



November 16, 2015

Council of the District of Columbia
1350 Pennsylvania Avenue, N.W.
Washington, D.C. 20004

Dear City Council members:

The Institute for Energy Economics and Financial Analysis (IEEFA), a non-profit organization headquartered in Cleveland, Ohio, conducts research and analyses on financial and economic issues related to energy and the environment. We published a report in January 2015 outlining our objections to the Exelon-Pepco merger. We have reviewed the new merger commitments expressed in the non-unanimous settlement filed October 6, 2015 with the D.C. Public Service Commission.

We wanted to alert you specifically to deficiencies we have identified in the ring-fence provisions outlined in the new merger commitments. Ring fencing refers to the practice of putting in place corporate structures and financial requirements that attempt to shield a corporate subsidiary from the potential bankruptcy of any of its affiliates or its parent company.

The ring-fencing provisions of the proposed settlement are very similar to the ring-fencing provisions originally proposed by Exelon. The attached memo highlights important shortcomings in these provisions, including:

- Nothing in the proposed ring-fence provisions prevents Exelon from supporting the dismantling of the ring fence in the context of an Exelon bankruptcy proceeding. Indeed, we have seen just such a situation unfold in Texas, where Energy Futures Holdings has supported the dismantling of the ring fence for its subsidiary Oncor as part of EFH's bankruptcy proceeding.
- Exelon is not currently required to provide assurances in all of its credit agreement provisions that its creditors have no claim to any asset of Pepco in the event of a dispute with Exelon.
- The annual certification that Exelon would be required to make attesting to its compliance with the ring-fence provisions could be strengthened. (Ratepayers would be better served if Exelon were required to post a bond to insure against any ring-fence violations).
- The settlement provisions regarding the accounting for merger synergy savings – which will be the first major test of the ring fence – are vague.

I hope that the attached memo will assist you in evaluating the ring-fence provisions in the proposed settlement. Feel free to contact me with any questions.

Sincerely,

Tom Sanzillo, Director of Finance



To: Council of the District of Columbia
From: Tom Sanzillo, Director of Finance, Institute
Date: November 16, 2015

Re: Ring Fence Provisions of the Exelon-Pepco Merger

We have reviewed the ring-fence provisions of the new Settlement Agreement¹ recently filed with the District of Columbia Public Service Commission on the Exelon-Pepco merger.

This memo raises important questions about the integrity of the deal's proposed ring fence and whether it would truly protect Pepco ratepayers.

Background

The ring-fence provisions of the Settlement Agreement are designed to maintain and protect the separate financial independence and integrity of Pepco, which will be a subsidiary of Exelon after the merger. Ring-fence provisions in this instance are supposed to protect the interests of the smaller Pepco utility from any potential financial headwinds encountered by the larger Exelon parent company (see: Settlement Agreement, paragraphs 63 through 105).

The ring-fence provisions cover post-merger debt issuances by Pepco, Pepco's incursion of liabilities, Pepco's revenue distributions to Exelon, Pepco's general business protocols and the maintenance of its books and records. All of these activities are to be carried out independently of Exelon. The Exelon parents' equity interest in Pepco is also separated from the Exelon parent corporate structure. Exelon's equity interest in Pepco will be held and managed by a third-party Special Purpose Entity (SPE) with governance, accounting and financial management strictures that prohibit Exelon from imposing any self-serving financial burdens on Pepco. Most specifically, the creation of the SPE is designed to remove Pepco's equity interest from the estate of Exelon for the purposes of bankruptcy (paragraph 68). Various reporting requirements for both Pepco and Exelon are required in the Settlement Agreement and Exelon is not allowed to take any actions that might impair the ring fence without the consent of the PSC.

Concerns with the Ring Fence

1. Paragraph 93 requires Exelon to secure an opinion of counsel that "a bankruptcy court would not consolidate the assets and liabilities of the SPE with those of Exelon or EEDC [Exelon Energy Delivery Company], in the event of an Exelon or EEDC bankruptcy, or the assets and liabilities of PHI or its subsidiaries with those of either the SPE, Exelon or EEDC in the event of a bankruptcy of the SPE, Exelon or EEDC."

This diligence step is useful, but perhaps offers more apparent than real protection. One cannot predict what a future bankruptcy court will decide.

¹ http://www.dcpsc.org/edocket/docketsheets_pdf_fs.asp?caseno=FC1119&docketno=959&flag=D&show_result=Y

There are many ways ring fences are dismantled. For example, in the ongoing bankruptcy proceeding of the Energy Future Holdings utility in Texas, a proposal has been made that would, according to Moody's, dismantle the ring fence around its subsidiary utility Oncor. The parent utility, Energy Future Holdings is supportive of the bankruptcy proposal.² The Texas PUC must decide. Nothing in the Exelon-Pepco Settlement Agreement precludes Exelon's support for the dismantling of the ring fence under similar circumstances, provided the District of Columbia PSC approved.

A number of questions come up here and in the points below:

- a. Do the ring-fence provisions prevent Exelon from supporting plans or elements of plans in any bankruptcy proceedings that would undermine the ring-fence protections?
 - b. Does the PSC have to approve any plan emerging from bankruptcy prior to it becoming effective?
2. Paragraph 99 requires Pepco to provide the Commission with an annual certificate from an officer of Exelon attesting to Exelon's general fealty to the ring fence. The certification would be strengthened if it included provisions that: 1) Exelon has not violated the ring-fencing provisions in the last year; 2) it does not plan to violate the provisions in the coming year; 3) it does not plan to petition the PSC to in any way change the terms of the ring-fence provisions in the coming year; 4) all of Exelon's principal creditors have been notified and agree that they have no right of action or claim to any asset of Pepco in the event of any dispute with Exelon; and 5) Exelon's annual certification is based upon both General Counsel opinion and opinion of independent corporate and bankruptcy counsel and is signed by the CEO of Exelon.
- a. Would Exelon accept each of the five strengthening provisions offered above?
3. Paragraph 84 states that Pepco will not include in any of its debt or credit agreements provisions that link it to Exelon in any cross default provisions or any other trigger provisions related to Exelon. There are no specific reciprocal requirements of Exelon. Exelon should be required to provide in all of its credit agreements provisions that its agreements in no way establish any right of action or claim to the assets of Pepco.
- a. Would Exelon agree to inclusion of language in all of its contracts, debt instruments and other relevant agreements that nothing in the agreements provides any claim or rights against Pepco, its assets, revenues or corporate officers?
4. The ring-fence provisions can expire at the end of five years if an application is made to the PSC and then approved by the agency (paragraph 105). Within the first five years the mechanism for review and oversight by the Commission appears to be reserved to the Commission's own initiative. Exelon agrees not to object to the Commission reviewing ring fence compliance at any time. One of the benefits that accrues to Exelon from the merger is an improvement in the ratio of regulated to unregulated revenues received by Exelon; Exelon will benefit from the more stable revenue stream from Pepco's regulated operations as Exelon's unregulated generation business continues to struggle. One of the risks borne by Pepco is the potential for Exelon's unregulated generation business to pose additional credit problems for the company. Pepco's interests might be better served if Exelon posted a bond for the five-year period that covered ring-fence violations.
- a. Would Exelon agree to post a bond that insures Pepco against any ring-fence violations?

²See Moody's recent review of company finances for fuller context: http://s3.amazonaws.com/static.texastribune.org/media/documents/EFH_Bankruptcy_Disclosure_Statement_is_Credit_Negative_for_Oncor.pdf and Dan Testa, *Moody's warns EFH's REIT conversion plan for ONCOR a credit negative*, SNL, July 30, 2015

5. The ring-fence provisions require a separate set of books for Exelon and Pepco and their respective subsidiaries. This separation is designed to protect Pepco, but at least in the short term the new accounting environment needs to be carefully monitored to ensure that Pepco receives its share of the benefits from the merger. The issue of savings from the merger illustrates the point. Operating savings and efficiencies are a critical element of the benefit package that flows from the Exelon-Pepco merger. There are paragraphs in the ring-fence portion of the Settlement Agreement that require Exelon to file an integration plan with the Public Service Commission (paragraph 90). While the contents of the plan are unspecified in the agreement, perhaps this is the venue for a more complete articulation of the savings plan and how the parent and subsidiary will benefit. How baseline expenses are established between the parent and Pepco subsidiary, how the savings are calculated, and how the savings are credited and on what timeline will all flow under the new post-merger ring-fence accounting relationship prescribed in the Settlement Agreement. Pepco ratepayers benefit from receiving a fair share of the savings. How these issues are settled is an important early test of the integrity of the ring fence as a tool to protect the financial condition of Pepco. The new accounting environment, while protective of many aspects of Pepco's assets also creates risks that Pepco receives less than its fair share of the savings.
- a. What are the specific savings initiatives that Exelon plans to achieve as part of the merger synergies?
 - b. What portion of each savings initiative will be allocated to Exelon and what portion to Pepco?
 - c. What are the assumptions and rationale used for the allocations?
 - d. What are the specific financial means by which the savings are measured and who determines if the savings have been achieved?
 - e. What are the specific financial mechanisms to be used to deliver the savings benefits to Pepco? Are cash transfers, accounting treatments or other systems of credits anticipated?