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To: Anya Schoolman, Executive Director, Community Power Network
From Tom Sanzillo, Director of Finance, Institute
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Re: Ring Fence Provisions of the Exelon-Pepco Merger

We have been asked to review the ring-fence provisions of the new Settlement Agreement[1] recently filed with the District of Columbia Public Service Commission on the Exelon-Pepco merger.

Background

The ring fence provision of the merger agreement is designed to maintain and protect the separate financial independence and integrity of the Pepco operation, a subsidiary of Exelon in a post-merger environment. Ring fence provisions in this instance are designed to protect the interests of the smaller Pepco utility from any potential financial headwinds encountered by the larger Exelon parent company. The ring fence provisions in the Settlement Agreement shield Pepco's assets from any intrusion by Exelon (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, Pepco's general business protocols and the maintenance of its books and records. All of these activities are to be carried out independently of the Exelon parent. The Exelon parents' equity interest in Pepco is also separated from the Exelon parent corporate structure. The Equity interest of 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, 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."
    a. This diligence step is useful, but perhaps offers more apparent than real protection. One cannot predict what a future bankruptcy court will decide.
    b. 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 to manage the local utility, Oncor. The proposal, according to Moody's, would dismantle the ring fence. The parent utility, Energy Future Holdings is supportive of the bankruptcy

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

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 these circumstances, provided the District of Columbia PSC approved.

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 anyway 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.

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.

4. The ring fence provisions can expire at the end of five years if a joint application is initiated at 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. One of the risks borne by Pepco is the potential for Exelon's unregulated fleet to pose additional credit problems for the company.[3] Pepco's interests might be better served if Exelon posted a bond for the five year period that covered ring fence violations.

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 (paragraphs 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 the timelines 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.

[2] 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

[3] See 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