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US Electric Utilities & IPPs

Framing the Utility REIT Complexities [Incl. Transcript]

Equities

Americas
Electric Utilities

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What's the Right Way to do a Utility within a REIT?

Following the news yesterday of the Hunt groups' walking from their REIT petition before the PUCT, we publish our latest transcript with Tim Toy on the complexities around the structure and prospects for others to follow suit. Overall, while clearly a possibility, we see a number of issues limiting the ability for the parties to pursue the structure; as such, we see the probability for a more conventional structure to succeed in acquiring the Oncor assets out of the bankruptcy and for others contemplating REIT structures not to do so. Beyond the simple question of ratepayer sharing of tax benefits is the underlying need for certainty in the structure given the risk of future shifts in tariffs and disallowance. Bottom line, the REIT trend may yet abate. It remains unclear if the PUCT will move forward with a generic docket to evaluate tax treatment for a REIT given the latest developments. As a final comment the fate of InfraREIT under the latest scrutiny of tax structures could be yet another clue on attitudes around the structure; the company has an ongoing rate case in Texas.

Conference Call with Tim Toy on Utility and REIT Complexities:

The following are highlights from our call with **Tim Toy**, Infrastructure REIT Expert.

Replay Information (available until 5/13):

Toll Free: 800 633 8284

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[March 24, 2016 Order Approving REIT Structure for Oncor]

Julien Dumoulin Smith: Thank you operator and good afternoon, everyone. I appreciate you joining us on what is at least a dreary rainy Friday afternoon here in the New York metro area. But to pick it up, we've got **Tim Toy** here to talk about the Utilities & REIT complexities associated therein.

Obviously it's been a fairly robust topic in recent weeks, with lots of discussion following EFH. He's going to provide some instructive remarks on how to think about the subject at large, including the latest events in Texas, and then we'll have time for your questions.

Separately, I encourage you to also see the annotated notes from the Oncor proceedings that are provided in a link in the reminder email that just came out. If you don't have that, feel free and send me an email and I'll try to forward that email onto you as well. So good afternoon, Tim. Thank you for taking the time. Perhaps share with us what do you think?

Tim Toy: In early April, 2014, I participated in a conference call hosted by the electric utilities research team at UBS Securities. My talk was on Demystifying Utility REIT Structures and I selected as my example Oncor Electric Utility Company, LLC (which I will refer to as Oncor).

--minimal Federal Energy Regulatory Commission involvement and just a single state regulatory body, namely the PUCT;

--Oncor was already a wires-only transmission and distribution (T&D) utility with the preponderance of its assets already REIT-eligible under a 2007 private letter ruling (PLR) from the IRS; and

--the parent company of Oncor---Energy Future Holdings (EFH)---had incurred debt in a 2008 leveraged buy-out that far exceeded the ability of EFH in 2014 to repay or restructure and Oncor was EFH's most valuable asset available to repay EFH creditors.

By the end of April 2014, EFH and substantially all of its non-Oncor subsidiaries had commenced a bankruptcy reorganization proceeding in Wilmington, Delaware.

At some point during the first half of 2015, one or more REIT proposals for Oncor began to coalesce as means of facilitating the emergence of EFH from its chapter 11 proceedings.

On August 10, 2015 EFH filed a reorganization plan the prime mover of which was the acquisition of Oncor by an investor consortium (led by Texas-based Hunt Consolidated) with Oncor being converted into a REIT. For those interested in the details, I invite you to look at current report on Form 8-K filed by EFH with the SEC on August 10, 2015 and an amendment to that report filed later on the same day. The proposed resulting REIT is described in intense detail by Ovation Acquisition I, LLC in its amended initial public offering registration statement on form S-1 filed with the SEC on February 2, 2016. Even though the registration statement was ultimately withdrawn on May 3, 2016, the registration statement is and will remain available on the SEC's EDGAR data base. Links to these items are provided in my annotation.

On September 29, 2015, an application with respect to the Oncor REIT aspects of the EFH's plan of reorganization was filed with the PUCT. The application was assigned PUCT Docket No. 45188. I will refer to this docket by its number to distinguish it from another related docket number, PUCT Docket No. 45815, that I will mention later in my remarks. A link to the application is provided in my annotation.

To understand Docket No 45188 and its result in context, some history is in order.

In 2008, Sharyland Utilities, LP was a retail electric utility providing transmission and distribution service within a 6,000-acre master-planned community called Sharyland Plantation situated between the Cities of McAllen and Mission along the border between Texas and Mexico. I will refer to Sharyland Utilities, LP as the "Sharyland OpCo." Sharyland OpCo was then privately owned by an investor group led by Hunt Consolidated.

In anticipation of a REIT conversion for Sharyland OpCo, the Sharyland investor group organized Sharyland Distribution & Transmission Services, LP, an entity that I will call "SDTS."

In 2007, a Hunt affiliate obtained an IRS private letter ruling (PLR) that, broadly speaking, held that electric transmission and distribution assets were real property of a character that could be owned by a REIT. On January 29, 2008 Sharyland OpCo and SDTS filed an application with the PUCT seeking approval of the conversion of Sharyland OpCo. The application was docketed under PUCT Docket No. 35287. I will call this the Sharyland docket. Links to the PLR and to the Sharyland application are provided in the annotation.

There were just a few interventions in the Sharyland docket. By the third week of May, Sharyland OpCo stated that all parties in the Sharyland docket had reached agreement on or did not oppose the general terms of a settlement that would resolve all of the issues in the Sharyland docket. By the second week in June, the parties had reached agreement on a series of commitments made by Sharyland OpCo—I will call these commitments the Sharyland commitments. On July 21, 2008, the PUCT issues its order approving the REIT conversion on the basis of the settlement agreement including the Sharyland commitments. The text of the Sharyland order comprises Annex A to my annotation. The Sharyland commitments comprise the twenty sub-paragraphs of paragraph 31 of the Sharyland order.

The reason for this history is that the Sharyland commitments included an approach to ratemaking that, in effect, allowed the REIT, on the one hand, and the

operating utility/lessee, on the other hand, to allocate between them, without PUCT scrutiny, the operating utility's PUCT-approved retail rates. Also, the Sharyland commitments did not contemplate or require any sharing of REIT tax benefits with ratepayers. The Sharyland commitments became the basis for expectations of the creditor and other constituencies that participated in the formulation and sponsorship of the Oncor REIT-based exit plan for EFH.

The August 2015 REIT-based plan for EFH hinged on receipt an "acceptable" approval order from the PUCT. Embedded in the August 2015 plan was a right for one or more participants to back-out if the PUCT order imposed defined "burdensome conditions." Excluded from the burdensome conditions permitting plan termination were conditions substantially similar to, or with the same effect as, conditions comprising the Sharyland commitments. The regulatory-out condition and the acceptable regulatory condition definitions are excerpted at Annex E to the annotation.

Early in Docket 45188, it became clear that adherence to the Sharyland commitments alone would not be sufficient to gain PUCT approval of an Oncor REIT. Intervenors in Docket 45188 were numerous and many intervenors were active. On October 15, 2015, the PUCT issued a list of seventy-six issues that were to be addressed in Docket 45188. While the bulk of Sharyland commitments remained at the core of proposed Oncor regulatory commitments, the lists of regulatory commitments proposed by the Docket 45188 participants grew and grew.

On February 19, 2016, the sponsors of the Oncor REIT provided a final listing of acceptable regulatory commitments. The text of the sponsors' final acceptable regulatory commitments is provided in Annex D to the annotation.

When the PUCT issued its approval order on March 24, 2016, the PUCT included no fewer than eighty numbered findings of fact (paragraphs 212 through 292), all of which were stated to be conditions to the effectiveness of the PUCT's approval. One of the conditions imposed a requirement that the terms and conditions of REIT lease be subjected to separate PUCT rate proceedings by April 6, 2016. The mandated rate case was filed by the Hunt consortium on April 6, 2016 in PUCT Docket 45815.

It was immediately clear that the March 24, 2016 order imposed conditions that were far outside the range of regulatory commitments acceptable to the debt and equity consortium led by Hunt Consolidated. The differences were detailed in the motion for rehearing filed by the Hunt consortium on April 18, 2016. Annex G to the annotation details the changes to the March 24, 2016 order being requested by the Hunt consortium. The requested changes were a last ditch effort to reshape the PUCT approval to fit the Sharyland mold.

The Hunt consortium had agreed that, in the event regulatory proceedings had not been satisfactorily concluded by April 30, 2016, a payment of $50 million would be due to a group of EFH creditors for a one-month extension of an April 30, 2016 drop-dead date. In quick succession over the weekend of April 30-May 1 things fell apart. By the end of the day on Monday, May 2nd, the confirmed plan and numerous inter-twined implementation agreements had become, in the words of the bankruptcy court order confirming the EFH August 2015 plan, "null and void."

As of today, it appears that members of the Hunt consortium and possibly others are scrambling to reposition a REIT conversion for Oncor as a part of a new exit plan for EHF. Bankruptcy court and PUCT status conferences are scheduled to occur over the next month. Stay tuned to this channel.

In my view, the success of the Sharyland commitments for the Sharyland REIT structure was an improbable regulatory occurrence. It unlikely that, with virtually any level of regulatory and intervenor scrutiny, the Sharyland success with only the Sharyland commitments can be replicated.

Why do I hold this view? Electric infrastructure REITs need a degree of regulatory predictability to take hold and prosper. Predictability means departures from the established norms of regulatory scrutiny. Departures can entail unforeseen risks for ratepayers. The possibility of ratepayer risks should be recognized in any REIT proposal. A sharing of the benefits of the REIT structure between the sponsor and ratepayers must be an integral part of any future REIT proposal for a regulated utility.

The essence of the Hunt consortium's motion for rehearing in Docket 45188 and its lease filing in Docket 45815 <u>is the argument for greater predictability than was afforded in the March 24, 2016 approval order</u>. Neither the motion for rehearing nor the lease filing offered the prospect of benefit sharing with ratepayers in exchange for increased predictability. Adherence to the sufficiency of the Sharyland commitments proved to be fatal.

Where might we go from here?

The good news for the prospect of an electric infrastructure REIT is that, after a thorough review, a state regulatory commission was able to get its arms around the idea and approve a deal. The magnitude of this accomplishment cannot be understated. The accomplishment should not be overshadowed by the disappointment surrounding the failure of the Hunt consortium's initial REIT plan.

Should the PUCT and Oncor's ratepayer constituencies demand that a REIT option for Oncor remain part of any bankruptcy exit plan for EFH? Should squabbling among EFH creditor groups preclude a potential REIT benefit available for sharing with ratepayers? These questions cannot be answered today.

Benefit sharing with ratepayers can take forms beyond rate relief. For example, the transmission function could be carved out of Oncor and subjected to a REIT structure as part of a plan for more complete control by ERCOT of ERCOT transmission systems. The transmission owner tariffs of the California investor-owned utilities transferred actual control of the transmission systems to the California Independent System Operator. The California transmission owner tariffs are remarkably close to being REIT-able leases. Design and implementation of an internally-managed all-ERCOT transmission REIT with ERCOT serving as the REIT lessee could be a cost effective means to achieve an ERCOT that is independent of generators, retail suppliers and distributors. Grid independence could be part of the REIT benefit to be shared with ratepayers.

The conditions imposed by the March 24, 2016 PUCT order are by no means so onerous that a REIT structure has become impossible. An electric infrastructure REIT could live comfortably within similar conditions. Ultimately, the failure of the Oncor REIT proposal arose from expectations (including yield and trading multiple expectations) resulting from the assumed ability to replicate the

Sharyland commitments on a large scale. The failure of the Oncor REIT proposal was a result of expectations that proved ultimately to be unrealistic.

On occasion, I have described CenterPoint, the Houston-based utility, as a prime candidate for active consideration of a REIT structure. Indeed, CenterPoint might garner a first-mover advantage by sponsoring an independent ERCOT REIT that would include both CenterPoint's transmission and that of Oncor.

The question can be asked: has the Oncor REIT proceeding so altered the conversation in Texas (and, perhaps, elsewhere) that the question for all investor-owned utilities in Texas has become "Why not a REIT?". The answer to the question is likely "No" at this juncture but might become a "Maybe" or a "Yes" in the near future depending on the attitude of the PUCT and the appearance of a new REIT plan for all or part of Oncor.

Julien Dumoulin Smith: Great, excellent. Well thank you so much, Tim. So maybe to kick off the Q&A piece – well first off that was a good summary of everything. Can you perhaps synthesize if you will what are the key points in your mind when it comes to no-go, unpalatable terms that take the REIT off the table? Can you perhaps summarize – you talk about the PUCT's attitude. Can you go back and really delineate which terms are really unpalatable in your view versus what are perhaps less important, trivial or immaterial?

Tim Toy: A commission taking the position that the lion's share of the benefits of the structure should accrue to rate payers would kill the structure. Ultimately a REIT is a different means to raise capital, and I think it can handle regulatory scrutiny – the asking and answering of questions.

Beyond a requirement that 100% of the benefit of a rate flowed through to rate payers – that would be fatal – and the next question becomes that in the event that the creation of a REIT creates a tax liability for the sponsor because of the recapture of depreciation and/or other similar favorable tax items. The ability for that tax liability to be recognized in rates going forward would be essential to the success of a REIT structure. I'm reminded of when Consumers Energy initially spun off its transmission. There was expressly included in rates a substantial regulatory asset that recognized that there were costs associated with a disposition of the transmission system for a price or a value that exceeded its then-depreciated basis for tax purposes. Other than those sorts of things, I don't think there are any insurmountable problems.

Julien Dumoulin Smith: Alright, excellent. We have a follow-up question and then I'll continue. So what about the regulatory concerns around the frequency of equity issuances, since the dividends required at a REIT structure are so high on an annualized basis – particularly significant in the context of a high CAPEX ability, as presumably would be the case in Texas.

Tim Toy: The ability of a utility to access the capital markets is very much a concern, particularly in the rate context. It's really not in my expertise as a lawyer to talk about that need to access the capital markets over a broad range of results.

I remember in the early 80s, when utilities were constantly in the equity markets to finance capital programs nukes and non-nukes, and I hate to bounce this back to you, Julien – but I think this question is better answered by you. But yes, it's true that it's a characteristic of rates that they need to access the capital markets more frequently.

Julien Dumoulin Smith: Yes, absolutely. That certainly is a point of concentration going through regulated for sure. Now I'd be curious – one of the nuances that's garnered a certain amount of attention is the treatment of the lease as a tariff itself. Can you explain the implications of that concisely?

Tim Toy: Sure. <u>The implication of treating the lease as a tariff is that the stated rent would be subject to the potential for a disallowance</u>, and by that I mean that the Utility Commission could order that the rent be dropped. And that is a concern, but utilities have been living for a long time with that possibility of rates being dropped, disallowances, regulatory issues and such. But if you have isolated into the REIT the capital components of rates and you put the operating component in the REIT lessee, I would argue that the commission has a better tool to reward and punish the operating aspects of the utility function without necessarily harming the capital raising function.

In other words, rather than dropping the rates generally and affecting not only capital raising, you've given the regulatory bodies a finer instrument with which to conduct their reviews because they can effectively focus their effort on the operator where it's an operational problem and there's not a capital raising issue.

Julien Dumoulin Smith: Got it. Can you go back and delineate a little bit more? So what are some of the concerns around this allowance, particularly to the lease, just because I suppose if I were to push back a little bit on the concept, presumably even under a traditional utility structure, certain aspects, investments into the expenses, could in theory be disallowed. Why is it so critical in this particular instance, if you can elaborate?

Tim Toy: Well to the extent that one envisions capturing all or most of the rate benefit in the lease rates – you get very sensitive to the possibility that that issue may be revisited in the later rate proceeding, whereas if you have reached a deal up front on the allocation of benefits and that's embedded upfront in the settlement, then I think the concern about disallowances is lessened. But you're quite right.

I mean – *who* manages the capital projects? What is a mechanism for disallowance if a particular capital project is not used and useful? It's the case that most if not all of the used and useful issues arise in the context of the generation function, not in the context of the transmission and distribution, generally speaking. And again its disallowance in my mind becomes less of an issue given the functions that are being isolated.

Julien Dumoulin Smith: Right, absolutely. Now is there anything to say, for instance, that there would be a certain level of tax and capturing? I mean obviously that's one of the core issues here. Is there any level of precedent anywhere to think about that? Perhaps you could elaborate on what the existing situation is with Sharyland as best you understand it, or any other precedents out there. I suppose to a certain extent if and/or ultimately assuming the commission does go toward the generic document and decides on the subject of taxing capture – what is the basis out there on which to decide?

Tim Toy: Well as I understand your question, a current commission can't bind a future commission, and yes, there was a settlement in Sharyland, but also Sharyland filed a general rate case not too long ago. Is the commission precluded now that they've become educated on these matters from revisiting the settlement in Sharyland? I think they could revisit it based on what they've learned.

Julien Dumoulin Smith: Why would that be actually? I'll stop you right there actually to ask you to elaborate. What about what they've learned would drive them to do that there?

Tim Toy: Well what they and others have learned is *how* REITs work – what the benefit is and how substantial the benefit can be. From my review of the Sharyland filings, there wasn't a lot of time thinking about these issues. There were substantial interrogatories and questions, but not in my estimation as much probing of some basic assumptions as occurred in the Oncor proceeding. And I'm not saying that a revisiting of the Sharyland commitments will occur as part of the Sharyland rate proceeding, but it wouldn't surprise me.

Julien Dumoulin Smith: Got it. Okay. But there's nothing necessarily out there that stands out in terms of the specifics of the tariff or anything like that?

Tim Toy: It's less the tariff and it's more the return that that tariff provides to the new publicly traded company, which is called Infra-REIT (NYSE: HIFR). I have not focused on this issue in connection with these remarks, so I hesitate to do anything other than lightly touching on the issue.

Julien Dumoulin Smith: Got it. I figured since you were bringing up the subject, I suppose more generically, are there *other states* or anything else that you can point to as far as the vehicle goes that would give you something to hang your hat on as far as the treatments of tax look-through and income tax treatment? I mean obviously we've had another few years here to get folks acquainted with the subject.

Tim Toy: Well the FERC has kept to its guns on their statement of position on income tax allowances and FERC rates. Texas has a statute that seems to provide for the benefits of flow-through structures not accruing to rate payers. I think it was earlier this year, but I think the California Commission, which had a position on not allowing income tax and rates. That position was upheld on an appeal. I can't remember whether it was an appeals court or California Supreme Court. On the other hand, it seems that Arizona has come down in favor of allowing a tax allowance even if the tax allowance is for an item that's not paid by the parent or the affiliate.

So there's a great deal of flux at the state level on the income tax allowance issue, and Texas itself had docketed, although the docket is inactive, a general docket on income tax allowance issues. There's increased scrutiny at the state level, and I've not done a recent multistate review of who is where.

Julien Dumoulin Smith: Got it. Okay. Fair enough. Can you describe a little bit the structure of the REIT here and maybe elaborate also on why you think the Center Point structure might be ideally set up for it? That was a particularly bold statement. Can you talk about the structure – how this is exactly set up. I mean obviously – and then maybe specifically here from what I understand – there's the asset column and there's the – I suppose the parent cover, if you will. And then you also separately made the comment that you thought Center Point was well positioned to potentially follow suit on one of these REIT structures, at least from a structural perspective. I'd be curious, what drove that comment?

Tim Toy: It's simply the fact that they are no longer affiliated with their generating sources, and generation assets do not fit in a REIT structure. So the utilities that have restructured themselves to separate generation and transmission are suited to

actively consider a REIT structure. PPL in Eastern Pennsylvania would be an example, particularly in light of the spinoff of the towel on energy.

Central Hudson – a small utility in the Hudson Valley – would be a candidate, albeit they're a small-cap utility. And it's really Center Point, for no other reason than the fact that they don't have much if any generation AEP. In Texas, I would not hold out Center Point as an example because their generation and transmission are more fully integrated throughout the AEP system. You'll also have the issue of the overall holding company structure, which cuts across now I believe 13 states. I haven't counted recently. I may have just gotten that number very wrong.

Julien Dumoulin Smith: No, you're correct. In moving the conversation forward – Commissioner Anderson on the PUCT articulated on March 1 a series of specific issues – to use his word – arising from any acquisition. Can you comment on some of those specifically? Obviously he's raised the tax expense issue, but he raises a series of other issues. I don't know if you're familiar with them or not, but I can read some of them to jog your memory, if you have any comments here.

Tim Toy: Yes. I'm familiar with the vast bulk of Commissioner Anderson's March 1 conditions, which are in the final order or in the March 26 order virtually verbatim in a number of cases.

Julien Dumoulin Smith: Fair enough. I suppose I come back full circle. Do you take issue with any of the specific issues that he's raised or not?

Tim Toy: No.

Julien Dumoulin Smith: Okay, Last thing: There's obviously this question about credit rating and dividend. Have you thought about that at all – about the asset co level of credit rating and dividends? That's been a subject of some further consternation out there in terms of the ability to maintain an S&P credit quality. Any thoughts there? I know that might be a little bit different from what you're focused on, but obviously structural subordination of the issues and requirements made on dividend have garnered a certain amount of attention.

Tim Toy: Yes. In my mind the quest for greater predictability by the Hunt Consortium in their request for a rehearing were the same types of predictability that would go into a credit analysis of the REIT and its operating REIT lessor company. By that I mean if you do a thorough analysis of rate payer costs and benefits, the greater their predictability and the greater ultimately the share of the benefits that go to rate payers, that ought to translate into a better credit rating picture. I think things align themselves on that front because the better the predictability for the REIT and its rent, the easier it will be for the rating agencies I would think to consider and pass on the credit standing of the REIT lessor.

Julien Dumoulin Smith: Right. Anything else you want to say? I have no further questions at this time from the lines here. Anything else we should be addressing?

Tim Toy: No, I think not. It's been a far more exciting week than I'd ever imagined when I initially signed up to do this phone call. Hopefully, if there's an occasion to talk about this again, it will be with fewer major events in a short period of time.

Julien Dumoulin Smith: Excellent. Well thank you, Tim, for taking the time. Thank you all for listening. We'll call it a day there. Thank you. Cheers.

Tim Toy: Thank you. Bye.

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Company Disclosures

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Calpine Corporation[4, 5, 6, 7, 16]	CPN.N	Buy	N/A	US$14.42	18 May 2016
Dynegy, Inc.[4, 16]	DYN.N	Buy	N/A	US$18.29	18 May 2016
NRG Energy Inc.[7, 16]	NRG.N	Buy	N/A	US$15.31	18 May 2016
Talen Energy Corp[4, 5, 6, 16]	TLN.N	Neutral	N/A	US$12.33	18 May 2016

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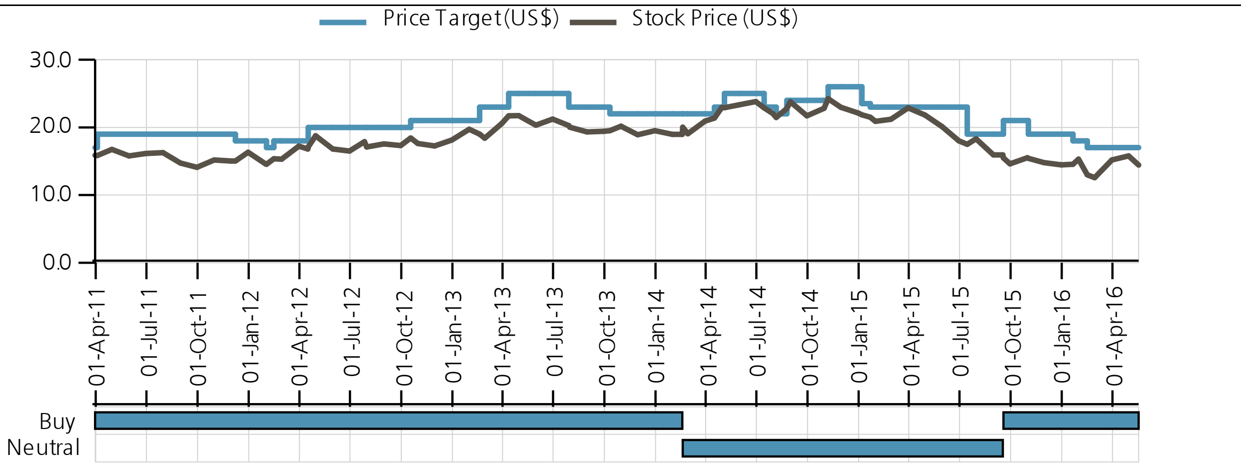
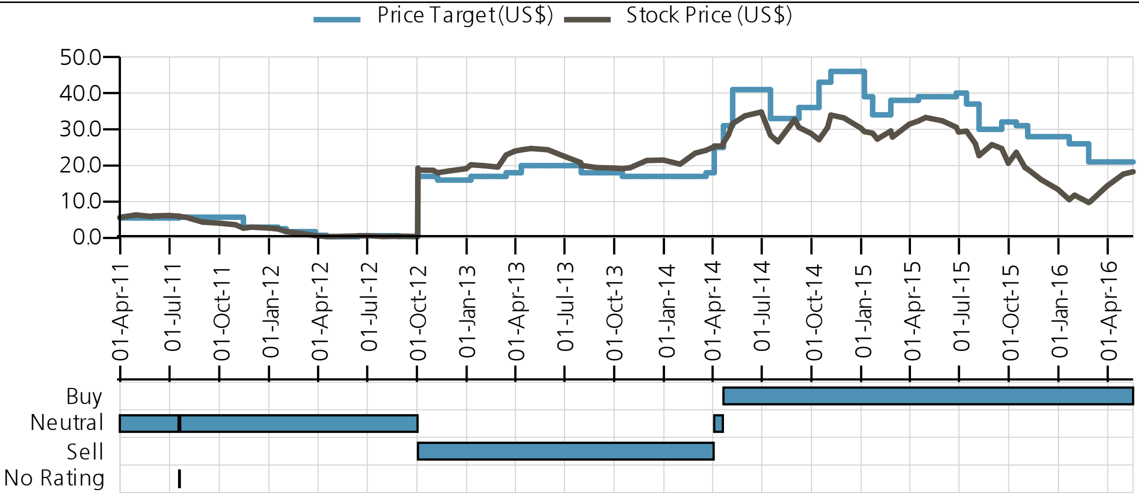
Calpine Corporation (US$)



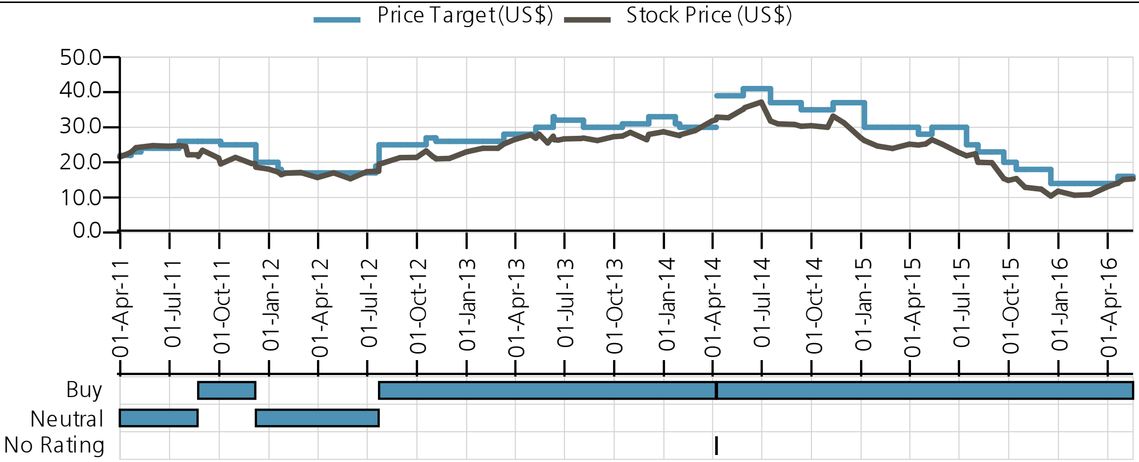
Source: UBS; as of 18 May 2016

Dynegy, Inc. (US$)



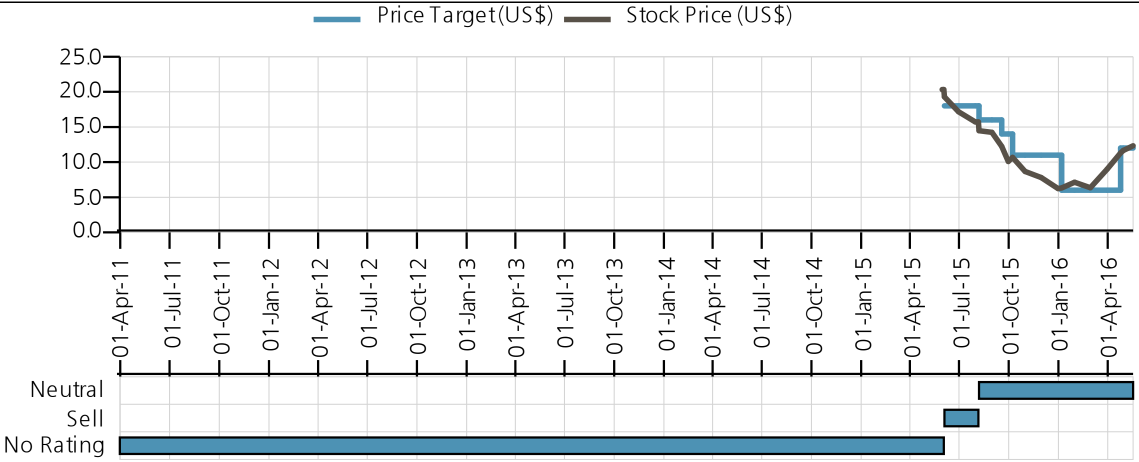
Source: UBS; as of 18 May 2016

NRG Energy Inc. (US$)



Source: UBS; as of 18 May 2016

Talen Energy Corp (US$)



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