Memorandum

CITY OF DALLAS

DATE April 15, 2016

TO The Honorable Mayor and Members of the City Council

SUBJECT Oncor Electric Delivery Company, LLC Transmission and Distribution Rates

On Wednesday, April 20, 2016, the City Council will be briefed on the Oncor Electric Delivery Company, LLC Transmission and Distribution Rates. A copy of the briefing is attached.

Please let me know if you need additional information.

Jeanne Chipperfield
Jeanne Chipperfield
Chief Financial Officer

c: A.C. Gonzalez, City Manager
Warren M.S; Ernst, City Attorney
Craig D. Kinton, City Auditor
Rosa A. Rios, City Secretary
Daniel F. Solis, Administrative Judge
Ryan S. Evans, First Assistant City Manager
Jill A. Jordan, P.E., Assistant City Manager
Joey Zapata, Assistant City Manager
Mark McDaniel, Assistant City Manager
Eric D. Campbell, Assistant City Manager
Sana Syed, Public Information Officer
Elsa Cantu, Assistant to the City Manager

Oncor Electric Delivery Company, LLC
Transmission and Distribution Rates

City Council Briefing

April 20, 2016

Purpose

- Review background related to current and proposed ownership of Oncor Electric Delivery Company, LLC (Oncor)
- Review legal authority related to requiring Oncor to justify transmission and distribution rates
- Review next steps and City Manager’s recommendation

Background

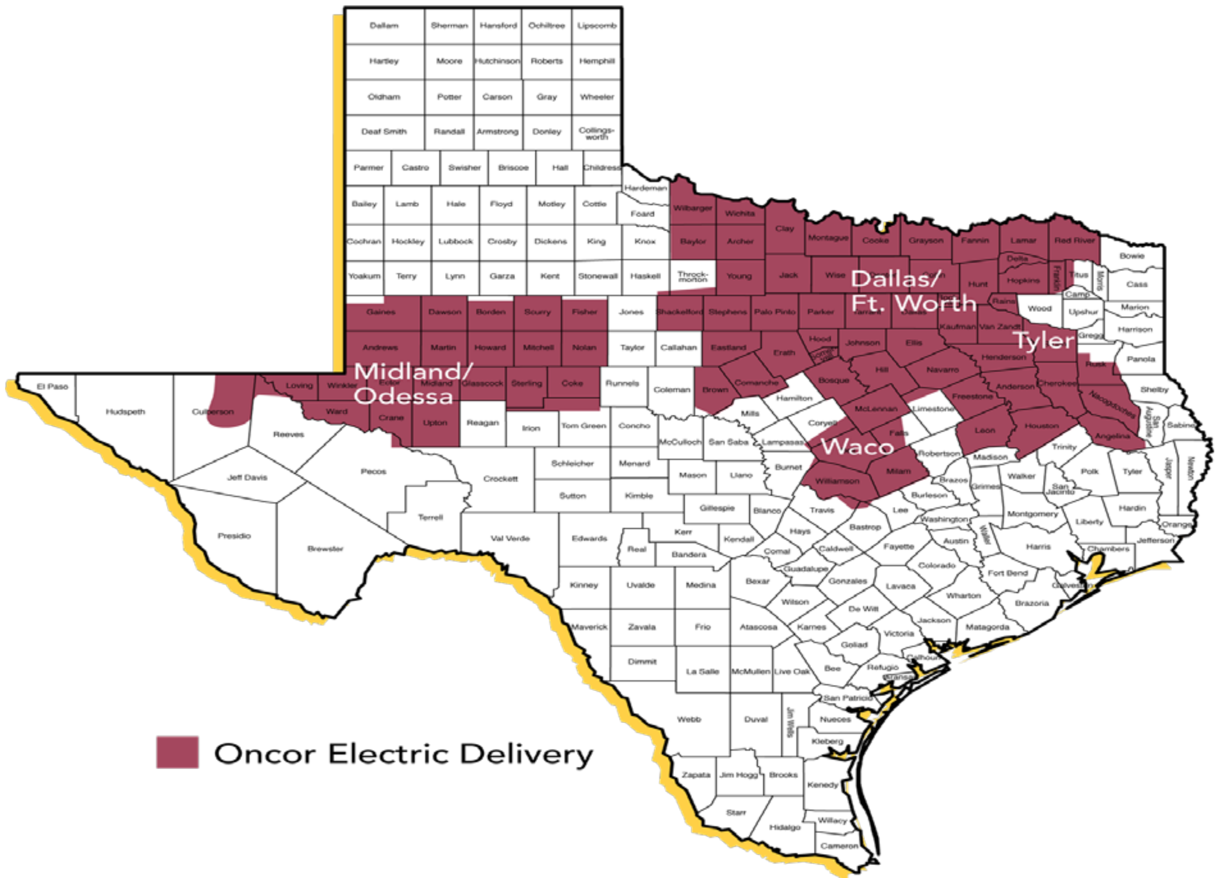
- As a result of Senate Bill 7, which deregulated the electric market in Texas January 1, 2002, TXU, Inc. was split into 3 separate companies:
  - TXU Energy – competitive Retail Electric Provider
  - Luminant – competitive generation company
  - Oncor Electric Delivery Company – regulated Transmission and Distribution (T&D) Utility
    - Provides wholesale T&D service to Retail Electric Providers (REPs) on a non-discriminatory basis
- All three companies were subsidiaries of publicly traded TXU, Inc.

Background (continued)

- Oncor is a transmission and distribution (T&D) utility operating under:
  - Certificate of Convenience and Necessity from Public Utility Commission of Texas (PUCT)
    - Authorizes Oncor to provide T&D service
    - Defines geographic service area
  - Franchise agreement from City of Dallas
    - Authorizes use of public streets and rights-of-ways to provide T&D service

Background (continued)

- Oncor service territory



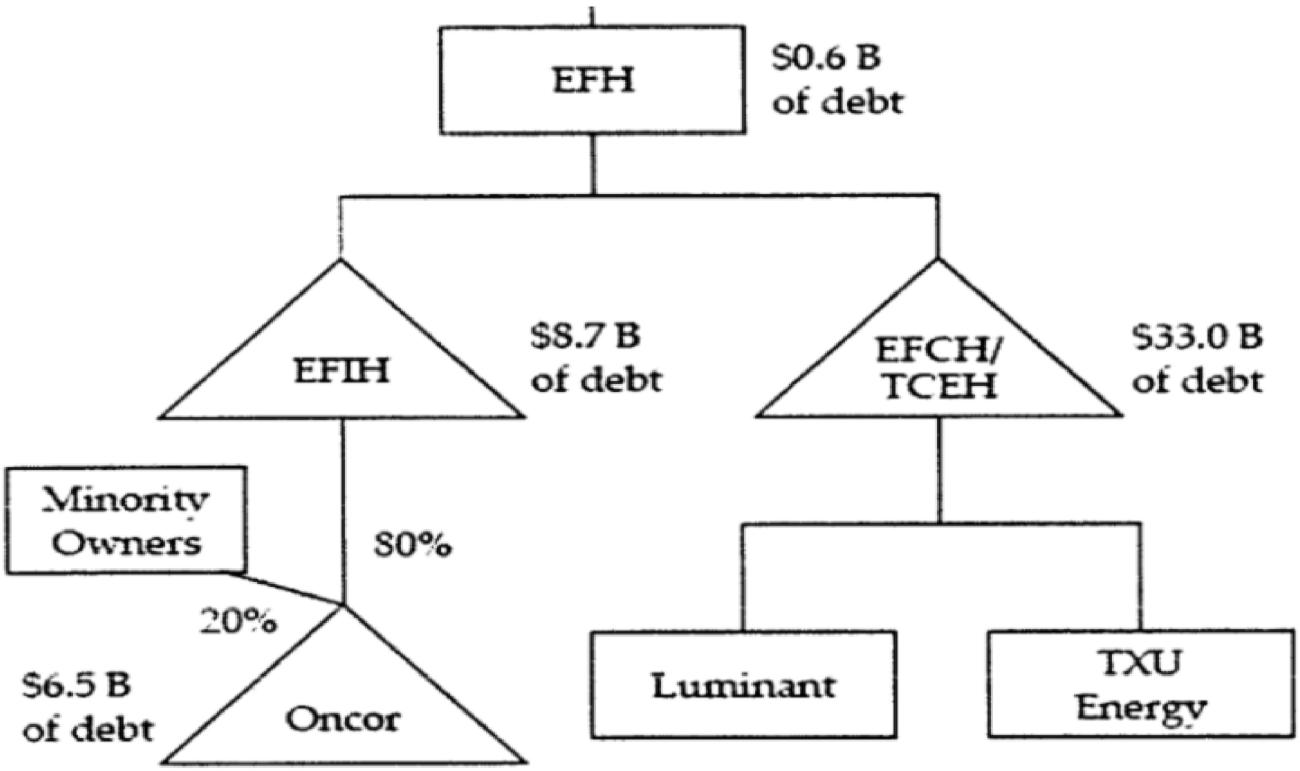
Background (continued)

- In 2007 publicly traded TXU was taken private by investors in largest leveraged buyout in history:
  - Energy Future Holdings (EFH) was new entity created to be parent of former TXU companies
  - Public Utility Commission of Texas (PUCT) in approving sale of TXU to EFH, required that Oncor be financially and structurally “ring-fenced” from deregulated portions of TXU (Luminant & TXU Energy) to insulate Oncor from credit risks of competitive entities

Background (continued)

- As a result of “ring fencing” Oncor, EFH was restructured:
  - Energy Future Intermediate Holdings (EFIH) was new subsidiary of EFH and parent of Oncor
  - Energy Future Competitive Holdings (EFCH) was new subsidiary of EFH and parent of Luminant and TXU Energy

Background (continued)



Background (continued)

- From 2008 to 2014 EFH struggled to make sufficient profits to meet its debt obligations:
  - Leveraged buyout left EFH with over $40 billion in debt
  - Electric rates dropped drastically during this time period
    - Electric rates are closely tied to natural gas prices
    - Natural gas prices decreased drastically due to shale gas production exceeding demand

Background (continued)

- EFH and more than 70 subsidiaries (excluding Oncor) filed for reorganization under Chapter 11 of U.S. Bankruptcy Code on April 29, 2014
  - U.S. Bankruptcy Court for District of Delaware confirmed EFH's 7th plan of reorganization on December 7, 2015
    - Plan contemplated sale of Oncor to a consortium of investors
    - Plan is subject to various regulatory approvals

Background (continued)

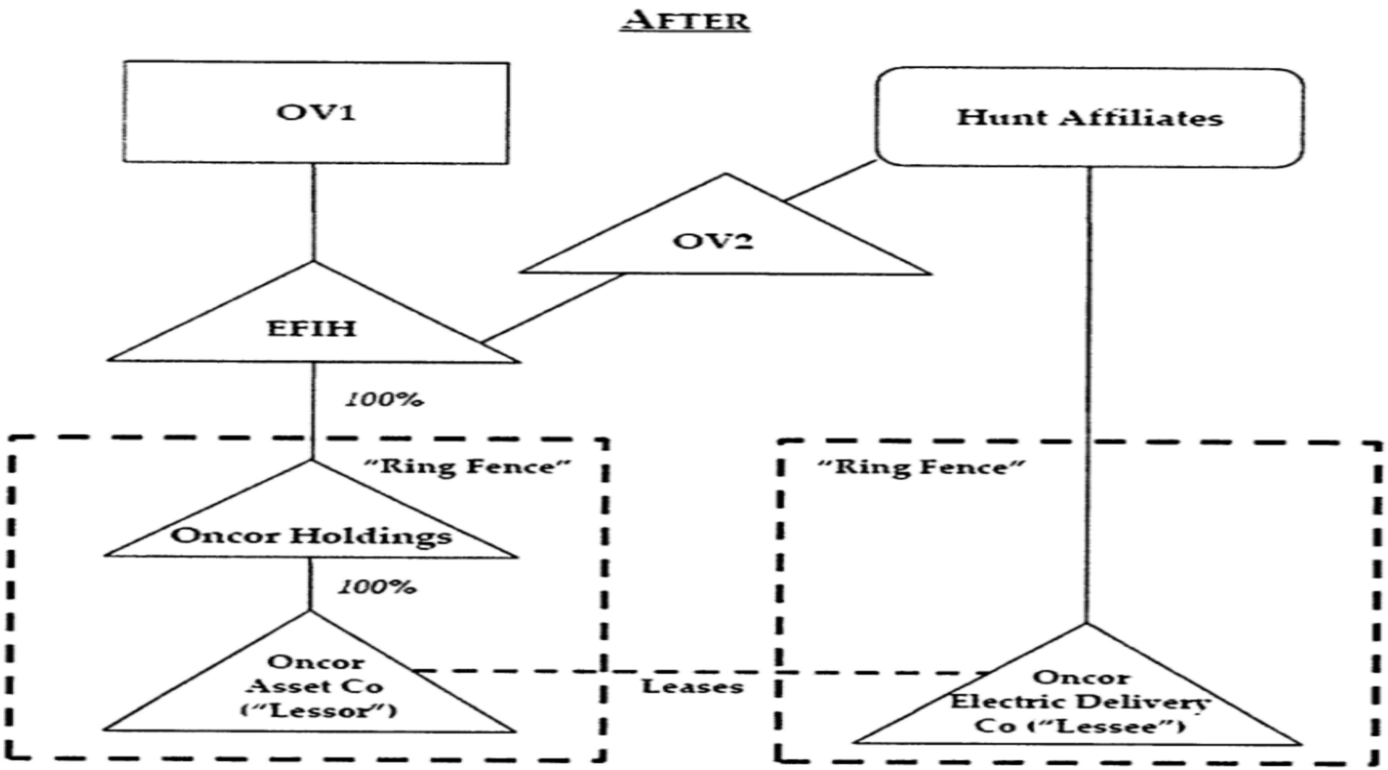
- Purchase of Oncor is complicated
  - Ovation Acquisition I, L.L.C. (OV1) and Ovation Acquisition II, L.L.C. (OV2 and, together with OV1, Ovation) are Delaware limited liability companies formed by Hunt Transmission Services L.L.C. a subsidiary of Hunt Consolidated, Inc.
  - OV1 will merge with a reorganized EFH resulting in OV1 acquiring EFH’s interest in Oncor
  - Funding for acquisition is provided through Ovation by a group of investors consisting of Hunter Hunt, certain creditors of EFCH and investors designated by Hunt
  - Investor group will contribute approximately $12.6 billion of new debt and equity

Background (continued)

- After transaction is complete, Oncor will be split into two separate companies both of which will be electric utilities as defined under Public Utilities Regulatory Act (PURA)
  - <u>Oncor Asset Company</u> – will hold legal title to all of Oncor's T&D assets
    - Owned by OV1
  - <u>Oncor Electric Delivery Company</u> (OEDC)– will operate assets and hold Certificates of Convenience and Necessity and other personal property
    - Exclusive operational control over Oncor's T&D assets
    - Shary Holdings, owned 100 percent by Hunter L. Hunt and members of his family, will control OEDC

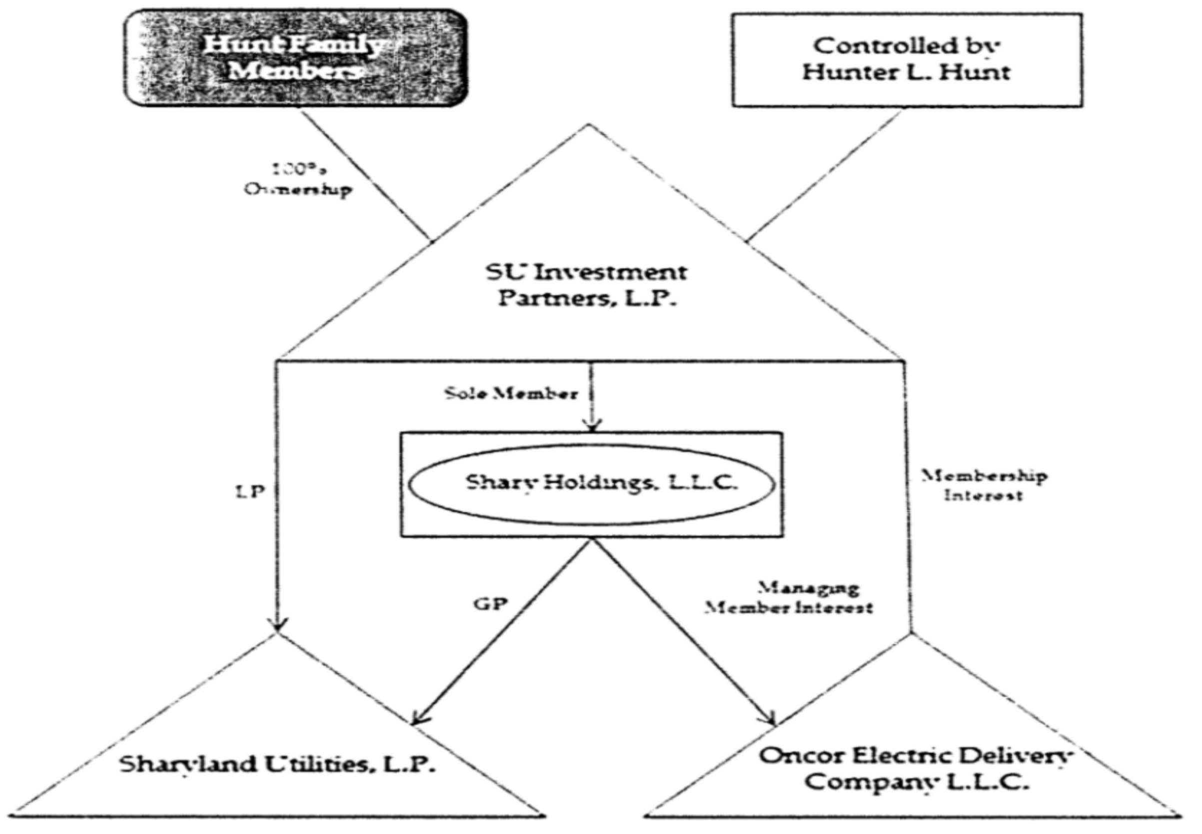
Background (continued)

- Ownership structure after sale:



Background (continued)

- Ownership structure Hunt Affiliates:



Background (continued)

- OV1 will be converted from an LLC to a Delaware Corporation
  - Indirect owner of Oncor Asset Company
  - Structured to qualify as a real estate investment trust (REIT)
    - REIT structure commonly used in real estate development projects
    - REIT structure never used before for utility of this size (used only once for much smaller utility, Sharyland Utilities)

Background (continued)

- OV1 - Oncor Asset Company
  - REITs that distribute income to investors do not pay federal income tax
  - Purchasers have indicated plan to distribute income to investors which results in no federal income tax liability for Oncor Asset Company
  - This aspect of transaction received a lot of discussion at PUCT hearings related to sale of Oncor
    - 2 of 3 PUCT commissioners stated publicly that this income tax savings should be shared with ratepayers
    - PUCT could not order reduced rates as part of proceeding to approve sale

Background (continued)

- PUCT approved sale of Oncor on March 24, 2016
  - PUCT order imposed numerous conditions on sale
  - Purchasers have until November 30, 2016 to close transaction
  - Due to conditions imposed by PUCT, purchasers may not be able to secure funding and complete transaction

Legal Authority

- Oncor owns, operates and maintains T&D system within City of Dallas
  - Provides wholesale T&D service to Retail Electric Providers on a non-discriminatory basis
- City of Dallas has original jurisdiction over rates charged by Oncor within City
  - PUCT has appellant jurisdiction over cities such as Dallas

Legal Authority (continued)

- PURA Section 36.151 provides that if a regulatory authority, such as the City of Dallas, on its own motion, after reasonable notice and hearing, finds that the existing rates of an electric utility for a service are unreasonable the regulatory authority shall enter an order establishing the just and reasonable rates to be observed thereafter

Legal Authority (continued)

- Staff has reason to believe that Oncor is over earning and that its rates are excessive
  - Current rates include over $200,000,000 annually in federal income taxes
    - Over $42,000,000 from Dallas customers
  - After sale, Oncor Asset Company will not have a federal income tax liability due to REIT structure
  - Distributing $200,000,000 in tax savings to investors would be an excessive rate of return for investors at expense of rate payers

Next Steps

- City Council consideration of a resolution (proposed for April 27, 2016) ordering Oncor to show good cause why its rates should not be reduced
  - Oncor will have until September 1, 2016 to file with City information that demonstrates why its rates should not be reduced
  - Oncor’s filing will be based on a test year of January 1, 2015 through December 31, 2015
  - Test year will be adjusted for known and measurable changes and may be updated for more current data

Next Steps (continued)

- Dallas is a member of the Steering Committee of Cities Served by Oncor (Steering Committee)
  - Steering Committee permits cities to coordinate efforts in regulatory and rate setting proceedings
  - Steering Committee has functioned continuously since 1988
  - Executive Committee of Steering Committee recommends that member cities adopt show cause resolutions to initiate a rate case so that Oncor rates may be reduced
  - Other cities in Oncor Service Area will be adopting similar Resolutions

Next Steps (continued)

- Steering Committee will assist member cities in investigating and reviewing Oncor filing
  - Steering Committee retained Geoffrey Gay with law firm of Lloyd, Gosselink, Rochelle & Townsend as legal counsel
  - Steering Committee will retain such consultants and experts as are necessary to investigate filing, prepare a report and make recommendations on behalf of member cities
  - Although fees and expenses of attorneys and consultants will be processed through Steering Committee, the City reserves right to seek reimbursement from Oncor pursuant to PURA

Next Steps (continued)

- It is anticipated that staff will brief City Council on findings and consultants' recommendations on December 7, 2016
  - December 14, 2016 there will be a public hearing along with an agenda item to set fair and reasonable rates
- Council may from time to time amend the procedural schedule established in resolution ordering Oncor to show cause why its rates should not be reduced
  - Entire proceeding could be dismissed if purchasers unable to close sale by PUCT imposed deadline

City Manager's Recommendation

- Adoption of a resolution ordering Oncor to show good cause why its rates should not be reduced
  - Item will be placed on April 27, 2016 City Council addendum

Questions and Comments