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Statement No. 8

PhWa 11/19/97

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Petition of Enron Energy Services Power, Inc.
for approval of an Electric Competition and Customer Choice Plan
and for authority pursuant to Section 2807(e)(3)
of the Public Utility Code
to serve as the Provider of Last Resort
in the service territory of PECO Energy Company

Direct Testimony

of

Andrew S. Fastow

on behalf

Enron Energy Services Power, Inc.

concerning

Various Aspects of Securitization

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1 Q. Please state your name and business address.

2 A. My name is Andrew S. Fastow. My business address is 1400 Smith Street, Houston,
3 Texas 77002.

4
5 Q. By whom are you employed and in what capacity?

6 A. I am a Senior Vice President of Enron Corp., responsible for Enron's corporate finance
7 and treasury activities, risk analytics, capital investment analysis and portfolio
8 management.

9
10 Q. Please relate your professional experience.

11 A. Prior to moving to Enron Corp. in 1996, I was a Managing Director with Enron
12 Capital & Trade Resources ("ECT"). I joined ECT in 1990 to develop the company's
13 funding business and provide and manage the debt and equity capital required for
14 ECT's third-party finance business, as well as for ECT's physical and financial
15 acquisitions and investments. Prior to joining ECT, I served as Senior Director in
16 Continental Bank's Asset Securitization Group in Chicago, where I acquired specialized
17 skills in structuring short and medium-term, asset-backed securities for commercial
18 banks, leasing companies and corporate clients.

19
20 Q. Please state your educational background.

21 A. I received an MM in Finance from Kellogg Graduate School of Management at
22 Northwestern University and a BA in Economics and Chinese from Tufts University.

23

1 Q. **Have you testified previously before this Commission or other utility regulatory**
2 **agencies?**

3 A. No.

4
5 Q. **What is the purpose of your testimony in this proceeding?**

6 A. I have been asked by Enron Energy Services Power, Inc. ("Enron") to describe the
7 financing proposal in the Choice Plan filed by Enron and to compare the financing
8 proposal in the Choice Plan with the financing plan in PECO's Partial Settlement.

9
10 Q. **Please summarize your testimony.**

11 A. First, I present the details of the financing proposal in the Choice Plan, and
12 demonstrate the reasonableness of the assumptions and calculations which form its
13 premise. Second, I outline for the Commission the similarities and differences between
14 the Choice Plan and the Partial Settlement. From this review, it is clear that the
15 financing proposal is an effective means of delivering the greater savings promised to
16 ratepayers in the Choice Plan.

17
18 Q. **Please describe how PECO would finance its stranded cost recovery under the**
19 **Choice Plan.**

20 A. PECO would file a qualified rate order ("QRO") to issue \$5.461 billion of transition
21 bonds with an interest rate of 9.66% (subject to possible adjustment) ("Transition
22 Bonds"). I describe the derivation of the interest rate subsumed in the Choice Plan
23 projections later in my testimony.

1 Q. **What structure would be used?**

2 A. The structure to be used by PECO would be similar to that described by PECO as its
3 "preferred structure" in the direct testimony of J. Barry Mitchell in the Application of
4 PECO Energy Company for issuance of a Qualified Rate Order under Sections 2808
5 and 2812 of the Public Utility Code ("PECO Application").

6
7 Q. **Please describe how PECO's preferred structure would work under the Choice
8 Plan.**

9 A. Under PECO's preferred structure, PECO will sell the intangible transition property
10 ("ITP") and related intangible transition charges ("ITC") to a bankruptcy-remote
11 special purpose entity ("SPE") established for the transaction (probably a trust).

12
13 Q. **Please describe the purpose of the "bankruptcy-remote special purpose entity."**

14 A. The purpose of the SPE will be to: (1) buy the ITP and related ITC from PECO, (2)
15 issue \$5.461 billion of Transition Bonds, (3) deposit the Transition Bonds in a grantor
16 trust established for the purpose of issuing pass-through certificates, (4) receive the ITC
17 revenues and (5) pay interest and principal on the Transition Bonds to the grantor trust.

18
19 Q. **How will the SPE finance the acquisition of the ITP and related ITC from PECO?**

20 A. The SPE will finance its acquisition of the ITP and related ITC by issuing \$5.461
21 billion of Transition Bonds, the proceeds of which will be remitted to PECO as the
22 purchase price of the ITP and related ITC.

23

1 Q. **Will the SPE have a reserve account?**

2 A. Yes. The SPE will be required to make certain deposits in reserve accounts that may
3 be necessary to obtain the desired tax ruling and mitigate possible fluctuations in
4 PECO's customer load levels over the life of the Transition Bonds.

5
6 Q. **What other characteristics of the transaction are pertinent?**

7 A. The sale of the ITP and the related ITC revenue stream to the SPE will be structured as
8 a "true sale" for bankruptcy purposes. For accounting purposes, PECO will record the
9 Transition Bonds on its books and records as debt. For federal income tax purposes,
10 PECO will report the transfer of the ITP and related ITC revenue stream and the
11 issuance of the Transition Bonds as a debt financing, not a sale. As a result, PECO
12 will not face an immediate tax burden from the transaction.

13
14 Q. **Who will purchase the \$5.461 billion of Transition Bonds?**

15 A. The entire \$5.461 billion of Transition Bonds will be deposited in a special purpose
16 entity known as a grantor trust.

17
18 Q. **How will the grantor trust obtain the funds to purchase the Transition Bonds?**

19 A. Enron (or its designee) will commit to cause the grantor trust to purchase the \$5.461
20 billion of Transition Bonds. The grantor trust will issue two classes of trust certificates
21 ("Pass-Through Certificates"). The Class A Pass-Through Certificates will be issued to
22 investors and will be backed by the principal and a portion of the interest payments the
23 grantor trust will receive as a result of its purchase of the \$5.461 billion of Transition

1 Bonds. In consideration for: (1) providing the commitment in respect of the grantor
2 trust, (2) arranging for the make-whole agreement described below, and (3) accepting
3 the risk of adverse interest rate movement, Enron (or its designee) will be issued Class
4 B Pass-Through Certificates backed only by the portion of the interest payments not
5 allocable to the Class A Pass-Through Certificates.
6

7 **Q. What is the anticipated net present value of the Class B Pass-Through Certificates**
8 **on the financing date?**

9 **A.** It is difficult to determine what the value of the Class B Pass-Through Certificates will
10 be because it is subject to the prevailing interest rate environment, as discussed below,
11 and because it can be affected by rating agency determinations with respect to the
12 Transition Bonds.
13

14 **Q. In its reply to the Choice Plan, PECO states that the financing proposal in the**
15 **Choice Plan includes a profit with a net present value of approximately \$1.0**
16 **billion. Is that accurate?**

17 **A.** I don't think so. It is unclear how much net profit Enron would make but we do know
18 that the Choice Plan's profitability would be at least \$500 million less than PECO's
19 profit under the Partial Settlement proposal.
20

21 **Q. Once PECO assigns the ITP and related ITC to the SPE, does PECO have any**
22 **other responsibilities?**

23 **A.** Yes. PECO will act as "servicer" of the ITC revenue stream.

1 Q. What are the obligations of the "servicer" of the revenue stream to the SPE?

2 A. Because the SPE has no staff, the SPE will rely on PECO to bill all customers of its
3 distribution system for the ITC and to make collections of the ITC from all default
4 service customers.

5
6 Q. Will PECO be reimbursed for expenses associated with servicing the revenue
7 stream to be paid to the SPE?

8 A. Yes. As is typical in securitization transactions, the servicer is paid an arm's length fee
9 for the administration costs of servicing the ITC revenue stream. PECO would be
10 entitled to such a fee.

11
12 Q. Will PECO have total entitlement to the "servicer" function?

13 A. Not necessarily. Other electric generation suppliers ("EGSs") licensed by the
14 Commonwealth of Pennsylvania may also collect ITC revenues on behalf of the SPE if
15 the Commission determines that this is in the public interest.

16
17 Q. Where will the monies collected for ITC payments go?

18 A. The ITC payments collected from customers will be deposited by PECO (and other
19 EGSs, if appropriate) into accounts set up by the SPE, on a regularly scheduled basis to
20 be determined by the rating agencies.

21
22 Q. Will the Commission's rules and regulations governing customer collections
23 pertain to ITC payments?

1 A. Yes. These collection activities will be subject to the Commission's regulations
2 regarding collections, customer relationships and other consumer-related matters.

3

4 Q. Please describe the proposed "true-up" mechanism.

5 A. Pursuant to the Electricity Generation Customer Choice and Competition Act
6 ("Competition Act"), there will be periodic "true-up" reviews of the ITC revenue
7 stream by the Commission.

8

9 Q. What is the purpose of the proposed "true-ups?"

10 A. The true-up mechanism permits PECO and the Commission to maintain the ITC at a
11 level that allows full recovery of the funds needed to make the payments of interest and
12 principal on the Transition Bonds, pursuant to the amortization schedule for the
13 Transition Bonds determined at the time of the offering.

14

15 Q. Is it likely that this true-up mechanism will increase the burden on ratepayers of
16 funding the repayment of the Transition Bonds under the Choice Plan?

17 A. I do not believe so. Under the Choice Plan, the true-up review is designed to result in
18 no increase in the amounts payable by ratepayers even if the ITC rate is increased.

19

20 Q. How is that so?

21 A. The Choice Plan will require a highly creditworthy party (the "Guarantor") to enter
22 into an agreement with PECO that will be known as the "ITC Shortfall Agreement."

23

1 Q. Please describe the ITC Shortfall Agreement.

2 A. The ITC Shortfall Agreement will require the Guarantor to fund shortfalls if the ITC
3 payment stream is not sufficient to meet the amortization schedule of the Transition
4 Bonds. The ITC Shortfall Agreement allows Enron to fulfill its promise to cap the
5 level of rates paid by ratepayers while satisfying the rating agencies' criteria requiring a
6 true-up mechanism in all transition bond financings as a condition of receiving the
7 highest available bond rating as well as what we believe to be required for a favorable
8 Internal Revenue Service ("IRS") ruling. Through the ITC Shortfall Agreement, Enron
9 is seeking to eliminate the risk that an increase in ITC payments pursuant to a true-up
10 will result in any increase in total amounts required to be paid by ratepayers in order to
11 service the Transition Bonds.

12
13 Q. Will there be a limit on the Guarantor's obligation under the ITC Shortfall
14 Agreement?

15 A. Yes. Enron will ask a major rating agency to determine the level of guaranty that
16 would be needed in a hypothetical case to keep the Transition Bonds rated at the highest
17 available bond rating for this asset class if they were issued with no true-up mechanism.
18 The amount of the guaranty recommended by the rating agency will become the
19 guaranty amount required under the ITC Shortfall Agreement ("Guaranty Amount").

20
21 Q. Please describe what will occur in a true-up review proceeding?

22 A. In a true-up review proceeding, PECO will report to the Commission on the adequacy
23 of ITC payments during the prior collection period. PECO will report to the

1 Commission whether there has been, or there is projected to be during the current
2 collection period, a shortfall in the ITC payments needed to service the Transition
3 Bonds ("ITC Shortfall").

4
5 **Q. What will the Commission do if an ITC Shortfall has occurred or is projected to**
6 **occur during the current collection period?**

7
8 **A. The Commission will increase the ITC rate that may be charged to ratepayers in the**
9 **following period to an amount sufficient to fully service the Transition Bonds ("ITC**
10 **Rate Increase").**

11
12 **Q. How will an ITC Rate Increase not lead to higher ITC payments from ratepayers?**

13 **A. Under the ITC Shortfall Agreement, the Guarantor would make payments to PECO in**
14 **an amount corresponding to the projected additional ITC to be collected from**
15 **ratepayers, which will allow rates otherwise to be collected from ratepayers to be**
16 **reduced by a corresponding amount, with the net amount to be collected from**
17 **ratepayers remaining the same.**

18
19 **Q. What will happen if ITC payment streams after an ITC Rate Increase exceed the**
20 **amount necessary to service the amortized debt?**

21 **A. If future ITC payment streams were to be more than sufficient to service the Transition**
22 **Bonds, the Guarantor would be reimbursed for the shortfall payments made pursuant to**
23 **the ITC Shortfall Agreement and the SPE's equity and reserves would be replenished.**

- 1 Q. What will happen if ITC payment streams pursuant to an ITC Rate Increase
2 continue to exceed the debt service obligations after reimbursement of the
3 Guarantor?
- 4 A. At the successive true-up proceeding, the Commission will decrease the ITC level to a
5 level that remains adequate to service the debt obligations ("ITC Rate Decrease"), but
6 an ITC Rate Decrease would be limited so as not to produce an ITC level below the
7 levels set for each year in the Choice Plan prior to the full payment of all principal and
8 interest payments on the Transition Bonds.
- 9
- 10 Q. Does this approach place the Guarantor designated by Enron at risk of losing all
11 of the Guaranty Amount?
- 12 A. Yes. Furthermore, the Guarantor will have no recourse to ratepayers, to PECO, to the
13 SPE or to the grantor trust.
- 14
- 15 Q. How might an ITC Shortfall occur?
- 16 A. An ITC Shortfall could occur principally as a result of a decline in the amount of
17 power delivered to customers over PECO's transmission and distribution lines from the
18 1996 base year ("Base Load Level") being used by the Partial Settlement and the
19 Choice Plan.
- 20
- 21 Q. Is there a risk that the ITC Shortfall will exceed the Guaranty Amount?

1 A. Practically speaking, there is no such risk. In establishing the Guaranty Amount, the
2 rating agency will be applying triple-A standards to the risk of a decline in Base Load
3 Level. These standards are very vigorous and are clearly more than adequate.
4

5 **Q. What flexibility is required to ensure that the proposed structure continue to**
6 **comport with the public interest over time?**

7 A. Regulatory flexibility is critical at this time of industry-wide transition. Because the
8 financing of customer transition cost payments through the issuance of bonds has not
9 yet been executed by an utility company in the United States, some uncertainty remains
10 on technical aspects of implementation, including tax treatments.
11

12 **Q. Please describe the tax treatment uncertainties for the Commission.**

13 A. PECO has stated that it proposes to characterize the issuance of transition bonds as debt
14 financing, rather than as a sale, for federal income tax purposes. Characterizing
15 transition bonds as a debt financing will allow PECO to recognize income or gain on
16 the ITC payment stream as it is collected rather than all at once upon the issuance of
17 transition bonds. PECO has indicated that they are applying for a private letter ruling
18 from the IRS seeking confirmation of the characterization of the issuance of transition
19 bonds as a debt financing for federal tax purposes. The California utilities have
20 recently received such a private letter ruling in connection with their issuance of
21 transition bonds. Enron believes that the financing proposal in the Choice Plan is
22 consistent in all material ways with the California proposals and the PECO Application

1 and that a private letter ruling can be obtained by PECO confirming the debt financing
2 characterization.

3
4 **Q. Are there any other uncertainties in the securitization transaction?**

5 A. It is possible that structural modifications may be required to address any further legal
6 and rating agency concerns. We believe that those uncertainties will be resolved in a
7 manner that does not require changes to our proposal; however, if those uncertainties
8 are resolved with an unexpected outcome, certain modifications to the proposal may be
9 required.

10
11 **Q. Please explain why the Transition Bonds will be recorded on PECO's books and
12 records as debt.**

13 A. The Securities and Exchange Commission has denied a request to record the issuance of
14 transition bonds similar to those proposed by the Choice Plan and by PECO as a sale.

15
16 **Q. Please explain why the Choice Plan proposes for PECO to issue Transition Bonds
17 with a 9.66% interest rate (subject to possible adjustment).**

18 A. The implicit interest rate is merely a product of the formula used to create an
19 amortization schedule that services \$5.461 billion in debt with the expected
20 \$9,533,389,183 in ITC payments over 124 months, assuming no increase in the Base
21 Load Level over that period ("Assumed ITC Payment Stream"). Accordingly, the
22 9.66% interest rate to be charged on the Transition Bonds represents an implicit interest
23 rate derived from comparing the present value of \$5.461 billion, the amount of

1 proceeds from issuing the transition bonds, to the Assumed ITC Payment Stream. In
2 other words, we knew the present value -- the \$5.461 billion in proceeds to be paid to
3 PECO -- and we knew the amount of Assumed ITC Payment Stream the Choice Plan's
4 tariff would generate, so we calculated the interest rate that makes the Assumed ITC
5 Payment Stream equal to a present value of \$5.461 billion. In calculating the implicit
6 interest rate, we chose not to consider seasonal fluctuations in energy usage. From the
7 proof of revenue, we obtained the 1999-2008 annual ITC payment streams. We next
8 converted the annual payment streams into monthly payment streams by dividing the
9 annual payment streams by 12, thereby simplifying the interest rate calculation. The
10 important point to recognize here is that the 9.66% interest rate is substantially less
11 than the implicit interest rate used by PECO. The difference between the PECO
12 implicit rate and the lower 9.66% rate in the Choice Plan allows Enron to save PECO's
13 customers over \$500 million (on a net present value basis) that PECO would have
14 otherwise kept for its management and shareholders.

15
16 **Q. What impact does the existence of a payment lag have on the interest rate**
17 **proposed?**

18 **A. An important factor in the calculation of the implicit interest rate is the timing of the**
19 **payment of transition bond payments in relation to the timing of the receipt of ITC cash**
20 **flows.**

1 Q. Please explain.

2 A. It is anticipated under the Choice Plan that PECO will be paid \$5.461 billion on August
3 31, 1998. Beginning on September 1, 1998, ITC obligations will begin to accrue on
4 customer accounts. However, there will be some delay before any ITC payments are
5 collected.

6
7 Q. How was the delay in payments factored into the determination of the interest
8 rate?

9 A. When we ran our financial model assuming the first payment would be made on
10 October 1, 1998, and on the first day of every month thereafter until maturity, the
11 implicit interest rate was approximately 9.72%. However, when we ran our financial
12 model assuming the first payment would be made on November 1, 1998, and on the
13 first day of every month thereafter until maturity, the implicit interest rate was
14 approximately 9.58%. For purposes of setting the interest rate, the Choice Plan
15 actually assumes that the ITC payment stream will be sufficient on the 15th day of each
16 month to service the Transition Bonds, with the first payment being made on October
17 15, 1998. Given the plan for payments to be made on October 15, 1998 and the
18 fifteenth day of every month thereafter until maturity, the implicit interest rate was
19 interpolated to be approximately in the middle between 9.72% and 9.58%, or
20 approximately 9.66%.

21
22 Q. Is the interest rate intended to reflect a market rate?

1 A. No. For clarification, it must be emphasized that the implicit interest rate is merely a
2 financing device designed to create an amortization schedule that services \$5.461
3 billion in debt with the Assumed ITC Payment Stream which keeps in the hands of
4 ratepayers over \$500 million that PECO plans to keep for itself.

5
6 Q. **Could there be an adjustment in the interest rate on the Transition Bonds?**

7 A. Yes.

8
9 Q. **Please explain why there may be an adjustment in the interest rate on the
10 Transition Bonds and how that adjustment works.**

11 A. A major aspect of the Choice Plan is the payment to PECO of \$5.461 billion. Given
12 that the proposed payment may not be made for 10 months, the Choice Plan presents
13 Enron with a significant risk that the interest rate environment could change
14 considerably by August, 1998, when the \$5.461 billion payment will be made. The
15 possible change in interest rates will affect Enron's cost to arrange for the issuance of
16 the Pass-Through Certificates. In order to deal with this risk, Enron proposed to leave
17 the Choice Plan as proposed provided that 10-year U.S. Treasury obligations (the
18 "Actual Index Interest Rate") remain in the range of 5.75% and 7%. Our analysis
19 indicated that Enron would be able to make a reasonable rate of return based on the
20 risks assumed by Enron under the Choice Plan, provided that said range was
21 maintained.

22

1 Q. Does the Choice Plan propose that Enron retain the benefit of a reduction in the
2 Actual Index Interest Rate?

3 A. Absolutely not. If the Actual Index Interest Rate falls below 5.75% on the financing
4 date, Enron will not keep the benefit of any additional interest rate reductions. Instead,
5 the Choice Plan provides that the ITC rate in the Choice Plan would be reduced with
6 the additional savings from the rate being below 5.75% being passed on to ratepayers
7 through a lower bell cap.

8
9 Q. What happens if the treasury rate rises above the 7% edge of the bandwidth?

10 A. In the event the Actual Index Interest Rate rises above 7%, the situation is more
11 problematic. For its part, Enron has concluded that it would be unacceptable to
12 increase the ITC and the bill cap to defer the cost of higher interest rates. The Choice
13 Plan reflects this commitment.

14
15 Q. How does the Choice Plan address an index rate above 7%?

16 A. To address the issue of a rising interest rate, the Choice Plan proposes that, at that
17 time, PECO make a filing with the Commission to increase ITC rates and decrease the
18 generation credit without raising the bill cap. This would prevent PECO ratepayers
19 from losing the promised rate reductions. The Commission should recognize that the
20 cost of such a change will likely be borne in the form of reduced competition in the
21 market due to the reduced generation credits.

22

1 Q. Do PECO's customers face this possible increase in CTC/ITC rates under the
2 Partial Settlement proposal?

3 A. PECO's Partial Settlement is unlikely to produce such an increase only because
4 PECO's proposal already includes at least \$500 million (on a net present value basis) in
5 CTC/ITC payments above Enron's Assumed ITC Payment Stream. Not only does
6 PECO take and keep that extra money, PECO also will keep any over collection due to
7 growth beyond the Base Load Level. Accordingly, PECO can well afford to claim that
8 it won't seek an increase in the CTC/ITC because it is already taking a profit above and
9 beyond its authorized stranded cost recovery that far exceeds its possible risk.

10

11 Q. Please describe how Table A in the Choice Plan relating to the movement of
12 interest rates was computed.

13 A. Table A illustrates the reduction in ITC payments that will result if the Actual Index
14 Interest Rate falls below 5.75%. The first line in that table demonstrates the outcome
15 if the Actual Index Interest Rate is 5.50%, which would be 25 basis points below the
16 5.75% floor. The first thing that would happen would be that the proposed 9.66%
17 interest rate on the bond would be adjusted by reducing it by 25 basis points and the
18 ITC would be reduced by an equal amount each year in order to bring the present value
19 of the cash flows back into line with the \$5.461 billion to be paid to PECO. Our
20 analysis has indicated that for every basis point reduction in the stated 9.66% rate, the
21 ITC would be reduced by approximately 0.0014 cents/kWh. With respect to a 25 basis
22 point reduction, the reduction would be 25 times that amount or 0.035 cents/kWh.

23

1 Q. **And for Table B?**

2 A. Likewise, Table B illustrates the effects of the Actual Index Interest Rate rising above
3 7%. A 25 basis point increase in the Actual Index Interest Rate beyond 7% would
4 result in a decrease in the present value of the ITC cash flows. In order to mitigate this
5 loss of value, the Choice Plan proposes that the ITC be increased by an equal amount
6 each year in order to bring the present value of the cash flows back into line with the
7 \$5.461 billion to be paid to PECO. Our analysis has indicated that for every basis
8 point increase in the stated 9.66% rate, the ITC would have to be increased by
9 approximately 0.0014 cents/kWh. With respect to a 25 basis point increase, the
10 increase would be 25 times that amount or an increase of 0.035 cents/kWh.

11

12 Q. **Why does the Choice Plan rely on the 10-year U.S. Treasury obligation rate to**
13 **establish the interest rate bandwidth?**

14 A. The 10-year U.S. Treasury serves as the Actual Index Interest Rate because it is a well-
15 known and daily published benchmark. It is also a good model for the Transition
16 Bonds because they have a weighted average life of approximately 7 years and a 124
17 month maturity.

18

19 Q. **Please explain the similarities and differences in how PECO would finance its**
20 **stranded cost recovery under the Partial Settlement and how PECO would finance**
21 **its stranded cost recovery under the Choice Plan.**

22 A. The structure of the two proposals and the procedures necessary for the issuance of
23 bonds under the two proposals are quite similar. Under both plans, PECO would make

1 an application for a QRO to issue Transition Bonds backed by ITC payments. In both
2 cases, PECO would include the mechanisms necessary to obtain very high credit ratings
3 and favorable tax treatment.

4
5 **Q. Please itemize those mechanisms which lead to a favorable credit rating and tax**
6 **treatments.**

7 **A.** The proposed mechanisms include: (i) requesting in the QRO that the order be
8 irrevocable, (ii) establishing a bankruptcy-remote special purpose vehicle to issue the
9 debt; (iii) obtaining a true sale opinion; (iv) incorporating reserves and other provisions
10 required to obtain a private letter ruling from the IRS; and (v) incorporating a true-up
11 mechanism in the plan.

12
13 **Q. What differences exist between the financing plan for the transition costs in the**
14 **Partial Settlement and that proposed in the Choice Plan?**

15 **A.** The main difference is the dramatically greater savings to ratepayers produced by the
16 Choice Plan. The other major differences between the two financing plans relate more
17 to the assignment of risks and benefits between ratepayers, PECO and Enron than to
18 structural variations.

19
20 **Q. Please provide some examples.**

21 **A.** Certainly. Under the Choice Plan, for example, if energy sales are higher over the ten
22 year period than the Base Load Level, Enron will petition the Commission to order
23 PECO to return the excess ITC payments to ratepayers after the full payment of all

1 principal and interest payments on the Transition Bonds. In contrast, under the Partial
2 Settlement, PECO will retain any overpayments of CTC/ITC at the end of the ten year
3 CTC/ITC payment period.
4

5 **Q. What if energy sales during the amortization period are lower than the Base Load**
6 **Level?**

7 **A.** Under the Choice Plan, if an energy sales decline results in an ITC Increase, the
8 Guarantor will pay any shortfall up to the Guaranty Amount without any impact on the
9 ratepayer's bill. In contrast, under the Partial Settlement, the ITC payment will be
10 increased, with a corresponding decrease in the remaining CTC, up to the amount of
11 the combined CTC/ITC payment. In either case, the total rate paid by ratepayers will
12 not increase unless there is a catastrophic decline in energy usage from the Base Load
13 Level.
14

15 **Q. Are there any other significant differences between the Choice Plan and the**
16 **Partial Settlement?**

17 **A.** Yes. As described above, the Choice Plan also offers a further rate reduction if the
18 Actual Index Interest Rate falls below 5.75%. Under the Partial Settlement, PECO
19 keeps the additional savings from such a decline in its coffers.
20

21 **Q. Is there any significant structural difference between the proposals?**

22 **A.** Yes. The significant structural variation between the two plans is that, under the
23 Choice Plan, PECO will issue the Transition Bonds to a grantor trust, which will in

1 turn issue Pass-Through Certificates to investors and to Enron (or its designee).

2 However, as discussed in the testimony of Susan Voorhees of Chase Securities Inc.,
3 this is not a novel or complex structure for a securitization financing.

4
5 **Q. Please explain any differences between the Assumed ITC Payment Stream and the
6 CTC/ITC payment stream proposed under the Partial Settlement?**

7 **A.** The Assumed ITC Payment Stream is at least \$500 million less (on a net present value
8 basis) than the CTC/ITC payment stream proposed by PECO. Furthermore, PECO
9 obtains most of its extra cash in the early years, which has the further benefit to PECO
10 of impeding competition by forcing down the generation credit.

11
12 **Q. Under the Choice Plan, what happens to the ITC collections if PECO experiences
13 load growth on its distribution system?**

14 **A.** If there is an increase in the Base Load Level, ITC collections can be suspended once
15 all of the principal and interest on the Transition Bonds has been paid.

16
17 **Q. Under the Choice Plan, what happens to the ITC collections if PECO experiences
18 load decline on its distribution system?**

19 **A.** If there is a decrease in the Base Load Level, the ITC rate will be increased, but there
20 will be no net increase in rates paid by ratepayers because the Guarantor will fund the
21 ITC Shortfall. PECO will not be responsible for making up shortfalls due to load
22 decline.

1 Q. Does this conclude your testimony?

2 A. Yes, at this time. I must say, however, that this testimony is based on my knowledge
3 of these matters as of today. Given the constant movement regarding securitization in
4 particular and electric industry restructuring in general, I must reserve my right to
5 update or supplement this Testimony to properly inform the Commission and to reflect
6 additional information as it becomes available.

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Petition of Enron Energy Services Power, Inc. for
Approval of an Electric Competition and Customer Choice Plan
and for Authority Pursuant to Section 2807(e)(3) of the
Public Utility Code to Serve as the Provider of Last Resort
in the Service Territory of PECO Energy Company

Rebuttal Testimony

of

Andrew S. Fastow

on behalf of

Enron Energy Services Power, Inc.

Concerning

Various Aspects of Securitization

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1 Q. PLEASE STATE YOUR NAME AND BUSINESS AFFILIATION.

2 A. My name is Andrew S. Fastow. I am a Senior Vice President of Enron Corp.

3

4 Q. HAVE YOU PREVIOUSLY SUBMITTED TESTIMONY IN THIS
5 PROCEEDING?

6 A. Yes, I submitted Enron Statement Number 8.

7

8 Q. HAVE YOU HAD THE OPPORTUNITY TO REVIEW THE PORTIONS OF
9 PECO'S TESTIMONY ON THE CHOICE PLAN APPLICABLE TO THE
10 FINANCING PROPOSAL?

11 A. Yes.

12

13 Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

14 A. To address the portions of the testimony of Messrs. Hill, Mitchell, Sharpe, Hiller and
15 Rayzis that address the financing proposal in the Choice Plan filed by Enron.

16

17 Q. WHAT ARE THE PRINCIPAL CLAIMS IN THE TESTIMONY OF THE PECO
18 WITNESSES WITH RESPECT TO THE FINANCING PROPOSAL IN THE
19 CHOICE PLAN?

20 A. There are seven principal claims:

21 1. Mr. Mitchell claims that Enron will make a profit on the financing plan, thereby
22 rendering the financing plan unworkable.

23 2. Mr. Mitchell claims that the financing plan will violate the Competition Act
24 because the transition bonds will be issued for more than ten years.

1 3. Mr. Hiller claims that the financing plan is unworkable because there is
2 insufficient cash flow in the early years to service the transition bonds.

3 4. Mr. Mitchell claims that the financing plan violates the PECO mortgage bond
4 indenture.

5 5. Mr. Sharpe claims that PECO will be unable to obtain favorable tax treatment for
6 the proceeds from issuance of the transition bonds under the financing plan.

7 6. Mr. Mitchell claims that the financing plan is detrimental to PECO because it
8 does not include certain financing costs to be incurred by PECO.

9 7. Mr. Mitchell claims that the financing plan will destroy PECO's financial health.
10

11 **Q. PLEASE ADDRESS THE CLAIM THAT ENRON WILL MAKE A PROFIT ON**
12 **THE FINANCING PLAN, THEREBY RENDERING IT UNWORKABLE.**

13 A. The potential profit that Enron may earn under the financing plan is not germane to any
14 substantive issue in this case. Enron has submitted a financing plan that provides
15 PECO with a cash payment of \$5.461 billion in exchange for the issuance by PECO of
16 \$5.461 billion of transition bonds with a AAA rating (or its equivalent) or the highest
17 possible rating for their asset type (the "Required Rating"). As discussed more
18 specifically below, the potential profit of Enron does not harm the viability of the
19 financing plan.

1 **Q. PLEASE ADDRESS THE CLAIM THAT THE FINANCING PLAN WILL**
2 **VIOLATE THE COMPETITION ACT BECAUSE THE TRANSITION BONDS**
3 **WILL BE ISSUED FOR MORE THAN TEN YEARS.**

4 A. In response to this claim, Enron is amending the financing proposal in the Choice Plan
5 to limit the transition bonds to a ten year maturity.
6

7 **Q. PLEASE ADDRESS THE CLAIM THAT THE FINANCING PLAN IS**
8 **UNWORKABLE BECAUSE THERE IS INSUFFICIENT CASH FLOW IN THE**
9 **EARLY YEARS TO SERVICE THE TRANSITION BONDS.**

10 A. This claim appears to relate to the treatment of gross receipts taxes ("GRT") under the
11 Choice Plan. In structuring our plan, a major effort was made to understand the
12 assumptions underlying the Partial Settlement. In preparing the Choice Plan, however,
13 it was not clear whether PECO's proposed CTC charges under the Partial Settlement
14 were inclusive of GRT. PECO's response testimony provides further information on
15 the treatment of the GRT on CTC charges by PECO and, in response to such additional
16 information, Enron has adjusted the financing proposal in the Choice Plan to reflect
17 this fact.
18

19 **Q. PLEASE ADDRESS THE CLAIM THAT THE FINANCING PLAN VIOLATES**
20 **THE FIRST MORTGAGE BOND INDENTURE.**

21 A. Mr. Mitchell claims that PECO could not obtain a release of Intangible Transition
22 Property ("ITP") from the lien of the PECO Mortgage under the financing plan because

1 the financing plan would not provide "the full fair value" of the ITP to the trustee
2 under the PECO Mortgage.

3
4 **Q. DO YOU BELIEVE ENRON WOULD BE FURNISHING FAIR AND**
5 **EQUIVALENT VALUE?**

6 A. Yes. PECO has stated that the CTC/ITC payment stream under the Partial Settlement
7 has a value of \$5.461 billion, given the other risks and obligations that they are
8 undertaking. The financing plan under the Choice Plan will give them \$5.461 billion
9 in cash. In addition, Enron will be taking load decline risk and interest rate risk from
10 PECO. Together, the cash and risk assumption represent full fair value. How the
11 grantor trust finances the purchase of the transition bonds is irrelevant.

12
13 **Q. WHAT OTHER VALUE DO YOU SEE THE FINANCING PLAN OFFERING**
14 **THAT PECO'S WITNESSES MAY HAVE OVERLOOKED OR DISCOUNTED?**

15 A. Enron has agreed to make available to PECO an up-front payment of \$5.461 billion.
16 Enron regards the size of that payment as a significant item of value, representing
17 Enron's willingness to furnish to PECO a sum that PECO is unable or unwilling to
18 raise on its own in the capital markets. It also furnishes the PECO Mortgage trustee
19 with additional cash to deploy to retire and service first mortgage bonds.
20

1 Q. NOT ALL OF THE ELEMENTS OF VALUE YOU MENTION ARE IN THE
2 FORM OF CASH. ARE THESE ELEMENTS OF VALUE STILL RELEVANT
3 TO THE "FAIR EQUIVALENCE" TEST UNDER THE PECO MORTGAGE?

4 A. The PECO Mortgage provides for release of mortgaged property "for cash or other
5 property of at least equal value." Counsel has advised me that these words mean what
6 they say. That is, by the way, contrary to the testimony of Mr. Mitchell, who stated
7 that equivalence had to be established between the ITP and cash.

8 Apart from being material from a legal standpoint, the non-cash value Enron is
9 providing speaks to the fairness of the transaction structure from the PECO Mortgage
10 bondholders' standpoint, which is important as a commercial matter.

11
12 Q. WHAT WOULD YOU SEE THE TRUSTEE DOING WITH THE LARGER
13 CASH PAYMENT IT WOULD RECEIVE FROM PECO VIA ENRON?

14 A. The PECO Mortgage provides for defeasance upon deposit with the trustee of amounts
15 sufficient to repay the PECO Mortgage bonds. It seems reasonable to think that if \$3.8
16 billion of bonds are outstanding and Enron furnishes \$5.461 billion in payments that
17 defeasance would be an alternative worth looking into.

18
19 Q. WHAT WOULD HAPPEN TO THE ITP IN THE EVENT OF A DEFEASANCE?

20 A. Based on advice of counsel, it appears that under the PECO Mortgage the lien of the
21 PECO Mortgage would be eliminated and no property of PECO, including the ITP,

1 would be subject to this lien any longer. In that case, the "collateral release" issue
2 raised by PECO's witnesses would be moot.

3
4 **Q. WERE THERE ANY OTHER ASPECTS OF PECO'S TESTIMONY**
5 **CONCERNING THE PECO MORTGAGE WITH WHICH YOU TAKE ISSUE?**

6 A. Yes, there are two. First, it was suggested by Mr. Rayzis that he would not release the
7 ITP from the lien of the PECO Mortgage without a request from PECO and without a
8 sworn statement from the president or a vice president of PECO, a resolution of the
9 PECO board of directors and a certificate of an independent expert. Enron sees no
10 reason why, as part of a resolution of the matter, these requirements cannot and should
11 not be easily satisfied.

12
13 **Q. WHAT IS YOUR OTHER CONCERN?**

14 A. It was stated that PECO would have to maintain its franchises and could not omit doing
15 so if in the opinion of PECO the change was inadvisable. This was interposed in Mr.
16 Mitchell's testimony as a barrier against Enron's becoming provider of last resort.
17 Enron is not seeking to cause PECO to do anything that is inadvisable from PECO's
18 standpoint. As with the matter of certificates, resolutions, appraisals and other such
19 matters, Enron trusts that the PECO Mortgage will not be interposed as a tactical
20 obstacle to PECO's performing responsibly in the emerging competitive environment
21 whether or not the Choice Plan is adopted.

1 Q. WHO IS THE COUNSEL WHOSE ADVICE YOU SOUGHT WITH REGARD
2 TO THE PECO MORTGAGE?

3 A. LeBoeuf, Lamb, Greene & MacRae, L.L.P., a law firm with extensive experience in
4 public utility financing transactions that has been acting as Enron's counsel in
5 connection with the Choice Plan.

6
7 Q. PLEASE ADDRESS THE CLAIM THAT PECO WILL BE UNABLE TO
8 OBTAIN FAVORABLE TAX TREATMENT FOR THE PROCEEDS FROM
9 ISSUANCE OF THE TRANSITION BONDS UNDER THE FINANCING PLAN.

10 A. The financing proposal in the Choice Plan, amended as stated here and above, contains
11 the four principal requirements that Mr. Sharpe's testimony states are believed to be
12 necessary for the IRS to be willing to issue a private letter ruling to PECO. The four
13 requirements believed to be essential are:

14 1. An initial capital contribution of 0.5% by PECO to the SPE. This has always
15 been contemplated by the Choice Plan and the financing proposal has been
16 amended to make this characteristic explicit.

17 2. Build-up of an overcollateralization reserve in the SPE. This has always been
18 contemplated by the Choice Plan and the financing proposal has been amended to
19 make this characteristic explicit.

20 3. Fixed payment schedule on the Transition Bonds. The financing proposal has
21 been amended to require this characteristic. Complying with this requirement is
22 completely consistent with the other provisions of the financing plan.

1 4. Quarterly payments by the SPE on the Transition Bonds. The financing proposal
2 has been amended to require this characteristic. Complying with this requirement
3 is completely consistent with the other provisions of the financing plan.
4

5 **Q. MR. SHARPE'S TESTIMONY ASSERTS THAT THE SECURITIZATION**
6 **TRANSACTION CONTEMPLATED BY THE CHOICE PLAN DIFFERS FROM**
7 **THE SECURITIZATION TRANSACTION CONTEMPLATED BY THE**
8 **PARTIAL SETTLEMENT IN WAYS THAT IN HIS OPINION WILL BE**
9 **"CRITICAL" TO THE IRS IN DECIDING WHETHER TO ISSUE A**
10 **FAVORABLE RULING. PLEASE COMMENT ON THE STATED "CRITICAL"**
11 **DIFFERENCES.**

12 **A.** Some of the differences referred to by Mr. Sharpe are addressed in the preceding
13 answer regarding compliance by the financing proposal with what Mr. Sharpe asserts
14 are the IRS's four essential requirements. Several of his other factual assertions are
15 incorrect or questionable, as discussed below. Finally, Mr. Sharpe offers no indication
16 or analysis about the possible relevance of any of the differences that he identifies.
17

18 **Q. PLEASE ADDRESS MR. SHARPE'S ASSERTION THAT THE ALLEGEDLY**
19 **ABOVE-MARKET INTEREST RATE ON THE TRANSITION BONDS MAY**
20 **HAVE AN ADVERSE IMPACT ON OBTAINING A TAX RULING.**

21 **A.** First, I note that Mr. Sharpe offers no support for his assertion that the interest rate on
22 the Transition Bonds is at higher than a market rate. Even if this unsupported assertion

1 were true, counsel has advised that a determination that the interest rate is above
2 market is likely to lead to a conclusion that there should be imputed for tax purposes a
3 separate payment from PECO to Enron and a deemed issuance of the Transition Bonds
4 at a premium, rather than an adverse determination regarding the treatment of the
5 Transition Bonds as debt. It is not unusual for debt to be issued at a premium, and Mr.
6 Sharpe does not offer any reasoning or analysis to support his statement that this will
7 adversely affect the characterization of the Transition Bonds as debt.
8

9 **Q. PLEASE ADDRESS MR. SHARPE'S ASSERTION THAT THE LARGER SIZE**
10 **OF THE SECURITIZATION WILL BE DETRIMENTAL TO OBTAINING THE**
11 **TAX TREATMENT.**

12 **A.** Mr. Sharpe's testimony indicates that the overriding concern is whether the SPE
13 maintains a significant equity interest in the Intangible Transition Property and related
14 ITC. Counsel has advised that the extent to which the four key elements required by
15 the IRS are present should assure this, and the analysis of whether such a significant
16 equity interest is maintained should not be materially affected by the size of the ITCs
17 securitized.
18

19 **Q. PLEASE ADDRESS MR. SHARPE'S ASSERTION THAT THE USE OF THE**
20 **GRANTOR TRUST WILL BE DETRIMENTAL TO OBTAINING THE TAX**
21 **TREATMENT.**

22 **A.** It is true that the Transition Bonds will be owned by the grantor trust, rather than by

1 investors. Counsel has advised that the grantor trust is transparent for tax purposes.
2 Accordingly, the investors (collectively the holders of the Class A Certificates and the
3 Class B Certificates) will be treated for tax purposes as if they directly owned the
4 Transition Bonds. Thus, Mr. Sharpe's statement is incorrect; its alleged significance,
5 moreover, is unclear and is never explained by Mr. Sharpe.

6
7 **Q. PLEASE ADDRESS MR. SHARPE'S ASSERTION THAT ENRON'S ALLEGED**
8 **OWNERSHIP OF THE "RESIDUAL OR EQUITY INTEREST" IN THE**
9 **TRANSITION BONDS WHILE AN AFFILIATE ENTERS INTO A POWER**
10 **PURCHASE AGREEMENT WILL BE DETRIMENTAL TO OBTAINING THE**
11 **DESIRED TAX TREATMENT.**

12 A. The Class B Certificates represent an interest in the Transition Bonds that is *pari passu*
13 with the Class A Certificates, and thus is not a residual interest in the Transition Bonds.
14 Moreover, the Class B Certificates may or may not be retained by Enron.
15 Accordingly, even if Mr. Sharpe could explain the significance of his assertion that the
16 stated difference could adversely affect the debt characterization of the Transition
17 Bonds, his factual premise is incorrect.

18
19 **Q. PLEASE ADDRESS MR. SHARPE'S ASSERTION THAT THE GUARANTEE**
20 **OF PAYMENT OF THE ITC BY EGSs PUTS ENRON IN THE POSITION OF**
21 **GUARANTEEING THE RECEIPT OF A PORTION OF THE ITCs REQUIRED**

1 **BY THE SPE TO MEET DEBT SERVICE ON TRANSITION BONDS OWNED**
2 **BY ENRON.**

3 A. This is incorrect. Under the Choice Plan, EGSs would only be required to remit ITCs
4 actually charged to customers and not, as Mr. Sharpe implies, any particular level of
5 ITCs. In addition, because the Class A Certificates and the Class B Certificates will be
6 pari passu, counsel has advised that Enron, if it retained the Class B Certificates, would
7 be treated as an owner of only that portion of the Transition Bonds represented by the
8 portion of interest thereon allocated to the Class B Certificates and not as the owner of
9 the entire Transition Bonds. Therefore, even if Mr. Sharpe could explain the
10 significance of his assertion that the stated difference could adversely affect the debt
11 characterization of the Transition Bonds, his factual premise is incorrect.

12
13 **Q. IS MR. SHARPE CORRECT THAT THE GRANTOR TRUST OR ENRON,**
14 **RATHER THAN THE SPE, PAYS THE FEE DUE TO THE GUARANTOR**
15 **UNDER THE ITC SHORTFALL AGREEMENT?**

16 A. No. The SPE will not be a party or have any rights under the ITC Shortfall
17 Agreement, which will run to PECO. Once again, even if Mr. Sharpe could explain
18 the significance of his assertion that the stated difference could adversely affect the debt
19 characterization of the Transition Bonds, his factual premise is incorrect.

20

1 Q. WHO IS THE COUNSEL WHOSE ADVICE ENRON SOUGHT WITH REGARD
2 TO THE EXPECTED TAX CONSEQUENCES OF THE SECURITIZATION
3 TRANSACTION CONTEMPLATED BY THE CHOICE PLAN?

4 A. Milbank, Tweed, Hadley & McCloy, a law firm with extensive experience in
5 securitization transactions, that has been acting as counsel to Chase Securities Inc., our
6 financial adviser in connection with the Choice Plan.

7
8 Q. PLEASE ADDRESS THE CLAIM THAT THE FINANCING PLAN IS
9 DETRIMENTAL TO PECO BECAUSE IT DOES NOT INCLUDE CERTAIN
10 FINANCING COSTS TO BE INCURRED BY PECO.

11 A. As stated in the rebuttal testimony of Ms. Voorhees, it is not possible to substantiate
12 the alleged costs based on the record.

13
14 Q. PLEASE ADDRESS MR. MITCHELL'S CLAIM THAT THE FINANCING
15 PLAN WILL DESTROY PECO'S FINANCIAL HEALTH.

16 A. Mr. Mitchell's conclusion rests on several questionable assumptions. For example,
17 Mr. Mitchell states that issuing the Transition Bonds will violate the debt equity ratio
18 covenant in PECO's \$900 million credit facility. Is Mr. Mitchell suggesting that a \$4
19 billion bond issuance will not violate it but a \$5.4 billion will (in which case he may be
20 assuming that the lender(s) are unwilling to accept the limited recourse nature of
21 PECO's obligations in either case)? Or is he reaching this conclusion based on the
22 erroneous assumption that PECO will not get favorable tax treatment? Or is he

1 assuming that PECO will not prudently use the proceeds to pay down other debt which
2 would improve the debt equity ratio? Unfortunately, PECO has failed to provide the
3 financial calculations and projections required for Enron and its financial adviser to
4 perform an analysis of such claim.

5
6 **Q. HAVE YOU HAD AN OPPORTUNITY TO REVIEW THE PORTIONS OF MR.**
7 **SILKMAN'S RESPONSIVE TESTIMONY RELATING TO THE ITC**
8 **SHORTFALL AGREEMENT?**

9 A. Yes.

10
11 **Q. HAS A DRAFT ITC SHORTFALL AGREEMENT BEEN PREPARED?**

12 A. No, but the principal terms of such agreement have been described in my direct
13 testimony. As a courtesy to this party, we have asked counsel to prepare a form of
14 agreement. I will file such draft agreement as a supplemental exhibit to my direct
15 testimony.

16
17 **Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**

A. Yes.