

# THORNTON FINANCIAL CONSULTING

*Utility Rates and Finance*

## Client Newsletter

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*Spring 2005*

### *LBOs of Utilities in the News*

*Exclusive interview with  
Arizona Corporation  
Commission Chairman Jeff  
Hatch-Miller regarding  
KKR's proposed acquisition  
of UniSource Energy  
Services (UNS NYSE)*



**TFC:** Commissioner Hatch-Miller, thank you very much for your time. I followed the docket regarding KKR's proposed acquisition of UniSource and I attended the December 2004 ACC Open Meeting at which the final decision was made. As a recap for my readers, KKR, Wachovia Capital Partners and JP Morgan Partners had proposed a leveraged buyout of UNS through Saguaro Utility Group L.P. The case was presented, testimony was filed, and hearings were held. The administrative law judge (ALJ) had subsequently drafted an order denying the acquisition, finding that the proposal was not in the public interest. Commissioner Spitzer, who was then the chairman, promulgated an amendment to the draft order that would have approved the acquisition subject to additional conditions. The chairman's amendment failed to pass and the final vote upheld the ALJ's draft order, thereby denying the acquisition.

What should a commission look for in a proposal in which a pure financial interest seeks to acquire a large public service corporation?

**JHM:** Clearly, the public good has to be maintained. A public utility has great importance for the community. There has to be proof that the sale will do no harm and then beyond that that the sale will produce reliable and affordable power to the

community. This needs to be a consistent view in the majority of participants. In the end, the applicants failed to win the argument toward a common view of the KKR offer and its effect on [TEP] and the financial underpinnings of the deal. We still had four or five different viewpoints of the offer and its results at the end of the proceedings. Experimentation is fine but not for providing essential energy services.

**TFC:** A number of issues arose at that Open Meeting including the \$400 MM of increased debt on the consolidated enterprise, the concentration of control into a few hands at the holding company, and the reduction in transparency because of the partnership structure. What financial or structural elements of the KKR/UNS proposal gave you unease?

**JHM:** All three of those issues gave me unease. That TEP could flow 100% of its earnings to the holding company once it reached 40% equity capitalization by satisfying an existing dividend restriction imposed by the Commission, to flow all earnings upward, gave me unease. The double leverage aspect of the deal in which the holding company issued debt to finance TEP's equity gave me unease.

**TFC:** From your comments on the day of the Open Meeting in Tucson, it appeared that you were searching for some semblance of a public interest in an effort to approve the proposal. In the end, has anything occurred to you that would have been particularly helpful to sway your decision in favor of such an acquisition?

**JHM:** I felt that I was a swing vote. I worked to maintain my objectivity and not prejudge the case but instead wait until I had heard everyone's point of view. The turning point was when I asked ACC Staff if it was assured all issues had been resolved. The

utility director said that Staff was still not there. There was clearly no consistency of opinion. I believe in the group process delving into such matters. I was searching for relative certainty that all parties understood the deal itself, and understood the potential financial and operational impacts of the deal. Given the lack of consistency and uncertainty, I had no other option than to vote no.

**TFC:** UNS' stock price rose rather splendidly after the merger was denied as investors started buying the stock from the arbitrageurs. UNS is currently trading at about \$30 per share compared to the KKR offer price of \$25.25. In fact, several 13-Ds for UNS were filed in January and February 2005. It seems as though everyone was better off for the denial except KKR. Do you have any reflections on customers' interests perhaps coinciding with shareholders' interests in this case?

**JHM:** Well, I wouldn't link the two. I think what happened was that KKR found value in UNS and that public attention to the process advertised that there was unrealized value in UNS. I don't think the ACC can take any credit for the rise in stock price.

**TFC:** It seemed as though Staff's neutral position and lack of a developed idea of what would make the proposal in the public interest made the Commission's decision more difficult in the end. What would you recommend for other commission staffs as they analyze these types of acquisitions?

**JHM:** Staff looked into the financial and legal aspects of the deal and the crystal ball gazing. It did an excellent job of it but I don't see Staff as advocates, just investigators much like police. The police don't argue for guilt or innocence, that role is up to the prosecutor. In the end, the deal still hadn't provided a public benefit.

**TFC:** As you know, the Oregon PUC recently denied TPG's application to acquire Portland General Electric (PGE) from the Enron bankruptcy estate. That acquisition was also a leveraged buyout (LBO) of an electric utility. The OPUC's order cited harms from the LBO debt including declining credit ratings, undue pressure to cut utility costs, increased risk of bankruptcy, and the use of variable rate debt. The order also cited harms from a lack of transparency and concentrated control. These risks seem eerily like

those discussed at the ACC's December 2004 open meeting regarding KKR & UNS. Is there any hope for LBO's of regulated entities when two commissions independently arrive at similar conclusions in similar circumstances?

**JHM:** Well, you can't rule out a buyout. Is leverage inherent in a buyout, I don't know. However, with leverage the perceived risk or harm is greater so the burden of proof is greater. For example, if Pacific Gas & Electric were to buy PGE then there would be less concern than if a pure financial company with no utility experience were to buy PGE. The perceived risks and harm are greater with a purely financial company. I think that there is opportunity for LBOs but electricity in the desert southwest is so critical that we can't treat an electric utility like a playing card in a larger financial game. There would be low growth and fewer business opportunities were it not for electricity to cool our homes and businesses. A financial firm might have many options on managing an electric utility here that might not be consistent with the public good, such as layoffs, spinoffs of utility operations, discontinued operations, etc. Clearly, the burden of proof has to be greater in an LBO. Perhaps all a purely financial company has to do is to manage three or four of these LBOs on a small scale to establish a track record.

**TFC:** A March 2005 *Investor Quarterly* newsletter of the Arizona Utility Investors' Association was headlined "Hatch-Miller Vote Scuttles Billion-Dollar Merger." The publication wasn't terribly flattering about the state of regulation in Arizona, calling it a "regulatory gulag." Would you like to comment on this rather broad assertion or on the state of decision making at the Commission?

**JHM:** As I recall the final vote was 4-1. How do you know which vote was the responsible party? What is important is that I kept an open mind until the end. There was no collaboration with the [Residential Utility Consumer Office] as reported in the newsletter and I was looking for more consistency. The only balance sheet that was looking better in the end was TEP, but UNS would have had more debt. Let's face it, that \$400 million was related to the acquisition but it was just more debt put into another box.

Do I like hedge funds? Well, I tend to like models that I know work. The deal had the potential to

damage the utilities [TEP and UES] and the service that ratepayers would receive. Lots of damage has been done by creative financial engineering and I needed the assurance, as if I were UNS' sole customer, that I would receive at least as good service as before. Remember, this is the state of Charles Keating, and we've seen plenty of examples of too much creativity in WorldCom, Enron, and others. If RJR Nabisco were to go out of business then Kellogg would be ready to step right in to pick up the market but there's no backup to public utilities. We need "tried and true" when we're talking about public utilities and the public good. We've had several examples in Arizona of failure of public policy that led to less than beneficial results. In this case we certainly treated all parties with respect. I simply voted to defend the public interest.

*Note: The views expressed herein are those of Commissioner Jeff Hatch-Miller and do not necessarily reflect the views of the ACC. Neither Commissioner Jeff Hatch-Miller nor the ACC endorse Thornton Financial Consulting. -JST*

### ***A Guide to the ACC, The "Fourth Branch" of Arizona Government***



The Arizona Corporation Commission was created by Article XV of the Arizona Constitution in 1912. Article XV grants the Commission broad powers to exercise exclusive state regulatory authority over public service corporations (public utilities). The responsibilities and authorities of the Commission are further defined in Arizona Revised Statutes, Section 40-201, et seq. and in the Arizona Administrative Code, Title 14, Chapter 2.

The Commission is a five-person panel. Commissioners are elected by the people of Arizona (each normally for a four-year term) with two or three Commissioners elected every two years. A majority of the Commissioners must vote for an item for it to pass. Commissioners vote in an "open meeting" held every three to four weeks.

The five current commissioners (with current term expirations) are,  
 Jeff Hatch Miller, Chairman (2008)  
 Marc Spitzer (2006)  
 William Mundell (2008)  
 Kristin Mayes (2006)  
 Michael Gleason (2008)

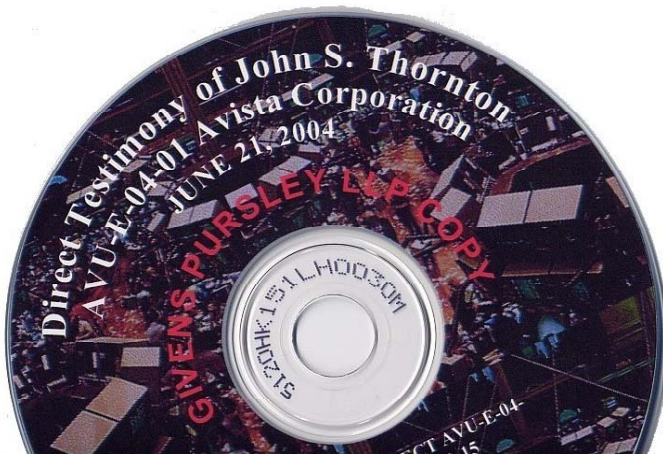
The Commission has authority to exercise continual review over the operations of utilities to ensure that consumers receive adequate, reliable, and safe utility service at reasonable rates and charges. A return is fair when it is comparable to returns earned by firms of comparable risk, sufficient for a utility to maintain its credit standing, and adequate to continue raising capital.

The Commission is organized into seven separate divisions: Administration, Corporations, Hearing, Legal, Securities, Information Technology, and Utilities. It is the Utilities Division staff that assists the Commission in fulfilling its utility-related activities and responsibilities with representation by the Legal Division. The Utilities Division consists of six sections: Financial & Regulatory Analysis, Administrative Services, Telecommunications & Energy, Engineering, Pipeline Safety, Consumer Services, and Compliance. The rate analysts are in the Financial & Regulatory Analysis Section.

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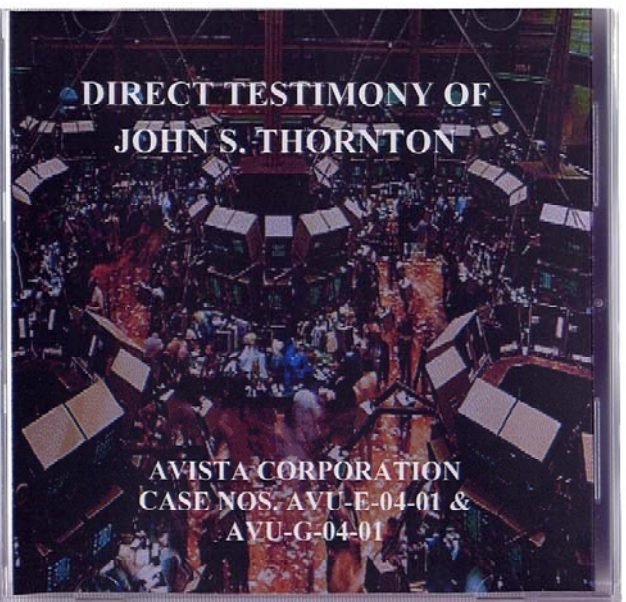
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