



Energy Future Holdings and Mining Reclamation Bonds in Texas

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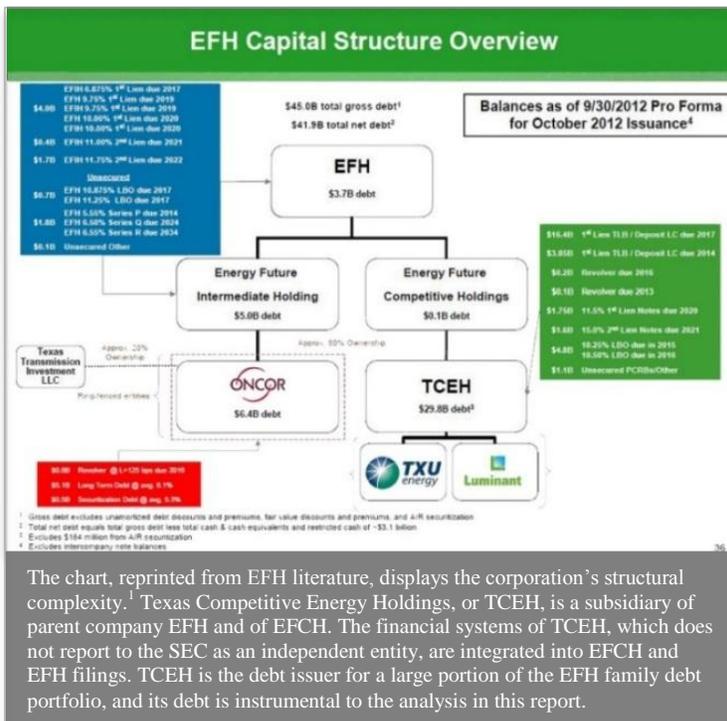
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EXECUTIVE SUMMARY

Energy Future Holdings (EFH) Company is publicly reported to be on the brink of a major financial reorganization. The financial problems of EFH and its subsidiaries stem from an ill-conceived buyout of TXU Corporation (the predecessor company) by the EFH management. The debt incurred for the buyout far exceeded the ability of the assets to pay for it. The company has stated that its top priority is debt management and most of its actions appear to be concerned with payment of debt service.¹

Energy Future Competitive Holdings (EFCH) is a subsidiary of EFH, which in turn has various subsidiaries that create a complex corporate structure. EFCH subsidiary Luminant Mining Company LLC, using Luminant Generation, also known as GENCO, as a third party insurer, has utilized a provision in Texas law that allows for a third party entity to guarantee the performance bond of the mining company. Luminant Mining and Luminant Generation have made multiple applications for such proposals amounting to \$1.01 billion in self-bonding authority.²



This report presents the case that recent applications made by Luminant Mining, using Luminant Generation as a third party guarantor to the Railroad Commission of Texas (RRC) for self-bonding authority, creates a misleading impression regarding Luminant Generation's financial condition. Luminant Mining and Luminant Generation are subsidiaries of EFCH and EFH. The report is based primarily on analysis of several EFCH Securities and Exchange Commission (SEC) filings. Those include EFCH's 2012 Form 10K, EFH's 2011 and 2012 Form

10Ks, and its 2102 3Q Form for the quarter ending September 30, 2012. The report is also based on the self-bonding applications for individual mines made by Luminant Mining and Luminant Generation to the RRC.

Under Texas state law, third-party self-bonding allows a financially solvent company to pledge existing assets against future reclamation claims related to mine operations for a

¹ Peter Lattman, "A Record Buyout Turns Sour," The New York Times, Feb. 28, 2012; Nicholas Sakelaris, Energy Future Holdings preparing for prepackaged bankruptcy, Dallas Business Journal, April 16, 2013; Julie Cresswell, "Energy Future Holdings offers bankruptcy plan," April 15, 2013.

² Self-bonding applications from Luminant Mining and Luminant Generation to the RRC.

company that may not meet financial health benchmarks. Luminant Generation's financial presentations to the RRC in multiple self-bonding applications claim that Luminant Generation qualifies for self-bonding and can serve as a third party guarantor to the State of Texas.

However, the applications made by Luminant Mining and Luminant Generation to the RRC, which were reviewed for this report, contain information and accounting representations that are at considerable variance with financial statements made by the companies' parent corporation – EFH/EFCH. Luminant Mining's and Luminant Generation's financial presentations in the self-bond applications portray the joint entities as sufficiently solvent to comply with program requirements. However, EFH/EFCH's filings to investors and the SEC portray EFH/EFCH as entities in deep, permanent financial distress³.

The wide discrepancies between the asset and liability representations of Luminant Generation and EFH/EFCH's enterprise-wide presentation demand that the commission conduct more than a simple, technical evaluation of the accounting presentations in the applications. Even if all accounting and legal requirements for compliance are met by Luminant's applications, the State of Texas's interest in ensuring that resources will be available for reclamation does not appear to be protected. As a substantive matter, the assets Luminant identifies in its applications to cover a prospective \$1.01 billion in self-bond costs may not meet a reasonable standard of accessible liquidity if a reclamation claim is made.

As this report points out, the underlying data provided to the RRC by Luminant Mining and Luminant Generation should require that the RRC exercise additional diligence and perhaps require the posting of additional security for the State of Texas. This report recommends a full, independent audit and review of the financial health of EFH and the availability of EFH assets. **That review should probe the main question raised by this report: How can assets under obligation as security to EFH debt also serve as security for mining reclamation obligations to the State of Texas?**

Until such time as the audit is complete, the State of Texas should hold additional liquid security from Luminant Mining in the form of cash, a letter of credit, or the equivalent. The audit should help the State of Texas better understand if and how EFH and Luminant Generation meet the financial benchmarks established in RRC regulations for self-bonding. This matter is particularly acute, given the potential bankruptcy of EFH or TCEH, parent companies of Luminant Mining and Luminant Generation.

ANALYSIS OF ENERGY FUTURE HOLDINGS AND MINING RECLAMATION BONDING

A. Background

The RRC of Texas regulates coal mining operations in the state. The RRC has been authorized by the U.S. Department of Interior to implement the federal Surface Mining Control and Reclamation Act, also known as SMCRA. SMCRA was passed by U.S. Congress in the 1970's out of concern over the environmental effects of strip mining and

³ Nicholas Sakelaris, "Energy Future Holdings Preparing for Prepackaged Bankruptcy," Dallas Business Journal, April 15, 2013. Also see Julie Creswell, "Energy Future Holdings Offers Bankruptcy Plan," New York Times, April 15, 2013.

mine abandonment. Reclamation of former mining sites is essential to protect land and water quality and restore the landscape following strip-mining operations. SMCRA and state statutes and regulations have requirements for standards of performance, permitting, bonding, inspections and enforcement, and mining restrictions in certain areas.⁴ The bonding requirements mandate that mining companies post a bond, letter of credit, or similar security sufficient to cover the cost of reclamation.⁵

The Railroad Commission monitors, reviews and approves applications from mine owners who seek self-bonding authority.⁶ In order to receive approval for self-bonding, the mine owner must apply to the RRC and meet certain financial tests.⁷ To show eligibility for self-bonding, an owner or third-party guarantor must demonstrate to the Commission that it is essentially solvent, and the third-party guarantor must meet the same standards as the applicant.⁸

In the analysis for this report, Luminant Mining LLC is the applicant and Luminant Generation LLC is the third-party guarantor. Both the applicant and the third-party guarantor are subsidiaries of EFCH and part of the broader EFH corporate family.⁹ The self-bonding guarantee and net worth metrics used in the applications are based upon Luminant Generation's annual audit statements.¹⁰ Luminant Mining's and Luminant Generation's application to the RRC must demonstrate that the following conditions are met:

- Luminant Generation has a tangible net worth of at least \$10 million;
- Luminant Generation has a ratio of total liabilities to net worth of 2.5 times or less;
- Luminant Generation has a ratio of current assets to current liabilities of 1.2 times or greater;
- Luminant Generation has provided its most recent financial statements accompanied by a report prepared by an independent certified public accountant.
- Luminant Generation must also provide updated quarterly statements for current year and quarter;
- Luminant Generation's cumulative value of all self-bonding approvals and proposals cannot exceed 25% of applicant's tangible net worth.¹¹

The basic principle of the RRC's self-bonding program rests on the ability of mine owners or third-party guarantors to demonstrate that their assets outweigh their liabilities enough to cover a predetermined amount needed for reclamation activity. What law and

⁴ Texas Natural Resources Code, Title 4, Mines and Mining, Chapter 135, Sec. 134.002(2), p. 1

⁵ Ibid. Sec 134.121(b) (c) p 50-51

⁶ Texas Administrative Code, Title 16, Rule 12.309 (citation refers to entire document). The State of Texas is the administrator in charge of state environmental and mining law and to fulfill mandates established under the federal Surface Mining Control and Reclamation Act of 1977, (SMCRA), Public Law 95-87. Section 509 c of SMCRA allows for States to design self-insurance programs when companies demonstrate "a history of financial solvency and continuous operation for authorization to self-insure or bond such amount." The overall program preference is for extraction companies to post performance bonds consistent with Section A of this same section. SMCRA also allows for the posting of cash and other liquid assets.

⁷ Ibid. p 3-4 (C) (i-iv); (D) (i)

⁸ Ibid. p 3-4 (D) (iii)

⁹ Energy Futures Holding, 2012 Form 10K, Energy Future Holdings Corporation and subsidiary, Exhibit 21-A.

¹⁰ Applicant of Luminant Mining Company, Replacement of Self-Bond for Big Brown Mine, Submitted to RRC Dec. 22, 2011

¹¹ Luminant Mining Company LLC's Application for Authorization to Self-Bond for Martin Lake Liberty Mine.

regulation assume is that the company application and RRC compliance review demonstrate that a company has access to liquid assets to meet an insurance claim should that event arise. However, the agency directive that guides RRC staff in evaluating applications contains few substantive standards for conducting diligence beyond the explicit language of the regulations. As a result, space for loopholes is created.¹²

As part of the application process, the State of Texas seeks certification by the parties involved in mining extraction that the full portfolio of assets identified by the applicant and any third-party guarantor (in this case Luminant Generation's power-generation plants) can pull the full weight of the liabilities identified by the parties in their respective financial documents, including a prudent amount set aside to cover self-bonding requirements. In the case analyzed in this report, that amount is \$1.01 billion for multiple mines.

The asset and liability levels in the formal applications submitted by Luminant Mining and Luminant Generation for self-bonding are taken directly from Luminant Generation Annual Financial Statements and accompanying accountants' reports. The calculations made in the applications are prepared and supported by Luminant Mining and Luminant Generation staff. RRC staff then review the applications and determine whether or not the application is in compliance with law and regulation. These calculations and judgments are based upon regulatory definitions of the terms for assets, net worth, tangible net worth, liabilities, current assets and current liabilities. RRC's acceptance of the presentation represents approval of the application.

B. Applications by Luminant Mining for Self-Bonding Authority

This report covers eleven individual applications made by Luminant Mining and Luminant Generation for self-bonding authority (see Table 1, Selected Financial Data). The applications contain the basic financial presentation made by the company, as required by the RRC's regulations. Each application contains a series of additional documents, presumably reviewed by RRC staff as part of the process. Most notably, the list of documents includes annual audits with statements by accountants from both Luminant Mining and Luminant Generation. All of the annual statements reviewed for this memo were prepared by accountants from Deloitte & Touche, which also prepares all SEC filings for EFH, EFCH, Energy Future Intermediate Holdings, Inc. (EFIH) and the other subsidiaries that file in the EFH family.¹³

For the purpose of this memo, the 2011 Annual Financial Statement and accompanying Accountant Report for Luminant Generation Company LLC were reviewed. Those annual statements and the independent, certified accounting statement prepared by Deloitte & Touche provide the basis for the substantive parts of the application. The applications consist primarily of direct transpositions of numbers from the annual statements and various calculations governed by the regulations.

¹² RRC of Texas, Surface Mining and Reclamation Division, Directive Notice, PR-AP-309(j).

¹³ EFH 2012 10K, Item 14, Principal Accounting Fees and Services, All of the Annual Statements reviewed for this memo were prepared by accountants from Deloitte and Touche (D&T).

Selected Financial Data Provided by Luminant Mining/Luminant Generation in self-bonding proposals to RCC (2008-2012)

Date Filed	Mine	Est. Bond \$Millions	Tot. Member Interest	Goodwill	Intangibles	Tangible Net Worth	Liabilities	Current Asset \$ Millions	Current Liabilities \$ Millions
9/28/12	Liberty Martin Lake	\$ 37.00	\$15,792,000,000	\$ 1,873,000,000	\$267,000,000	\$13,652,000,000	\$7,101,000,000	\$ 645.0	\$ 516.0
11/30/12	Oak Hill	\$ 203.00	\$15,792,000,000	\$ 1,873,000,000	\$267,000,000	\$13,652,000,000	\$7,101,000,000	\$ 645.0	\$ 516.0
12/22/11	Big Brown Perm- 3E	\$ 86.00	\$17,253,000,000	\$ 1,873,000,000	\$635,000,000	\$14,745,000,000	\$7,362,000,000	\$ 665.0	\$ 427.0
12/22/11	Three Oaks No 48	\$ 60.00	\$17,253,000,000	\$ 1,873,000,000	\$635,000,000	\$14,745,000,000	\$7,362,000,000	\$ 665.0	\$ 427.0
12/22/11	Monticello/Winfield	\$ 120.00	\$17,253,000,000	\$ 1,873,000,000	\$635,000,000	\$14,745,000,000	\$7,362,000,000	\$ 665.0	\$ 427.0
12/21/11	Monticello Therm 5G	\$ 43.00	\$17,253,000,000	\$ 1,873,000,000	\$635,000,000	\$14,745,000,000	\$7,362,000,000	\$ 665.0	\$ 427.0
12/21/11	Thermo A1 Mine New	\$ 3.19	\$17,253,000,000	\$ 1,873,000,000	\$635,000,000	\$14,745,000,000	\$7,362,000,000	\$ 665.0	\$ 427.0
12/19/11	Kosse Mine	\$ 150.00	\$17,253,000,000	\$ 1,873,000,000	\$635,000,000	\$14,745,000,000	\$7,362,000,000	\$ 665.0	\$ 427.0
3/31/10	Turlington Mine	\$ 27.00	\$21,487,000,000	\$ 5,523,000,000	\$749,000,000	\$15,215,000,000	\$8,134,000,000	\$ 918.0	\$ 509.0
8/5/09	Twin Oak Mine	\$ 2.23	\$22,315,000,000	\$ 5,537,000,000	\$894,000,000	\$15,884,000,000	\$8,602,000,000	\$ 900.0	\$ 677.0
11/10/08	Martin Lake AIV South	\$ 42.72	\$26,827,000,000	\$10,757,000,000	\$1,445,000,000	\$14,625,000,000	\$8,580,000,000	\$1,814.0	\$ 0.25

C. Case Example of How One Application Works

For the purposes of discussion and illuminating the self-bonding application process, the Martin Lake Liberty Mine application is presented as an example. The RRC received this application by Luminant Mining on Sept. 28 2012. Like all of the other applications, it uses Luminant Generation, or GENCO, as a third-party self-bonding guarantor. The Liberty Mine serves the Martin Lake coal-fired power station. The application sought approval for a \$37 million self-bond proposal. The application relies upon the 2011 audited annual statement for both Luminant Generation and Luminant Mining.¹⁴

To meet the tangible net worth requirements Luminant Mining/Luminant Generation provides the following information for Luminant Generation:

Table 2: Data was drawn from the self-bonding application for Martin Lake Liberty Mine, which was submitted to the RRC. See documentation for Table 1.

Selected Financial Data from/Luminant Mining/ Luminant Generation in support of 2012 Liberty Mine Application for self-bonding before the RRC	
Financial Metric	Amount
Total Membership Interest	\$15,792,000,000 ¹
Goodwill	\$ 1,873,000,000 ¹
Intangible Assets	\$ 267,000,000 ¹
Net Tangible Worth	\$13,652,000,000 ¹

Luminant Mining/Luminant Generation declares that its net tangible worth was \$13.7 billion. The application therefore meets the \$10 million test under the regulations.¹⁵

The application then discloses information in support of its compliance with the standard requiring that total liabilities are less than 2.5 times net worth. The application uses the \$15.79 billion as net worth and subtracts a liability figure of \$7.1 billion.¹⁶ This gives a ratio of liabilities to net worth of 0.445. Luminant Mining/Luminant Generation claims compliance.¹⁷

For the third part of the test the applicant states that current assets are \$645 million and current liabilities are \$516 million. This disclosure demonstrates that the ratio is 1.25, which is higher than the 1.2 standard. Luminant Mining/Luminant Generation asserts compliance.¹⁸

For the final part of the test, Luminant Generation compares its cumulative self-bonding obligations of \$1,009,000,000 against its tangible net worth of \$13,652,000,000. The cumulative self-bonding obligations are only 7.39 % of tangible net worth, below the

¹⁴ Luminant Mining Company's Application for Authorization to Self-Bond, Martin Lake Liberty Mine. p. 2

¹⁵ Ibid. p 3-4

¹⁶ Ibid. p. 5

¹⁷ Ibid. p 4-5

¹⁸ Ibid. p. 5 and 6. Based on updated quarterly filings Luminant Generation/Luminant Mining asserts the ratio as of June 30, 2012 was 1.6 times.

compliance standard of 25%. So Luminant Generation/Luminant Mining asserts compliance.¹⁹

D. Concerns: Questionable Aspects of Asset and Liability Claims

Assets:

1. Luminant Generation's claim of a net worth of \$15.792 billion in the self-bonding application is questionable. The coal, nuclear and natural gas generation plants held by Luminant Generation are a core value and revenue producing asset for its parent company, EFH/EFCH.²⁰ For the year ending Dec. 31, 2011, EFCH declared \$37.3 billion in assets and \$45.05 billion in liabilities (see Table 1). Those assets included 15,247 megawatts of coal, nuclear and natural gas assets – Luminant Generation's businesses. In other words, EFH/EFCH, in its financial statements, lists Luminant Generation's generation capacities as its [EFC/EFCH's] own assets. However, Luminant Generation, in its self-bonding application, does not define the assets that make up its declared \$15.792 billion of value. Therefore, those assets may not be available to guarantee reclamation costs for Luminant Mining because they are pledged to cover EFCH debt.
2. In early 2011, both Kravis, Kohlberg and Roberts (KKR) and the Texas Pacific Group (TPG), two companies that sit on the board of EFH and hold significant equity interests, each publicly downgraded the value of its holdings. KKR assumed its investment was now worth 20% of its original value and TPG estimated its investment at 40% of original value.²¹ Since TXU was bought for \$46 billion, these downgrades would place the value of the entire EFH enterprise as a whole at somewhere between \$9.2 and \$18.4 billion.²² Considering that the entire firm is worth less than \$18.4 billion, Luminant Generation's declaration of a \$15,792 billion net worth in its 2011 Annual Statement is questionable. It should also be noted that Luminant Generation is clearly not the only asset holder in the EFH family. If the significant equity write-down cited by KKR and TPG are valid, the asset value could be substantially less than that presented in Luminant Generation's 2011 Annual Financial Statement. EFH has itself declared \$13.3 billion in goodwill impairment losses since 2008²³ -- a value that could put Luminant Generation at risk of failing to meet most if not all of the compliance tests in the RRC's regulations.²⁴ The self-bond application explains Luminant Generation's Total Membership Interest amount of \$15.792 billion as follows: "Since Luminant Generation is a limited liability company instead of a corporation, it has membership interests instead of shareholder equity. Thus, Luminant Generation's net worth is calculated as total assets less total liabilities and is known as Total Membership Interest."

At the same time, Luminant Generation's parent company, EFCH/EFH has negative equity. According to financial disclosure in Luminant Mining's self-bonding application, the parent has a negative equity balance of \$7.1 billion (by end of 2012

¹⁹ Ibid.

²⁰ Energy Future Competitive Holdings Corp. 2012 Form 10-K. Also see previous footnote 10 for documentation of EFCH listing of Luminant Generation Company as a subsidiary.

²¹ Julia Creswell, "A Portfolio's Price," New York Times, January 4, 2011.

²² Tom Sanzillo, "The case To Retire Big Brown, Monticello and Martin," March 17, 2011. p. 4

²³ EFCH and subsidiaries selected consolidated financial data, 2012 EFCH 10K, Item 6, p 36

²⁴ Luminant Mining application to self-bond. p 3-4

the negative balance was \$10.3 billion). The variance between shareholder equity of EFH and the Total Membership Interest of Luminant Generation are extraordinary.

The vast discrepancy between the various statements made by the company regarding its application for self-bonding to Texas regulators and those made in public by the owners of the company are major inconsistencies. They require regulators to redouble their diligence efforts.

Liabilities:

1. The 2012 application (and Luminant Generation's 2011 Annual Statement) to the RRC shows \$7.1 billion in liabilities for Luminant Generation. This seems understated. According to EFCH's 2012 Form 10K, EFCH has \$45 billion in liabilities of which at least \$30 billion is in long-term debt.²⁵ The debt is guaranteed under the EFCH umbrella of which Luminant Generation is a significant part.
2. In fact, according to Luminant Generation's 2011 Annual Statement filed with the RRC and quoted in the following paragraph, all of Luminant Generation's tangible and intangible assets and all of its capital stock is pledged to the outstanding debt.

“Pursuant to the terms of the TCEH Senior Secured Facilities and TCEH Senior Second Notes, we (along with certain other subsidiaries of TCEH) provide the following credit support for TCEH's obligations under such indebtedness: an unconditional joint and several guarantee that is secured on a first priority basis by substantially *all of our current and future tangible and intangible assets*. In addition, pursuant to the terms of the TCEH Senior Secured Facilities, TCEH Senior Second Notes and TCEH Senior Second Lien Notes, *all of the capital stock of TCEH and its subsidiaries (including Generation) is pledged as collateral, subject to certain exceptions, to secure TCEH's obligation under such indebtedness.*”²⁶

Thus, according to Luminant Generation's annual statement, the firm is being used as collateral in a self-bonding application for Luminant mining, even though all of its “*current and future tangible and intangible assets*” are pledged to secure other debt.

The Luminant Generation 2011 Annual Statement discusses in great detail the nature of debt guaranteed by Luminant Generation's power generation assets.²⁷ In total, Luminant Generation is guaranteeing \$29.3 billion in EFH, EFCH and EFIH debt with its generation assets.²⁸ According to Luminant Generation's 2011 Annual Statement, Luminant Generation does not carry any of the \$29.3 billion on its balance sheet. It is not deemed a liability on Luminant Generation's books.²⁹ It is an off-balance sheet liability.

3. To accept the Luminant Generation filing to the RRC, one would have to believe that the assets of \$15.79 billion, which constitute almost half of the asset base in the entire EFCH 2012 Form 10K presentation, carry less than 15% of the total liabilities of the company (\$7.1 billion).
4. This accounting treatment allows the asset value of the plants and other Luminant Generation holdings to be carried on Luminant Generation's annual statement. The

²⁵ EFCH 2012 Form 10K, p. 84

²⁶ Luminant Generation 2011 Annual Statement, Sec. 1, Business and Significant Accounting Policies.

²⁷ Luminant Generation 2011 Annual Statement, Sec. “Activity related to TCEH debt guaranteed by generation,” p 18-24

²⁸ Luminant Generation 2011 Annual Statement, p. 24

²⁹ This debt, plus additional debt is found on EFCH's balance sheets: EFCH 2012 Form 10K, p.84. It is also integrated into the larger parent company figures at EFH.

same accounting treatment, however, does not carry the long-term debt that the generation assets underwrite as a liability on the Luminant Generation balance sheet.

5. Given EFH/EFCH's complex system of corporate interlocks³⁰ and deteriorating financial condition, the RRC must exercise further diligence to determine if the asset and liability values claimed by Luminant Generation are reasonable. **The key question is: Which assets are pledged and which liabilities are apportioned to Luminant Generation and are they reasonably valued and apportioned, particularly given the high existing debt burden?**

Current Assets and Current Liabilities:

1. The Liberty Mine application asserts that Luminant Generation has \$645 million in current assets and \$516 million in current liabilities, based on its 2011 Annual Statement (see previous documentation). In this scenario Luminant Generation has sufficient assets to marginally cover liabilities to meet compliance standards. According to EFCH representations, in 2011 the EFH/EFCH Company had \$5.1 billion in current assets and \$5.4 billion in current liabilities. In fact, these metrics further deteriorated in 2012. In neither year would the EFH/EFCH enterprise as a whole have met the RRC threshold ratio for current assets to current liabilities.
2. Again, to conclude that the Luminant Generation guarantee is adequate, the RRC would have to accept that the core assets of Luminant Generation as reflected in the application are partially unencumbered and of greater value than the remaining assets of the entire EFCH enterprise.

E. Concerns Regarding the Luminant Mining/Luminant Generation Applications and EFCH 10K Annual Filings Taken As a Whole

Table 3 and Table 4 graph the Current Assets and Current Liability and Total Assets and Total Liability provided by Luminant Mining/Luminant Generation in its applications for self-bond authority. For each of the years 2008 through 2011, current and total assets exceed liabilities by a sufficient margin to claim compliance with RRC standards.

Table 5 and 6 graph the Current Assets and Current Liabilities and Total Assets and Total Liabilities of Energy Futures Competitive Holdings, the parent corporation of Luminant Mining and Luminant Generation. In each of the years 2008-2012 current and total assets are less than liabilities. The RRC standards would not be met for the enterprise as a whole.

The stark variance between the deteriorating EFH/EFCH financial presentations and the claims of solvency of Luminant Mining/Luminant Generation requires a public explanation and reconciliation by the company.

³⁰ Energy Future Holdings Corp., Moody's Investor Service, Aug. 18, 2010, p 3-4. For a discussion of the complex debt structure and how value was being apportioned in 2009 see: Moody's, "Energy Futures Holding Corporation," Analysis, April 2009.

Table 3: RRC Applications: Luminant (Genco) Total Assets to Total Liabilities (2008 to 2011) (\$ billions)

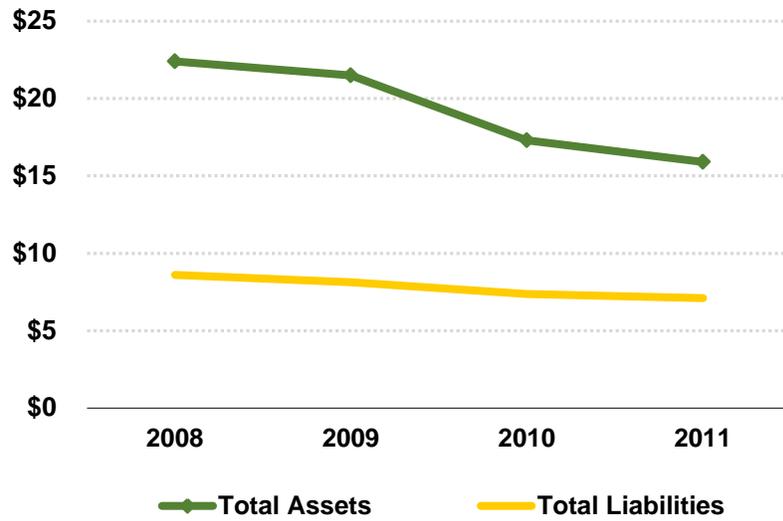
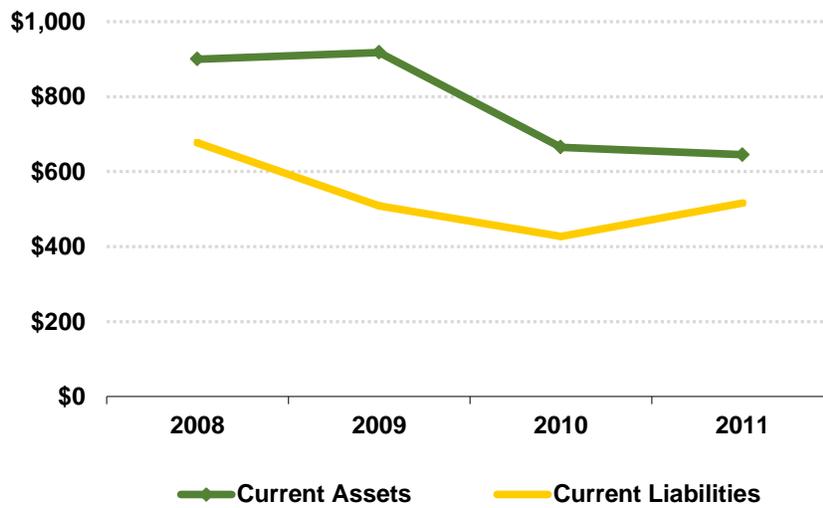
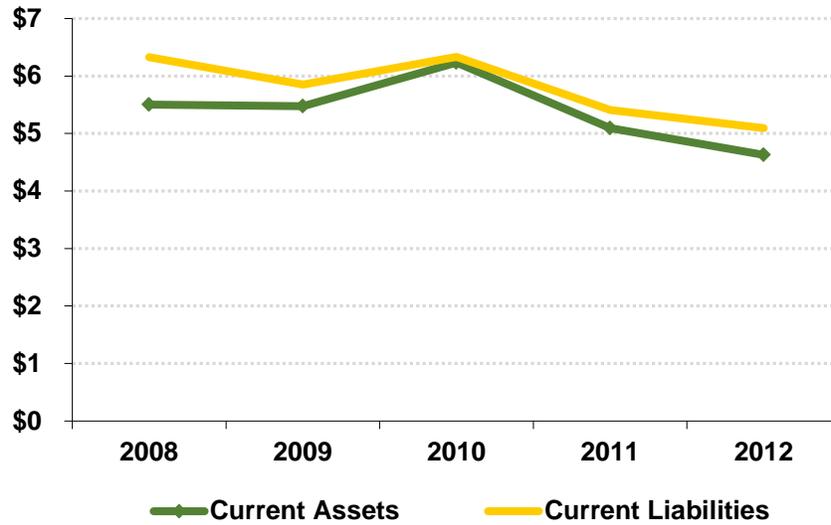


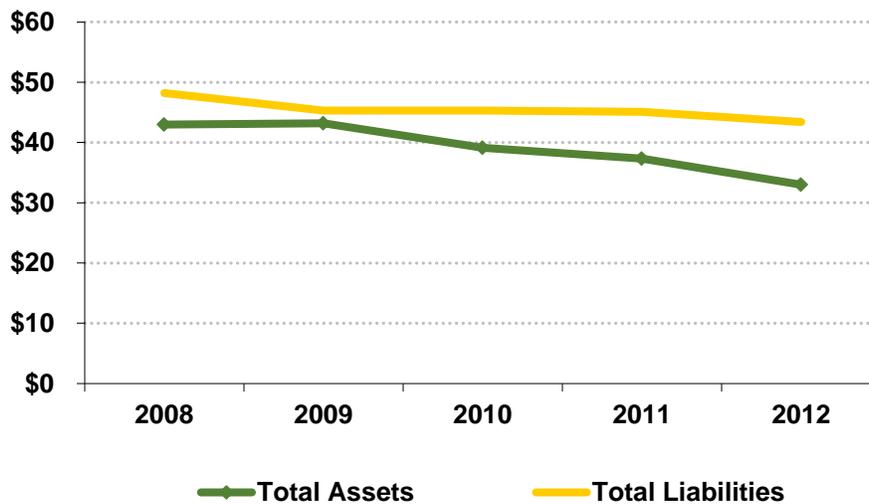
Table 4: RRC Applications: Luminant (Genco) Current Assets to Current Liabilities (2008-2011) (\$ millions)



**Table 5: EFCH 10K: Current Assets to Current Liabilities
(2008-2012)
(\$ billions)**



**Table 6: EFCH 10 K Forms: Total Assets to Total Liabilities
(2008-2012)
(\$ billions)**



The overall picture of EFH/EFCH's 10K Annual Statement and the 2011 Luminant Generation Annual Statement suggest the company has no assets unencumbered by liabilities. For example, the 2012 EFCH 10K shows \$29.9 billion in long term debt and

an additional \$2.1 billion in short term borrowings.³¹ The combined \$32 billion in debt liabilities alone all but equals the company's stated assets of \$32.9 billion.

A theoretical argument could be made that the liabilities held on EFCH's balance sheet make no or limited demands on the Luminant Generation revenue. Given the deteriorated financial condition of EFH/EFCH, it might be expected then that Luminant Generation would firewall the State of Texas' interest from such demands.

In fact, there is no such segmentation or firewalling of Luminant Generation's assets and/or the overall company's liability. Neither Luminant Generation nor EFCH have provided an explicit commitment that the cumulative reclamation guarantee of \$1.09 billion is firewalled from other assets in a manner that is consistent with the intent of the RRC program and protection of Texas taxpayers. In fact, statements made by EFCH seem to indicate quite the contrary:

“In 2009 EFH Corporation implemented a liability management program focused on improving EFH corporations and its competitive subsidiaries (including our) balance sheet. Accordingly we and EFH expect to opportunistically look for ways to reduce the amount and extend the maturity of more outstanding debt.”³²

This statement, like that in the 2011 Luminant Generation Annual Statement, combines all assets and capital stock and the underlying indebtedness of the enterprise as a whole into an integrated debt management program. It makes evident that all assets and all liabilities of EFCH subsidiaries are linked, particularly the all-important \$30 billion in outstanding long term debt and \$2.1 billion in short term debt. These appear to be the collective obligations of the EFCH family notwithstanding Luminant Generation's off balance sheet debt liabilities.

In sharp contrast, EFH/EFCH has gone to great lengths to segment and separate the financial obligations of Oncor, the subsidiary utility company of EFH/EFCH. The filings of EFH and Oncor have a series of “ring-fence” disclosures that establish Oncor's firewalled position in relation to EFH's overwhelming debt burdens. This ring-fence is designed to protect Oncor assets from any adverse actions that may occur due to any work out of the EFH financial condition.³³ No such ring-fence is presented to protect the Luminant Mining or Luminant Generation assets so that Texas residents are not on the hook for reclamation costs.

F. Regulatory Status: A Greater Level of Diligence is Needed

The RRC has recently issued orders in Luminant Mining/Luminant Generation self-bond matters that demonstrate concern about EFH's underlying financial strains. In response to Luminant Generation's recent applications in the Oak Hill and Liberty Mine proposals, RRC staff and the Commission have instituted a program of more frequent financial reporting by Luminant Mining/Luminant Generation.³⁴ The impetus appears to have

³¹ EFCH 2012 Form 10K, p.84

³² EFH 2012 Form 10K, p. 3

³³ Oncor Electric Delivery Company, LLC. 2012 Form 10K, February 2013, p. 1

³⁴ Railroad Commission of Texas, Hearings Division, “Order Accepting Self-Bond With Third Party Guarantee and Indemnity Agreement by Luminant Generation Company,” p. 9-10 (Commission Order).

been an article that appeared in the *Dallas Morning News*³⁵ on October 6, 2012 raising concerns about a potential bankruptcy filing by EFH for one or more of its subsidiaries.

“Because of financial notes contained in the December 31, 2011 audited financial statements and Staff’s request that the Administrative Division review the financial footnotes contained in the December 31, 2011 financial statements of Luminant and Genco (also known as Luminant Generation) that indicate that certain loans and obligations of Genco and related entities have spring maturities contingent on company interrelationships and other obligations, the examine requested that Staff and applicant attempt to agree upon additional more frequent financial reporting, including reporting on the financial viability of Luminant and Genco with each quarterly report to include a narrative discussion indicating any matters that could affect Luminant/Genco’s ability to continue to self-bond its obligations to the Commission.”³⁶

This additional reporting to the RRC is insufficient to protect the State of Texas.

In response to an inquiry from the RRC staff, a Luminant official provided additional support via email for the company’s third-party guarantee, self-bond application, assuring the RRC that the parent company had sufficient liquidity for 2013. In an email dated Nov. 12, 2012, Sid Stroud, director for environmental mining, wrote:

“In addition, as we recently informed our investors in connection with our third quarter financial results, EFH the ultimate parent company of both Luminant and Genco (*Luminant Generation, added for clarity*) has ample liquidity to support its operations, including Luminant’s reclamation obligations. As stated in our recent SEC filings, EFH and its subsidiaries have no significant debt maturities in 2013 and \$3.8 billion of liquidity. Moreover, we expect EFH and its subsidiaries to be in compliance with all debt covenants in 2013.”³⁷

A review of EFH’s third quarter filings, referred to above, confirms that the company presents \$3.8 billion in Available Liquidity, but reveals that \$2 billion of that amount is short-term borrowed proceeds.³⁸

“Available liquidity increased \$1.447 billion since December 31, 2011 reflecting proceeds from the issuance of \$2.0 billion of EFH senior notes (see Note 6 to Financial Statements), a portion of which was used to repay borrowings under the TCEH Revolving Credit Facility. The change in liquidity also reflected use of \$583 million for the nine months ended September 30, 2012 as capital expenditures, including nuclear fuel purchases, exceed cash provided by operating activities.”

If some or all of the \$2 billion appeared on the Luminant Generation balance sheet, perhaps as a current liability, then the company would be out of compliance with the current liability and current asset test.

An additional \$680 million of the \$3.8 billion is cash “held in escrow to settle the demand notes payable by EFH Corp to TCEH,”³⁹ and thus appears to be an encumbered asset. If one reduces the liquidity by the \$2.0 billion⁴⁰ in borrowed proceeds and then again by \$680 million because the funds seem to be pledged for other corporate purposes,

³⁵ Commission Order, p. 9-10

³⁶ Railroad Commission of Texas, Hearings Division, Case Summary, Re: Luminant Mining Company, LLC, Docket No. C12-0006-SC-46-E, Oak Hill Mine, Permit 46Bm Application for Replacement Bond, November 28, 2012, p. 2-3.

³⁷ Email from Sid Stroud, Director, Environmental Mining, Subject: Luminant bonds – Financial Review, Luminant dated November 12, 2012.

³⁸ Energy Future Holdings, Corp., Form 10Q for the quarterly period ended September 30, 2012, p. 68. (EFH 2012-3Q Form 10Q)

³⁹ EFH 2012-3Q Form 10Q, p. 68

⁴⁰ None of the \$2.0 billion is presented as a liability on Luminant Generation’s balance sheet. It does appear on EFH and EFCH balance sheets.

then the liquidity number would shrink to between \$1.12 and \$1.8 billion, down from \$3.8 billion.

However, by December 31, 2012, the end of the 2012 fourth quarter, EFH Available Liquidity dropped to \$2.78 billion.⁴¹ The short-term borrowing of EFIG rose to \$2.25 billion and the \$680 million remained the same. Using the same liquidity measure from the email the Available Liquidity could zero out altogether or drop to \$.53 billion, well under the \$1.09 billion pledged under the self-bond authority.

In short, it appears available liquidity is based on short-term borrowing and includes an encumbered asset in the liquidity calculation. Luminant Generation's liquidity, to the extent that it actually exists, is not based on the value of underlying assets.

Statements made in EFH and EFCH SEC filings raise additional questions about the actual availability of liquid assets pledged to the RRC. In the section entitled *Material Credit Rating Covenants and Credit Worthiness Effects on Liquidity*, the statement includes the following:

“The RRC has rules in place to assure that parties can meet their mining reclamation obligations, including through self-bonding when appropriate. If Luminant Generation Company LLC (a subsidiary of TCEH) does not continue to meet the self-bonding requirements as applied by the RRC, TCEH may be required to post cash, letter of credit or other tangible assets as collateral support in an amount currently estimated to be approximately \$850 million to \$1.1 billion. The actual amount (if required) could vary depending upon numerous factors, including the amount of Luminant Generation Company LLC's self-bond accepted by the RRC and the level of mining reclamation obligations.”⁴²

If Luminant Generation/EFCH/EFH has available liquidity from underlying assets then a cash or letter of credit call should not rise to the level of a liquidity or credit risk.

In its 2012 Accountants Letter accompanying EFCH's 2012 Form 10K, company auditors Deloitte & Touche state:

“EFCH continues to experience net losses, has substantial indebtedness and has significant cash interest requirements.”⁴³

This is the first time the company accountant has made such statements regarding the company's position. The Accountants letter then states that EFCH and EFH will be discussing options with bond holders as a way to correct this condition. EFCH's recent quarterly statement provides an update concerning those discussions, acknowledging that the company is considering a series of actions including voluntary bankruptcy.⁴⁴

G. Conclusions and Recommendations

The foregoing discussion makes clear that Luminant Generation's financial condition may not actually provide the liquidity anticipated under State law to cover the cost of mining reclamation and emergencies. To accept the Luminant Generation/Luminant Mining applications, one would have to accept a series of assumptions about the decoupling of Luminant Generation's assets from the EFH network of debt, including the approximately \$30 billion in debt held by the direct parent subsidiary of Luminant, Texas

⁴¹ Energy Future Holdings, 2012 Form 10K, February 19, 2013, p.79

⁴² EFH 2012 Form 10k, p. 85. Cut next and EFH Form 10Q – 2012, Q3 and 2013, Q1, p. 73 and 66 respectively.

⁴³ EFCH 2012 Form 10K, p. 80. Beside the net losses and other evidence of financial deterioration the company also took a \$1.2 goodwill impairment write-down in 2012.

⁴⁴ EFCH, 2013-1Q Form 10Q, May 2, 2013, p. 5

Competitive Energy Holdings (TCEH). Such a decoupling is attempted in Luminant Generation's annual report through an accounting treatment that places Luminant Generation's assets on its balance sheet filed with the RRC, but places the liabilities in an off-balance sheet arrangement. This accounting treatment may be appropriate as a tool of corporate financial disclosure and debt management. However, it is highly questionable whether Luminant Generation's actual financial condition can meet a real-world standard – that real, reachable assets must be available for mine reclamation and emergency expenditures.

The applications made by Luminant Mining and Luminant Generation to the RRC and reviewed for this report contain information and accounting representations that are at considerable variance with statements made by EFH/EFCH, the parent corporation describing its financial condition.

In the case of Luminant Mining and Luminant Generation, the financial presentations made in the self-bond applications portray a solvent company. In the case of EFH/EFCH, its filings to investors and the SEC portray a company in deep financial distress. The wide discrepancies related to the asset and liability representations of Luminant Generation's position compared to the EFH/EFCH enterprise wide presentation and the current asset and current liability test demand more than a simple, technical judgment by the RRC. **All accounting and legal requirements for compliance may be met by the application and filing. However, as a substantive matter the assets identified in the application to cover prospective self-bond costs may not meet a reasonable standard of accessible liquidity if a reclamation claim is made.** As the rest of this memo points out, the underlying data provided to the RRC by Luminant Mining and Luminant Generation requires additional diligence and perhaps additional security for the State of Texas.

The fundamental problem is that there does not appear to be any unencumbered capital obligated to the State of Texas to cover the costs of mining reclamation at the Luminant Mining sites, should EFH or TCEH undergo a bankruptcy that results in the assignment of Luminant Generation assets to new owners. **Such a bankruptcy could result in the abandonment of one or more mining sites, with reclamation costs being uncovered, in direct variance with the core intent of SMCRA and state regulations.**

RRC program administrators may elect to exercise further diligence to realign assets and liabilities in the light of the EFH parent company and its subsidiaries' financial condition, complex corporate structure, accounting treatments and the terms and conditions of its financing agreements. This undertaking is likely to tax the resources of a regulatory agency designed to monitor mining activity and mine financing. In the face of this risk the RRC could elect, as EFCH 10K posits, to require a cash or letter of credit posting for the \$1 billion obligation, until such time as a detailed audit of the availability of Luminant Generation's assets to be available to the state of Texas upon the bankruptcy of the EFH or TCEH parent companies.