are profitable.
- Constellation has increased its equity ratio over the last year from 32% to 43%.
- It has invested \$450m in its utility subsidiary over the last two years and taken minimal dividends.
- 2002 credit ratings were:

Moody's Baa1

S&P A-

BG&E Overview

- BG&E'S 2002 credit ratings were:
Moody's A-
S&P A1
- As part of the PSC proceedings to review the proposed spin-off, Constellation agreed to:
 - Provide the PSC with all SEC and NRC filings when made;
 - Regularly update the PSC on the Company's capital structure and capitalization as part of quarterly earnings reports;
 - Notify the Commission if any affiliate acquires assets in the future. (Md. PSC Order, October 2002)

DOMINION RESOURCES

Overview

- Dominion's investments have significantly exceeded its internally generated cash over the last 2 years, but with cutbacks in construction, cash investments are expected to be met by internally-generated cash flow in 2004.
- Dominion's earnings in 2001 were less than its dividends, but its earnings were substantially higher than dividends in 2002.
- With the successful equity issuance in 2002, its common equity ratio has increased to 37.5% (9/30/02) from 33% at year end 2000.
- Dominion has maintained an investment grade rating of Baa1 (Moody's), BBB+ (S&P).
- Its unregulated businesses appear profitable.

DOMINION VIRGINIA POWER

Overview

- Virginia Power dividends have been below its earnings for all relevant time periods.
- Its investments have been above its depreciation and substantially below internally-generated cash.
- Its common equity ratio has risen to 45%.
- Its bond ratings are strong, at A2 (Moody's), A- (S&P) .

OBSERVATIONS

- Flat structure, where the utility is the holding company, is fraught with peril.
- A well-capitalized parent and utility affiliate can withstand the write-off of “reasonably-sized” unregulated investments.
- State regulators can play an important role in determining what is “reasonably sized.” In the words of Steve Reynolds, new CEO of Puget Sound, in a speech given earlier this week, “Thank God for the regulator; they can protect us from ourselves.”

OBSERVATIONS, Con't

- The speed at which competitive markets can turn and make unregulated investment worthless is truly amazing. Regulation -- after the turn -- may be like trying to put Humpty Dumpty back together again.
- The SEC guideline, that a 30% equity ratio is “reasonably sized,” may be a minimal threshold.
- “Reasonably sized” for some investments might have to be determined by considering their risk and the impact on the capitalization of the parent IF the investment were totally written off.

OBSERVATIONS, Con't

- The Hobson Choice for regulators is real when addressing the financial needs of the regulated utility.
- The impacts we are seeing now are from the unregulated affiliates' activities overseas and outside their own service territories.
- It is too early to tell what impacts there may be for companies that spun out generation to unregulated subsidiaries and are currently selling in their own service territories.