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Overview of Concerns on Private Equity Buyout of TXU: Problems and Solutions

In late February, TXU announced it was being acquired by two private equity firms—Kohlberg Kravis Roberts (KKR) and Texas Pacific Group (TPG), with Goldman Sachs, Lehman Bros, Citigroup and Morgan Stanley acting as equity partners. Below are a number of concerns about this proposed deal.

- ***OTHER STATES REJECTED SIMILAR DEALS BECAUSE OF TOO MUCH DEBT.*** More than 80 percent of the \$45 billion purchase price is leveraged debt, meaning that KKR and TPG are borrowing \$37 billion from the four investment banks to buy TXU. Borrowing that much money is inherently risky and places enormous financial pressure on the borrowers (KKR and TPG) to pay back that money—and fast. The high level of debt will ruin TXU's credit ratings, making it more expensive for the company to borrow money, meaning ratepayer's bills will rise. Indeed, KKR and TPG each were rejected in recent attempts to acquire other utilities, with state officials nixing the deals citing the highly leveraged debt as posing inherent risks to ratepayers. In March 2005, the Oregon Public Utility Commission unanimously rejected the proposed buyout of Portland General Electric by TPG, citing the "large debt burden and short-term ownership as the major sources of risk."¹ In December 2004, the Arizona Corporation Commission rejected an attempt by KKR, JP Morgan Chase and Wachovia to acquire Tucson Electric. Arizona regulators found the financial firms' offer was not in the public interest because the new company's debt load imposed too many risks for consumers.²
- ***NO LONG TERM COMMITMENT.*** While many of KKR and TPG's environmental commitments are to be applauded (such as not building 8 of 11 coal power plants, investing in energy efficiency and wind and pledging to reduce greenhouse gas emissions), ultimately many of these pledges are not enforceable, as KKR and TPG will not make a long-term commitment to own the utility. So any deal reached with them today won't necessarily be enforceable when KKR and TPG sell TXU in just a few years. For example, in 2004 KKR and TPG teamed up with the Blackstone Group and Hellman & Friedman to buy Texas Genco from Houston's CenterPoint for \$3.5 billion (70 percent was leveraged debt). One year later, these private equity players sold Texas Genco to NRG for a \$5 billion profit.

¹ www.puc.state.or.us/PUC/news/2005/2005_007.shtml

² www.cc.state.az.us/news/pr12-23-04.htm

- ***TAKING A COMPANY PRIVATE REMOVES KEY INFORMATION FROM THE PUBLIC.***

Because TXU is currently an investor-owned company—meaning the owners are all the people who hold TXU stock—the company is forced to disclose important details of its business and profits to the U.S. Securities and Exchange Commission. This information is vital to help evaluate the company’s profits and environmental record. But KKR and TPG will buy 100% of TXU’s stock, meaning the new owners will never have to file any details on the company’s operations with the SEC. Removing all this information will keep Texans in the dark about the company’s profits and environmental plans.

- ***TXU CONTROLS TOO MUCH OF THE TEXAS POWER MARKET.***

TXU currently controls nearly 16,000 MW of power plant capacity in Texas, giving the company control over half of all generation in key parts of the state. This monopoly over power plants gives TXU an easy opportunity to unilaterally raise prices and price-gouge consumers. The new owners have little presence in Texas, and, given their huge debt, will be under pressure to charge ratepayers higher prices to recover their enormous leveraged costs. Indeed, Texas officials are recommending that TXU pay a \$210 million penalty for the company’s role in manipulating the Texas electricity market, Enron-style.

- ***THE EQUITY PARTNERS HAVE A QUESTIONABLE TRACK RECORD.***

The four investment banks behind the TXU buyout have paid a combined \$6.3 *billion* to settle various allegations of fraud, abuse and energy market manipulation. This troubled history gives pause to them owning the largest utility in the Texas deregulated market. Details of these problems can be found in the appendix.

Conditions that Must be Met in Order For the Acquisition to Be Approved

1. **Texas Officials Must Review The Deal.**

Right now, the Public Utility Commission of Texas *has no authority* to review the proposed acquisition. SB 896 would correct this grave oversight and give Texans the right to carefully examine whether the proposed deal is good for the state and if not, to reject it or at least condition its approval. In addition, the current threshold under which such a transaction is approved—that it be “consistent with the public interest”—must be strengthened to a “positive benefits standard of review.” This would ensure that any acquiring or merging entity would have to prove that positive benefits will flow to customers and to Texas as a result of the proposed change in control. Suggested factors that the PUC should consider: the effect of foreign or absentee ownership, elimination of competition, parent company structure complexity, the integration of corporate structures, the increased or decreased financial capacities and flexibility, the impact on service standards, interference with regulatory jurisdiction, the effect on rates, the effect on credit ratings, and the maintenance of financial integrity.

2. **Fix Texas' Broken Deregulation Experiment.**

This proposed acquisition gives Texans a great opportunity to address glaring problems in the Texas wholesale power market. Electric deregulation hasn't worked because fostering adequately competitive electricity markets is proving to be impossible. It doesn't help that too few companies control too much of the market. That results in high prices for households. One solution would be to return *all* Texas power plants to cost-of-service ratemaking for two years until a full assessment of deregulation's woes can be studied. An alternative solution to cost-of-service rates would be to implement strong wholesale rate caps; force all wholesale bidders to publicly identify themselves when submitting bids (right now, all power bidders remain anonymous); and limit the total amount of power plants allowed to be owned by one company.

3. **One Representative Each of Household Consumer And Environmentalists Must Be Placed On the Real TXU Board Of Directors (And Not on An "Advisory Board").**

This would give actual voting power to Texans (and not powerful New York investment bankers), ensuring the company will be responsive to consumers and environmentalists.

4. **Give the Public Utility Commission of Texas Full Access to the Books and Records All The Way to the Very Top of KKR, TPG, Goldman Sachs, Lehman Bros, Citigroup and Morgan Stanley and any other equity partner.**

In order for Texans to effectively regulate TXU, the Public Utility Commission must have full access to all books of records of the entire operations of KKR, TPG, Goldman Sachs and all equity owners in order to ensure that Texas officials have full regulatory control over the company's operations.

5. **Implement "Ring Fencing" Protections.**

KKR, TPG, Goldman Sachs and all other owners must agree to protect TXU from any financial issues at the parent companies by establishing so-called "ring fencing" protections. Such provisions would also protect TXU's valuable assets from being misused by KKR et al (for example, limiting their ability to borrow money on TXU's assets to make investments in non-utility ventures).

6. **Enact Strong Renewable Energy & Energy Efficiency Standards.**

TXU should match the nation's strongest renewable energy development/purchase requirement: 24 percent of TXU's power must come from renewable energy sources by 2013.³ In addition, a recent report outlined energy efficiency programs that should be adopted as well.⁴ These requirements will eliminate the need for TXU to build 3 new coal fired power plants and make Texas the leader in producing clean energy.

7. **Mandate a 40 percent Cut in Household Rates.**

The companies' 10 percent rate cut proposal is inadequate. Since 2003, electric rates for households served by TXU have jumped 44 percent, while TXU's profits have increased over 400 percent.

³ www.dps.state.ny.us/03e0188.htm

⁴ <http://aceee.org/pubs/e073.htm>

8. Require Strong Protections for Low-Income Texas Households.

TXU should match the strongest standards in the country in terms of shutoffs, bill payment and other key criteria.

Appendix

- In April 2003, Goldman Sachs paid \$110 million to settle allegations the company engaged in conflicts of interest in the research it was providing to investors.⁵ In January 2005, Goldman Sachs agreed to pay \$40 million for illegal practices surrounding IPOs.⁶ In September 2003, Goldman Sachs paid over \$9.3 million for trading in insider information on Treasury 30-year bonds.⁷ In July 2004, Goldman Sachs was ordered to pay \$5 million as a penalty for corporate high yield bonds trading violations.⁸ In May 2006, Goldman Sachs paid \$1.5 million to the SEC for manipulating municipal bond auctions⁹ and an additional \$140,000 to NASD.¹⁰ In December 2002 Goldman paid \$1.65 million for failing to retain email communications as required by law.¹¹ In March 2007, Goldman paid a \$1 million civil penalty for illegal trading.¹² Japan's Financial Services Agency issued a "business-improvement order" against Goldman Sachs Asset Management and barred it from managing investment-trust funds for improper stock-trading activities in December 2005.¹³

⁵ www.sec.gov/news/press/2003-54.htm

⁶ www.sec.gov/news/press/2005-10.htm

⁷ www.sec.gov/news/press/2003-107.htm

⁸ www.nasd.com/PressRoom/NewsReleases/2004NewsReleases/NASDW_010892

⁹ www.sec.gov/news/press/2006/2006-83.htm

¹⁰ www.nasd.com/PressRoom/NewsReleases/2005NewsReleases/NASDW_014639

¹¹ www.sec.gov/news/press/2002-173.htm

¹² www.sec.gov/litigation/admin/2007/34-55465.pdf

¹³ "Japan Post Bars Goldman Work on Future Funds," December 29, 2005, *The Wall Street Journal*.

- In June 2005, Citigroup agreed to pay \$2 *billion* to Enron shareholders over the sale of stock and bonds before Enron’s bankruptcy.¹⁴ In November 2004, Citigroup paid \$2.58 *billion* to settle a lawsuit brought by WorldCom shareholders over Citigroup’s role in the collapse of that company.¹⁵ In April 2003, Citigroup agreed to pay \$400 million to settle federal and state charges that it lured investors into buying shares in companies known to be troubled.¹⁶ In September 2002, Citigroup paid \$215 million to the Federal Trade Commission to settle charges that it manipulated consumers into buying overpriced mortgages and credit insurance.¹⁷ In May 2005, Citigroup paid \$208 million to the SEC to settle charges that it denied investors mutual fund discounts and instead collected them as profit.¹⁸ In July 2003, Citigroup agreed to pay \$120 million to settle SEC allegations that it helped Enron and Dynegy commit fraud.¹⁹ A British regulator, the Financial Services Authority, forced Citigroup to pay \$25.4 million for illegal trades of Eurobonds.²⁰ In March 2005, Citigroup paid \$26.25 million to the SEC to settle charges that it failed to disclose conflicts of interest at the company.²¹ In May 2006, Citigroup paid \$1.5 million to the SEC for manipulating municipal bond auctions²² and an additional \$60,000 to NASD.²³ In November 2001, the SEC cited Citigroup for violating federal securities laws by selling bonds illegally in the U.S.²⁴ In September 2004, Japan’s Financial Services Agency ordered Citigroup to close its entire private banking operation because it had violated the country’s financial rules after finding lax money-laundering controls and improper trading practices.²⁵ In June 2006, Korea fined Citigroup \$582,000 for irregularities in lending.²⁶

- In November 2004 Lehman Bros paid \$222.5 million to investors over the company’s participation in the sale of Enron notes shortly before the company went bankrupt.²⁷ In April 2003, Lehman agreed to pay \$80 million to settle allegations of conflicts of interests in the research it provided to investors.²⁸ In August 2003, Lehman paid a \$2.5 million penalty for failing to adequately supervise a broker who stole millions from investors.²⁹ In May 2006, Lehman paid \$1.5 million to the SEC for manipulating municipal bond auctions.³⁰ In May

¹⁴ John Roper, “Citigroup agrees to \$2 billion Enron Settlement,” *The Houston Chronicle*, June 10, 2005.

¹⁵ www.worldcomlitigation.com/courtdox/2004-11-10OrderApprovingCGSett&Fees.pdf

¹⁶ www.sec.gov/news/press/2003-54.htm

¹⁷ www.ftc.gov/opa/2002/09/associates.htm

¹⁸ www.sec.gov/news/press/2005-80.htm

¹⁹ www.sec.gov/news/press/2003-87.htm

²⁰ Heather Timmons, “Bond Trades Far Too Agile Cost Citigroup \$25 million,” June 29, 2005, *The New York Times*.

²¹ www.sec.gov/news/press/2005-39.htm

²² www.sec.gov/news/press/2006/2006-83.htm

²³ www.nasd.com/PressRoom/NewsReleases/2005NewsReleases/NASDW_014639

²⁴ www.sec.gov/news/press/2001-139.txt

²⁵ www.citigroup.com/citigroup/press/2004/040917a.htm

²⁶ “Korea’s FTC Fines Kookmin, Citibank Korea,” *The Wall Street Journal*, June 7, 2006.

²⁷ Mary Flood, “Lehman Bros. settles lawsuit,” *The Houston Chronicle*, October 29, 2004.

²⁸ www.sec.gov/news/press/2003-54.htm

²⁹ www.sec.gov/news/press/2003-96.htm

³⁰ www.sec.gov/news/press/2006/2006-83.htm

2006, Lehman paid the New York Stock Exchange \$400,000 for submitting false information.³¹ In February 2004, Lehman paid \$124,000 to settle charges that it defrauded mutual fund investors.³²

- In March 2004, Morgan Stanley paid \$857,000 to settle allegations the company manipulated energy markets.³³ In April 2003, Morgan Stanley paid \$125 million to settle allegations the company had conflicts of interest in providing research to investors.³⁴ In January 2005, Morgan Stanley agreed to pay \$40 million to settle allegations of illegal practices surrounding IPOs.³⁵ In November 2003, Morgan Stanley agreed to pay \$50 million to settle charges the company failed to provide customers important information relating to their purchases of mutual fund.³⁶ In December 2002 Morgan Stanley paid \$1.65 million for failing to retain email communications as required by law.³⁷ In August 2005, NASD fined Morgan Stanley \$6.1 million for violations of securities rules.³⁸ In February 2006, Morgan Stanley agreed to pay \$15 million for failing to retain emails as part of an investigation by the SEC.³⁹ In May 2006, Morgan Stanley paid \$1.5 million to the SEC for manipulating municipal bond auctions.⁴⁰ In May 2006, Morgan Stanley paid \$1.5 million to the SEC for manipulating municipal bond auctions.⁴¹

³¹ www.nyse.com/press/1148314125304.html

³² www.sec.gov/news/press/2004-17.htm

³³ www.ferc.gov/whats-new/comm-meet/030304/E-40.pdf

³⁴ www.sec.gov/news/press/2003-54.htm

³⁵ www.sec.gov/news/press/2005-10.htm

³⁶ www.sec.gov/news/press/2003-159.htm

³⁷ www.sec.gov/news/press/2002-173.htm

³⁸ www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_014804&ssSourceNodId=5

³⁹ www.sec.gov/news/press/2006/2006-69.htm

⁴⁰ www.sec.gov/news/press/2006/2006-83.htm

⁴¹ www.sec.gov/news/press/2006/2006-83.htm