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APPLICATION OF CENTERPOINT § BEFORE THE STATE OFFICE
ENERGY HOUSTON ELECTRIC, LLC, PUBLIC UTILITY COMMISSION
RELIANT ENERGY RETAIL § FILING CLERK OF
SERVICES, LLC AND TEXAS GENCO, §
LP TO DETERMINE STRANDED § ADMINISTRATIVE HEARINGS
COSTS AND OTHER TRUE-UP §
BALANCES PURSUANT TO PURA §
§39.262 §

REBUTTAL TESTIMONY OF

MARC KILBRIDE

FOR

**CENTERPOINT ENERGY HOUSTON ELECTRIC, LLC,
RELIANT ENERGY RETAIL SERVICES, LLC, AND TEXAS GENCO, LP**

JUNE 14, 2004

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Confidential MK-R1
Confidential MK-R2

June 8, 2004 Maxcor Electric Utility Research Report
Summary of Daily Cash Position of TGN

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME, OCCUPATION AND ADDRESS.

A. My name is Marc Kilbride. I am currently Vice President and Treasurer of CenterPoint Energy, Inc. ("CenterPoint Energy" or "CNP"). My business address is 1111 Louisiana Street, Houston, Texas 77002.

Q. PLEASE GIVE YOUR EDUCATIONAL BACKGROUND, QUALIFICATIONS AND EXPERIENCE.

A. I have a B.A. in Economics from Dartmouth College and a Master of Business Administration degree with a concentration in Finance from The University of Texas at Austin. I have taken various post-baccalaureate courses in accounting and taxation at the University of Houston. I am a Certified Public Accountant in the State of Texas.

I have been employed at CenterPoint Energy or its predecessor companies and affiliates since 1977. In my current position, I am responsible for corporate finance activities at CenterPoint Energy and its subsidiaries. I am also responsible for banking relationships, treasury operations, insurance risk management, and benefit plan investments, among other functions.

Since I first became Assistant Treasurer of Houston Industries Incorporated—a predecessor to CenterPoint Energy—in 1986, I have been responsible for arranging most of the corporate financings and bank credit facilities for the Company and its utility subsidiaries. Since the beginning of 2003, CenterPoint Energy and its subsidiaries have raised over \$4 billion in the capital markets and have put in place or materially amended credit facilities in excess of \$6 billion.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. My testimony will address five principal issues raised by the direct testimony of various witnesses: (1) the reasonableness of the allocation of debt at restructuring between Reliant Resources, Inc. (“RRI”) and what became CenterPoint Energy; (2) why no debt was assumed or incurred by Texas Genco (“TGN”) at restructuring; (3) what practical considerations limited TGN’s incurrence of debt at various stages of its existence; (4) what cash liquidity TGN has had at various stages of its existence; and (5) what considerations lay behind the decision whether or not to have TGN’s credit rated by the various rating agencies.

Q. PLEASE SUMMARIZE YOUR TESTIMONY ON THE ABOVE ISSUES.

A. (1) At least one witness characterizes the allocation of Reliant Energy, Incorporated’s (“Reliant Energy”) debt at restructuring between RRI and CenterPoint Energy as inherently flawed or even nefarious. There is simply no basis for that assertion. The intent was to balance the business and financial risk for both companies.

(2) At least one witness implied that TGN should have assumed some of the existing debt of one or more of its affiliates at the time of the Reliant Energy restructuring. However, parties to Reliant Energy’s business separation plan (“BSP”) proceeding—Docket No. 21956—objected to initially capitalizing TGN with debt and the Commission approved the BSP with with no debt at TGN. Further, the legal documents that governed the debt did not permit a transfer to TGN without approval by the holders of the debt and obtaining that approval was not feasible.

(3) While various parties have filed testimony in which they assert that TGN should have a more leveraged capital structure, they generally look at TGN’s operations

1 and financial condition and the state of the bank and capital markets as if the
2 conditions that exist today have existed since the 2002 Reliant Energy
3 restructuring when Texas Genco obtained its generation assets. This is a very
4 superficial analysis and is therefore incorrect and misleading. Various parties
5 have also failed to consider the practical consequences of leverage at TGN.

6 (4) Various parties have noted that on particular dates TGN had no borrowings
7 outstanding and indeed had temporary cash investments outstanding. Their
8 failure to evaluate the transitory nature of these cash investments and the
9 significant “swings” in TGN’s intra-month cash flows, however, again reflects a
10 very superficial analysis that has led them to draw incorrect and misleading
11 conclusions.

12 (5) Various parties have suggested that not having TGN rated by the rating agencies
13 demonstrated a failure or oversight on the part of TGN. TGN did request a rating,
14 but for reasons I explain in detail, a rating became unnecessary. In any event,
15 TGN’s lack of a rating was not detrimental.

16 **II. ALLOCATION OF DEBT BETWEEN CENTERPOINT AND RELIANT AT** 17 **RESTRUCTURING**

18 **Q. MR. GORMAN BEGINNING ON PAGE 5 OF HIS DIRECT TESTIMONY**
19 **SUGGESTS THAT THE ALLOCATION OF RELIANT ENERGY DEBT AT**
20 **RESTRUCTURING BETWEEN RRI AND WHAT BECAME CENTERPOINT**
21 **ENERGY WAS UNREASONABLE AND THAT THIS “IMPAIRED CNP’S**
22 **ABILITY TO PROTECT AND ENHANCE THE VALUE OF TGN.” HOW DO**
23 **YOU RESPOND?**

1 A. There is no basis for Mr. Gorman's suggestion. At the time Reliant Energy submitted its
2 BSP to the Commission in 2000, Reliant Energy also presented it to the rating agencies to
3 be sure that both resulting companies would achieve investment grade ratings based upon
4 the resulting mix of business and financial risk, which Mr. Gorman seems to
5 acknowledge as important in later portions of his testimony. All three rating agencies
6 provided such investment grade indicative ratings, and actual investment grade ratings
7 were assigned to CNP at the time of the restructuring and spin off. Incidentally,
8 CenterPoint Energy is still on the same path that it presented to the rating agencies back
9 in 2000 when Reliant Energy sought the indicative ratings; there has been no deviation
10 from what we told the agencies we planned to do.

11 III. CAPITALIZATION OF TGN AT RESTRUCTURING

12 Q. WHEN DID TGN ACQUIRE ITS GENERATION ASSETS?

13 A. TGN acquired Reliant Energy's portfolio of Texas generation facilities and related
14 business effective August 31, 2002. It did so as part of the Reliant Energy restructuring
15 and in accordance with the Second Amended BSP filed by Reliant Energy on August 9,
16 2000 in Docket No. 21956 and approved by the Commission. From January 1, 2002
17 through August 30, 2002, the generation facilities were operated as a separate division
18 within Reliant Energy.

19 Q. WAS THE DECISION TO INITIALLY CAPITALIZE TGN WITHOUT ANY 20 LONG-TERM DEBT AN ISSUE ADDRESSED IN THE BSP?

21 A. Yes. Page 11 of the pleading that accompanied the Second Amended BSP
22 unambiguously stated that "No long term debt will be transferred to ERCOT GENCO."

1 And page C-37 of the Second Amended BSP itself sets forth the capital structure of TGN
2 following restructuring and clearly shows that TGN will have no debt. Ordering
3 Paragraph 9 of the Commission's May 25, 2001 order approving the Second Amended
4 BSP in Docket No. 21956 states that "[e]xcept as otherwise specifically addressed in this
5 order, Reliant's Second Amended Plan, as amended and modified, is approved and
6 adopted." That order does not otherwise address the decision that TGN be capitalized
7 without long term debt and thus that is one of the provisions that was approved and
8 adopted through Ordering Paragraph 9.

9 **Q. DID THE SECOND AMENDED BSP DIFFER FROM THE PRIOR FILED**
10 **VERSION OF THE BSP WITH RESPECT TO CAPITALIZING TGN WITHOUT**
11 **DEBT?**

12 A. Yes. Page C-30 of the First Amendment to the BSP, filed on March 27, 2000 in Docket
13 No. 21956, stated: "The PGC and/or the REP will assume debt of Reliant Energy to the
14 extent authorized by the terms of the applicable indentures and agreements and to the
15 extent any such assumption or transfer can be accomplished without significant
16 refinancing costs."

17 **Q. WHY WAS THAT CHANGED IN THE SECOND AMENDED BSP?**

18 A. Several parties in Docket No. 21956 objected to capitalizing TGN with debt.

19 **Q. WHAT PARTIES IN DOCKET NO. 21956 ARE ALSO PARTIES TO THIS**
20 **PROCEEDING?**

21 A. Staff, the State of Texas, the City of Houston, the Office of Public Utility Council, Texas
22 Industrial Energy Consumers, and Gulf Coast Coalition of Cities.

1 Q. DID ANY OF THOSE PARTIES TO DOCKET NO. 21956 OBJECT DURING
2 THAT PROCEEDING TO CAPITALIZING TGN WITHOUT DEBT?

3 A. No.

4 Q. SINCE THERE HAD BEEN DEBT AT THE INTEGRATED ELECTRIC
5 UTILITY, SOME OF WHICH PRESUMABLY HAD BEEN USED TO FINANCE
6 THE CONSTRUCTION OF THE GENERATING ASSETS, WHY DID TGN NOT
7 ASSUME A PROPORTIONATE AMOUNT OF THE DEBT THAT HAD BEEN
8 AN OBLIGATION OF RELIANT ENERGY, AS DR. SZERSZEN SUGGESTS AT
9 PAGE 18 OF HER DIRECT TESTIMONY?

10 A. In addition to the parties in Docket No. 21956 objecting to capitalization of TGN with
11 debt, under the terms of the indentures that governed all but the First Mortgage Bonds of
12 Reliant Energy, the debt had to be assumed by the new holding company, CenterPoint
13 Energy. Further, under the terms of the Reliant Energy Mortgage and Deed of Trust, the
14 First Mortgage Bonds had to remain with Reliant Energy post-restructuring, which is
15 now CenterPoint Energy Houston Electric, LLC ("CEHE"). Transferring any of that debt
16 would have therefore required approval of the holders of that debt.

17 Q. WOULD OBTAINING DEBT HOLDER APPROVAL HAVE BEEN FEASIBLE?

18 A. Not in my judgment. Without regards to the merits of a particular situation, it is
19 generally extremely difficult to get bondholder approval of amendments. It is not
20 something that the holders of public debt frequently agree to. And because an
21 amendment of this type (a change in obligors not contemplated in the debt documents)
22 would have required obtaining a vote of 100% of the bondholders, TGN's assumption of
23 this debt was highly implausible. Moreover, in this particular case, one would have to

1 speculate as to whether or not holders of the debt would have been willing to exchange
2 obligors. As one can deduce from my later testimony, it is not at all clear that
3 bondholders would have elected to have TGN assume the sole responsibility for servicing
4 their debt in late 2002.

5 **Q. COULD TGN HAVE AGREED WITH CENTERPOINT ENERGY OR CEHE TO**
6 **ASSUME RESPONSIBILITY FOR SERVICING SOME OF THIS DEBT?**

7 A. Yes, but short of obtaining an amendment, there would have been no way to release
8 either CenterPoint Energy or CEHE from their primary obligations to the bondholders.

9 **Q. SO WHERE THE EXISTING DEBT ENDED UP, AND THE FACT THAT TGN**
10 **WAS NOT ASSIGNED A CERTAIN AMOUNT OF THE DEBT OF RELIANT**
11 **ENERGY, WAS NOT A DECISION MADE BY RELIANT ENERGY OR**
12 **CENTERPOINT ENERGY?**

13 A. That is correct. Where the debt ended up was governed by the applicable legal
14 documents that related to the debt obligations.

15 **Q. DR. SZERSZEN TESTIFIES THAT TGN COULD ALSO HAVE REFUNDED**
16 **DEBT OUTSTANDING AT AN AFFILIATE (PARTICULARLY, POLLUTION**
17 **CONTROL REVENUE BONDS) WITH THE PROCEEDS OF ONE OR MORE**
18 **TGN DEBT ISSUES AT THE TIME THAT TGN WAS FORMED. WAS THAT A**
19 **POSSIBILITY?**

20 A. This would not have worked for several reasons. First, contrary to her assertion, most of
21 the pollution control bonds outstanding were not then callable. Dr. Szerszen may have
22 assumed that, because all of these bonds are subject to one or more call provisions, this
23 means that the bonds were all callable at the Company's option at the time of the
24 restructuring. But they were not.

1 In the alternative, Dr. Szerszen suggests that the affiliate could have tendered for the
2 bonds. As she correctly points out, doing this would have involved paying a tender
3 premium as Central Power & Light did some years back when it tendered for debt
4 following its securitization of regulatory assets. It all depends on specifics, of course, but
5 tender premiums are not typically immaterial in terms of cost.

6 **Q. ARE THERE ANY OTHER PROBLEMS WITH DR. SZERSZEN'S REFUNDING**
7 **IDEA?**

8 A. Yes, at least one big one: it should be obvious that in order to implement this idea, TGN
9 or one of its subsidiaries must be the obligor on the new bonds. Later in my testimony I
10 will describe why I do not believe that TGN could have raised funds in the taxable
11 market at the time of its creation. Based upon my experience, there is nowhere near the
12 demand for below investment-grade rated credits in the tax-exempt market as there is in
13 the taxable market. That is just a characteristic of the tax-exempt market. And refunding
14 tax-exempt debt with below-investment grade taxable debt at TGN would have been
15 highly destructive from a value standpoint (even assuming, for argument's sake, that
16 TGN could have sold taxable debt). First, the rate on the new debt would have been
17 higher than the rate on refunded debt (even before consideration of a tender premium).
18 Second, once tax-exempt debt is refunded with taxable debt (and thus retired), a company
19 cannot later refund the new debt with tax-exempt debt. Instead, the company will have
20 forever lost the ability to have that amount of tax-exempt debt in its capital structure.
21 This would not have been a prudent thing to do.

IV. INCURRENCE OF DEBT AT TGN POST-RESTRUCTURING

Q. A NUMBER OF INTERVENORS, INCLUDING MR. MITTAG, MR. GORMAN, DR. SZERSZEN AND MR. JOHNSON, SEEK TO FAULT TGN FOR NOT HAVING ACCESSED THE CAPITAL MARKETS IN LATE 2002 OR EARLY 2003. PLEASE DISCUSS HOW THE COMPANY VIEWED THE PROSPECT OF DEBT FINANCING AT TGN DURING THAT TIMEFRAME.

A. I will defer to Mr. McGoldrick and Mr. Kind for a discussion of capital structure and strategic matters. However, I can comment on the state of debt markets and what TGN did, in fact, do during this period.

Q. COULD TGN HAVE BORROWED MONEY ON REASONABLE TERMS ON ITS OWN IN LATE 2002 OR EARLY 2003?

A. One has to appreciate what TGN looked like from a credit standpoint beginning on August 31, 2002 when it acquired its generation assets. It was a newly-created company, operating in an untested market, and, based upon the forward capacity sales it had entered into, looked to have relatively weak credit protection measures going forward. Further, TGN's first capacity auction was affected by the terror attacks of September 11, 2001 and, consequently, TGN received very low prices in the auction. Moreover, after September 11 the whole economy had a cloud of uncertainty hanging over it. Also, as Mr. Kind has testified, it was very unlikely that TGN could have had a successful IPO in early 2003. The equity markets and the debt markets do not move in lock-step, but I think that the same factors that weighed against a successful IPO would have militated against a successful debt offering. I note that Mr. Tietjan at page 28 of his direct

1 testimony acknowledges that having minimum leverage at TGN at the time of its
2 inception was not an unreasonable thing to do.

3 **Q. DID YOU EXAMINE WHETHER OR NOT TGN COULD RAISE FUNDS FROM**
4 **A DEBT OFFERING IN THE LATTER PART OF 2002?**

5 A. We did. In late 2002 we entered into extensive discussions with a major investment
6 banking firm about the possibility of issuing debt at TGN.

7 **Q. WHAT MOTIVATED YOU TO ASSESS DEBT FINANCING AT TGN IN LATE**
8 **2002?**

9 A. With a view towards TGN's needs, we had hoped that TGN might be able to borrow
10 funds on more attractive terms than could be offered via intercompany loans. By then,
11 CNP had become a registered public utility holding company, and the rate that could be
12 offered on intercompany loans by CNP to subsidiaries was set by the "money pool"
13 provisions of the Public Utility Holding Company Act of 1935 (the "35 Act") at a rate
14 equal to CenterPoint Energy's borrowing cost. From CNP's standpoint, arranging an
15 independent source of liquidity for TGN would have relieved CNP of the need to
16 maintain liquidity resources to meet the requirements of TGN. We expected those needs
17 to be significant during 2003, when we expected to make \$150 million in capital
18 investment in TGN (\$98 million of which was environmental emission control
19 equipment). Contrary to Mr. Mittag's implication in his direct testimony, CNP was
20 keenly interested in establishing an independent source of liquidity for TGN, particularly
21 during that time period. Being relieved of the obligation to fund all of TGN's cash needs
22 would have been far more beneficial to CNP than was the interest it earned on money
23 pool loans. Mr. Mittag perhaps does not appreciate that CNP, because it is subject to the

1 requirements of the 35 Act, can only earn through money pool loans what it costs it to
2 provide the funds it invests. The money pool is not a profit center for 35 Act companies.

3 **Q. DID TGN BORROW SIGNIFICANT AMOUNTS OF MONEY FROM THE**
4 **MONEY POOL DURING 2002 AND 2003?**

5 A. Yes, in both years. The year 2002 was not a great year for TGN. TGN had a net loss.
6 And then, of course, winter is not the peak revenue season for TGN, so it was not
7 expected to generate significant cash in early 2003 based on existing capacity sales. On
8 May 19, 2003, the outstanding balance that TGN had borrowed from the money pool had
9 grown to \$256 million. This was the highest amount that TGN has borrowed from the
10 money pool since TGN was established in 2002.

11 **Q. SO WHAT HAPPENED WHEN YOU EVALUATED DEBT FINANCING FOR**
12 **TGN IN LATE 2002?**

13 A. We spent a substantial amount of time analyzing different alternatives. In my opinion,
14 any debt financing entered into by TGN at that time would have been expensive and
15 complicated. I should also add that the alternatives that we were looking at then involved
16 going to the private debt market. This is where weaker credits often end up. There was
17 no possibility of TGN doing a registered public debt offering at that time.

18 Loans in the private market tend to be relatively expensive and structured. Certainly, any
19 such financing would have contained a number of restrictions on TGN's activities that
20 did not exist under the terms of the CNP money pool loans. It is important to recall that
21 the timeframe that we are talking about here (late 2002) was a period marked by very
22 unfavorable conditions in both the debt capital markets and the bank markets. Banks and

1 institutional lenders were fleeing the energy sector. Terms aside, it is also not clear that
2 TGN would have been successful in arranging any such financing.

3 **Q. WHY DO YOU BELIEVE TGN MAY NOT HAVE BEEN SUCCESSFUL IN**
4 **ARRANGING EXTERNAL DEBT FINANCING IN LATE 2002?**

5 A. One factor is that in 2002, CEHE, which at that point was an investment grade regulated
6 transmission and distribution utility, entered into a secured debt arrangement with a
7 group of lenders that included entities affiliated with Warren Buffet and Credit Suisse
8 First Boston. In order to obtain that secured loan, CEHE had to pay an interest rate of
9 LIBOR plus 975 basis points with a floor of 12.75%. A similar TGN financing would
10 have also been a secured transaction, but at an entity that was an unrated, unregulated,
11 commodity-based business. Even though TGN had no other debt at that time, except for
12 intercompany debt, I would certainly assess the TGN business risk to have been greater
13 than the combined business and financial risk of the transmission and distribution utility.

14 **Q. DID YOU THEN CEASE TO PURSUE RAISING EXTERNAL DEBT AT TGN?**

15 A. No, not entirely, but because of the likely cost, the complexity of the structure and the
16 limited odds of success of a TGN debt financing, we did concentrate our efforts
17 elsewhere. In particular, we thought that it made sense to focus on modifying the credit
18 facility at the parent company. We believed that this would increase the market
19 receptivity for all of our affiliated companies.

20 **Q. DID THE MARKET RECEPTIVITY FOR FINANCINGS OF CNP AND ITS**
21 **AFFILIATES INCREASE FOLLOWING AMENDMENT OF THE CNP**
22 **FACILITY?**

1 A. It did. Following the restructuring of the parent company facility in February 2003 (by
2 which we extended the maturity date and eliminated “hard” mandatory prepayment
3 requirements), we embarked on a series of successful financings and refundings that
4 involved capital market transactions totaling in excess of \$4 billion.

5 **Q. SO, DID YOU PURSUE RAISING EXTERNAL DEBT AT TGN LATER IN 2003?**

6 A. Not the same type of financing. By mid-2003 two things had begun to happen. First,
7 TGN had entered into its peak summer season and thus had begun to generate net cash.
8 This was used to start paying down TGN’s money pool obligations. Second, the capacity
9 prices that TGN was locking in on its forward sales had begun to rise. In due course, we
10 began to see projections that indicated that these forward sales, assuming no major
11 unplanned outages at TGN, might enable TGN to completely pay off all intercompany
12 debt by late 2003 or early 2004. So while the feasibility of debt financing at TGN started
13 to improve significantly, the question arose as to what TGN would do with the cash from
14 a debt offering if in fact the internal cash generation lived up to projections.

15 Finally, we decided in the second half of 2003 that, given the evolving circumstances,
16 probably all that TGN would require would be a relatively small working capital facility.
17 In December 2003, we arranged such a revolving credit facility at Texas Genco, LP—a
18 subsidiary of TGN—on attractive terms with a group of relationship banks.

19 **Q. WHY WAS A REVOLVING CREDIT FACILITY ARRANGED INSTEAD OF A**
20 **CAPITAL MARKETS TRANSACTION?**

21 A. The primary reason was that it was becoming clearer that, from an operations standpoint,
22 TGN might not have a permanent need for debt in its capital structure. If we had sold
23 debt in a typical capital markets transaction, there would have been no way to pay down

1 the debt if and when TGN generated cash in excess of its business needs. With a
2 revolving credit facility, TGN could borrow what cash it needed, when it needed it, and
3 repay the loans when it had excess cash. Thus, a revolver more closely matched TGN's
4 operational needs.

5 **Q. GIVEN TGN'S CASH POSITION IN LATE 2003 AND EARLY 2004, AND**
6 **PROJECTIONS OF IMPROVING LIQUIDITY, WHY ENTER INTO ANY**
7 **BORROWING ARRANGEMENTS AT ALL?**

8 A. To ensure a source of liquidity to TGN. This is particularly important in the case of TGN
9 because TGN experiences significant swings in its cash needs within each month. Also,
10 once TGN became an exempt wholesale generator ("EWG") in October 2003, TGN was
11 no longer eligible to borrow from CenterPoint Energy or TGN's utility affiliates under
12 SEC rules. Accordingly, its ability to borrow on an intercompany basis is now severely
13 limited.

14 **Q. COULD TGN RAISE FUNDS IN THE DEBT CAPITAL MARKETS TODAY, IN**
15 **YOUR OPINION?**

16 A. I believe so. TGN's performance and the state of the bank and capital markets today
17 (particularly in contrast to late 2002) would enable TGN to raise debt funds.

18 **Q. WHAT IS THE MAXIMUM AMOUNT OF DEBT THAT TGN COULD RAISE**
19 **TODAY?**

20 A. Discussing "maximums" is a tricky business. I think that one really has to add qualifiers
21 to properly frame this type of question, or else the answer is meaningless. A more
22 meaningful starting point would be: "What is the maximum amount of debt that TGN
23 could incur at attractive rates while limiting the restrictions that lenders may seek to

1 impose on its business and financial operations?” It is disingenuous to focus on just one
2 factor: the amount.

3 Certainly, I would not want to provide an estimate without evaluating different
4 alternatives and consequences against a backdrop of TGN’s strategic plan. I have not
5 performed such an analysis.

6 **Q. DO PEOPLE SOMETIMES FAIL TO CONSIDER THE TERMS OF DEBT**
7 **INSTRUMENTS AND THE IMPLICATIONS OF AGREEING TO SUCH**
8 **TERMS?**

9 A. Certain parties have in this proceeding. Testimony has been offered to the effect that
10 TGN could raise as much as \$2.1 billion in the debt capital markets given current market
11 conditions. This is a number based upon an assessment that TGN received from an
12 investment banking firm, Citigroup (“Citi”). It is ironic to me that witnesses have thrown
13 out this number as some sort of a benchmark without any further discussion. One might
14 be led to believe that TGN could borrow funds at this level on terms that would not
15 materially affect the way it conducts its business. Some of the same presentations from
16 which parties have extracted the \$2.1 billion number make clear that this is not the case.
17 The proposed covenant package for that level of debt would require the company to
18 accept limitations on dividends (indeed, probably prohibit dividends), would require
19 “sweeps” of excess cash flow, and would limit the business activities that TGN could
20 enter into, among other things. It is important to distinguish between what is feasible and
21 what is optimal. As Citi pointed out in its presentation, the resulting ratings of TGN
22 would be expected to be well below investment grade with this level of debt. That could

1 not only limit future financial flexibility at TGN, but could also impact its current and
2 future commercial relationships with counterparties.

3 **Q. SOME OF THE INTERVENOR WITNESSES CRITICIZE AND WOULD**
4 **PENALIZE TGN FOR NOT TAKING ON MORE DEBT AS THIS BECAME**
5 **MORE FEASIBLE FROM A CREDIT STANDPOINT. WHY DID TEXAS**
6 **GENCO NOT BORROW \$1 BILLION OR MORE AS THE INTERVENORS**
7 **SUGGEST IT SHOULD HAVE DONE?**

8 A Without regard to any specific amount that might be borrowed on terms attractive to
9 TGN, let me offer the following. TGN did not need to take on any debt to finance its
10 operations and did not have any planned new investments on which the borrowed dollars
11 would be spent. We did not view taking on debt for debt's sake as a sound business
12 practice for Texas Genco.

13 Let me also add what I think to be another important fact bearing on this discussion.
14 Because CNP had broadly announced to all the markets that it intended to sell its
15 ownership interest in TGN in 2004, lenders would have been keenly focused on this fact
16 and would likely have required a change in control provision. Indeed, there is a change
17 in control provision in the current small revolver at TGN, as is typical for bank credit
18 facilities.

19 **Q. WHAT IS A CHANGE IN CONTROL PROVISION?**

20 A. A typical "change in control" provision would specify that a change in ownership of a
21 majority of the stock of the borrower (in this case, the stock of TGN) would be a
22 covenant breach and thus trigger an event of default. Where such provisions exist, the

1 company to be acquired either has to pay off the debt or obtain consent of the lenders
2 prior to closing to keep the debt in place.

3 **Q. DOES EVERY AGREEMENT GOVERNING ALL TYPES OF DEBT**
4 **FINANCING CONTAIN CHANGE IN CONTROL PROVISIONS?**

5 A. No.

6 **Q. DO YOU THINK THAT TGN COULD HAVE ARRANGED FINANCING ON**
7 **REASONABLE TERMS WITHOUT HAVING TO ACCEPT A CHANGE IN**
8 **CONTROL PROVISION AS A CONDITION?**

9 A. It is difficult to say. There are a number of different markets, and it could depend in
10 terms of timing, what TGN would be willing to pay, or what restrictions TGN would be
11 willing to accept. But certainly, the fact that CNP had communicated its intent to sell its
12 interest in TGN, and the characteristics of TGN itself (its newness, the fact that it is a
13 commodity based business, etc.), would have worked against this possibility.

14 I have not conducted a study of all potential sources of debt capital to see whether or not
15 it would have been possible to find a provider of funds who would not have required a
16 change in control provision. But at a minimum, having access only to those sources who
17 would not require a change in control provision would significantly limit the field of
18 alternatives. I also think that, in at least some instances where you might find lenders
19 willing to do so, the trade-off would be a covenant package so restrictive that it would
20 cause you to consider whether or not such financing was really in the best interest of
21 TGN's business.

22 **Q. WHY DO YOU THINK THIS "CHANGE IN CONTROL" ISSUE IS RELEVANT**
23 **TO THE CURRENT DISCUSSION?**

1 A. I believe it to be relevant because it is another factor a prudent financial person has to
2 consider in assessing whether it makes sense to borrow significant amounts at TGN. It
3 may not make sense to borrow funds at TGN in excess of its interim operating needs if
4 TGN can only retain the funds until the point at which CNP sells its interest.

5 **Q. WHY IS THIS NEED TO LOOK AT THE TOTALITY OF THE**
6 **CONSEQUENCES OF LEVERAGING UP TGN PARTICULARLY RELEVANT**
7 **IN THE CONTEXT OF TESTIMONY THAT HAS BEEN FILED BY SOME**
8 **OTHER WITNESSES?**

9 A. In my view, it is critical to look at the concept of debt at TGN in the context of the
10 observation I made about the relationship between the degree of leverage a company like
11 TGN can incur and the restrictions that lenders are going to seek to impose on TGN.
12 Witnesses in this proceeding, at least by implication, have been willing to “validate” the
13 notion that TGN could incur debt in excess of \$2 billion. Quite apart from whether or not
14 this would be a wise thing to do, the same witnesses propose elsewhere in their testimony
15 that TGN do (or should have done) a variety of strategies to “enhance” the value of the
16 stock, including pay larger dividends and enunciate a growth strategy. Unfortunately,
17 you can’t have it both ways. The more one seeks to increase the leverage at a company
18 like TGN, the more likely TGN is to find that the lenders will want to increase the control
19 they exert over the company’s ability to do these very things. To claim otherwise is false.
20 Also, I think it interesting to look at testimony offered by intervenors on this point in
21 light of the TGN decision to exercise its right of first refusal (“ROFR”) for AEP’s interest
22 in the South Texas Project. I am not qualified to speak to the merits of this investment,
23 but clearly the TGN Board of Directors thought that the exercise of the ROFR adds value

1 to TGN. If TGN had already taken on the incremental debt suggested by the intervenors
2 and paid it out in dividends or repurchased TGN common stock, it would mean that TGN
3 would likely have to seek approval of the existing lenders in order to incur additional
4 debt for the exercise of the ROFR. Maybe TGN would obtain that approval; maybe not.
5 Even the small \$75 million revolver currently in place at TGN imposes a limit on the
6 amount of additional secured indebtedness that TGN can incur.

7 **Q. MR. PURCELL AT PAGE 47 OF HIS TESTIMONY STATES THAT**
8 **CITIGROUP “ADVOCATED \$2.1 BILLION OF DEBT FINANCING FOR TGN.”**
9 **IS THIS A FAIR CHARACTERIZATION, AS YOU UNDERSTAND IT?**

10 A. No. Mr. Purcell’s choice of words is misleading. Citi was not recommending this course
11 of action for TGN as it currently exists. Citi instead provided information about what
12 degree of debt a financial buyer might be able to assume if it were to acquire TGN. This
13 would likely be for a financial buyer used to dealing in the world of highly leveraged
14 finance. Citi is at least as aware as I am of what the (adverse) impact of this type of debt
15 might be on TGN as it currently exists, and how this could significantly constrain TGN’s
16 business operations.

17 **Q. MR. TALBOT AT PAGE 28 OF HIS DIRECT TESTIMONY STATES THAT A**
18 **40% LEVEL OF DEBT AT TGN WOULD HAVE BEEN “REASONABLE” IN**
19 **MID- TO LATE 2003. HOW DO YOU RESPOND?**

20 A. I disagree with Mr. Talbot. Based upon my observations at the time, I sincerely doubt
21 such would have been possible. And I have greater doubt about whether it would have
22 been reasonable to do so, even if it had been possible.

Q. DO ALL ANALYSTS AGREE WITH THE INTERVENOR WITNESSES' HYPOTHESIS THAT TAKING ON MORE DEBT WOULD INCREASE MARKET VALUE?

A. No. On June 8, 2004, Maxcor Electric Utilities Research published a report focusing in part on this proceeding. The report includes the following statement: "The staff argued that stranded costs (difference between market value and book value) would be lower had Texas Genco a more normal capital structure (TGN capital structure is almost all equity). We believe that the high market value of TGN stemmed from its rich capital structure." A copy of that research report was produced as Attachment 8 to TIEC1-24 Supp2 and is attached hereto as Figure MK-R1.

Q. DOES THIS CONCLUDE YOUR COMMENTS REGARDING THE AMOUNT OF LEVERAGE THAT TGN COULD HAVE INCURRED?

A. Not quite. I want to comment on certain statements made by Mr. Peavy in his testimony. Several witnesses have been content to draw conclusions based on information that the Company received from Citi in the second quarter of 2004 concerning the amount of debt that TGN could incur. Since I disagree with their conclusions, or believe the witnesses to have not presented the entire story, I have stated my reasons for disagreeing with them. But at the end of the day, I recognize that the witnesses are simply advocates for their clients and presenting their case in the best possible light to buttress the positions taken by their clients.

However, Mr. Peavy has opted to go further in his testimony and effectively allege misdeeds on the part of the Company. I draw your attention to two portions of his testimony. Mr. Peavy on page 31 of his direct testimony states: "I find it quite

1 contradictory that on March 9, 2004, Citigroup made a presentation to CenterPoint
2 Energy . . . about a contemplated \$2 billion financing offering . . . the entire proceeds [of
3 which] . . . would be used to pay dividends to TGN's stockholders." This is offered in an
4 attempt to impeach the direct testimony offered by Applicant witnesses Kind and
5 McGoldrick. At page 34 of his direct testimony, Mr. Peavy states the following after
6 quoting the comments of CNP CEO David McClanahan in a call with analysts to the
7 effect that the Board of TGN had not made a determination as to what TGN might do
8 with any free cash at TGN: "The above public statements are in direct contrast to *TGN's*
9 *private timeline* to incur a substantial amount of additional leverage and pay a huge cash
10 dividend" (emphasis added). As I previously explained, Citi had presented a number of
11 options as to what TGN or a purchaser might do, and then Citi discussed the pros and
12 cons of such alternatives. I do not think Citi was recommending a particular course of
13 action to CNP or TGN. But regardless, no action on any such proposal has been taken by
14 the TGN Board, nor to the best of my knowledge has a recommendation in this regard
15 been made to the Board of TGN by management. And I believe I'd know, because I'd be
16 running the deal. If Mr. Peavy has any experience in working with investment banking
17 firms, he will know that a company such as CenterPoint Energy receives a vast array of
18 pitch books throughout the year. Many of these written presentations include a timeline
19 for the transaction that is being proposed by the investment bank. Possession of this
20 material does not make this "TGN's private timeline."

V. TEXAS GENCO'S CASH LIQUIDITY

Q. MESSRS. GORMAN, MITTAG, PEAVY AND PURCELL ASSERT THAT TGN IS ACCUMULATING LARGE AMOUNTS OF CASH OR ACCUSE TEXAS GENCO OF HAVING "HOARDED CASH". HAS TGN ACCUMULATED LARGE AMOUNTS OF EXCESS CASH?

A. No. These comments display a lack of understanding of the cash requirements of businesses like TGN. The amount of cash on TGN's books at December 31, 2003—\$44.5 million—was extremely modest. Significantly, the cash balance had been negative \$26 million just 9 days earlier and by January 9 the entire December 31 cash balance had been used and TGN had been forced to borrow nearly \$38 million to fund its operations. The deficit grew to nearly \$69 million dollars by January 20 but had returned to a positive balance of \$30 million by the end of the month. The same pattern was followed in February with the opening positive balance of \$30 million becoming negative by the third day of the month and not returning to a positive balance until February 25. The same general pattern recurred in March 2004. April of 2004 was the first month in TGN's entire existence in which it had positive cash balances for the entire month. While recent projections did show a December 31, 2004 cash balance of \$299 million, all but \$124 million of that amount is expected to be used to purchase AEP's interest in the South Texas Project nuclear facility.

Q. SEVERAL WITNESSES, INCLUDING MR. MITTAG AND MR. GORMAN, HAVE SOUGHT TO USE TGN'S CASH OR INVESTMENT BALANCES AT SPECIFIC POINTS IN TIME AS BEING IN SOME WAY ILLUSTRATIVE OF

1 TGN'S LIQUIDITY. CAN YOU DESCRIBE WHY THIS MAY NOT
2 NECESSARILY BE SO?

3 A. Yes. As shown above, such "snapshots" can be misleading, particularly for a company
4 such as TGN because of the large intra-month swings in its cash position.

5 Q. WHAT DO YOU MEAN BY INTRA-MONTH "SWINGS" IN CASH POSITION?

6 A. Intra-month "swings" refer to the fact that TGN's cash balances do not increase gradually
7 day-by-day. There are certain days of the month on which TGN receives payments for
8 capacity and certain days of the month on which it has to make payments to third parties,
9 such as for gas purchases. TGN generally receives capacity payments (inflows) only
10 during the last third of the month. In contrast, it does tend to have large payments
11 (outflows) during the first half of the month. On balance, therefore, TGN's relative cash
12 position is always going to look strongest after it has received its capacity payments for
13 the month, and is always going to look weakest just before it receives these same capacity
14 payments.

15 Q. WHY MUST THE PATTERN OF TGN'S LIQUIDITY NEEDS BE CONSIDERED
16 WHEN ASSESSING TGN'S LIQUIDITY?

17 A. Because there are significant changes in TGN's cash position by day within each month.
18 Mr. Mittag and Mr. Gorman provided testimony in which they point to TGN's cash
19 balances as of a certain day. This is not really relevant from the standpoint of making
20 decisions or taking action.

21 Q. PLEASE PROVIDE AN EXAMPLE OF WHY TGN'S CASH BALANCES AS OF
22 A CERTAIN POINT IN TIME ARE NOT RELEVANT FROM THE
23 STANDPOINT OF MAKING DECISIONS OR TAKING ACTION.

1 A. One data point Mr. Mittag and Mr. Gorman cite was the TGN investment balance as of
2 December 31, 2003. On that day, TGN did not have any debt borrowed and was an
3 investor in the money pool to the tune of \$44 million. While making a correct statement,
4 Mr. Mittag and Mr. Gorman both failed to observe that by January 9, 2004—just a few
5 business days later—TGN had used up all of its temporary cash investments and was by
6 that time a net borrower in the amount of \$38 million.

7 **Q. IS THE INTRA-MONTH LIQUIDITY “SWING” EXPERIENCED IN JANUARY**
8 **2004 AN ISOLATED OCCURRENCE?**

9 A. No. Another reference point cited in Mr. Gorman’s testimony was the position as of
10 March 31, 2004. On that day, TGN had an investment balance of \$52 million. However,
11 what was unsaid by Mr. Gorman was that on March 22, 2004, TGN had no investments
12 and was a net borrower in the amount of \$54 million and that on April 19, 2004, TGN
13 had a net investment position of only \$1 million.

14 **Q. DO YOU HAVE A SUMMARY OF THE DAILY CASH POSITION OF TGN?**

15 A. Yes. Please refer to Figure MK-R2, which shows the daily net cash (temporary
16 investment/short term borrowing) position of TGN.

17 VI. RATING OF TEXAS GENCO

18 **Q. MR. MITTAG AT PAGE 29, LINES 18-20 STATES THAT “SECURING AN**
19 **INVESTMENT GRADE RATING FROM THE RATING AGENCIES ALSO**
20 **WOULD HAVE BROADENED THE COMPANY’S APPEAL TO CERTAIN**
21 **INSTITUTIONAL INVESTORS.” DID THE COMPANY CONSIDER HAVING**
22 **TGN OR ONE OF ITS SUBSIDIARIES RATED BY THE RATING AGENCIES?**

1 A. Yes.

2 **Q. WHEN WAS A DEBT RATING FOR TGN OR ONE OF ITS SUBSIDIARIES**
3 **FIRST CONSIDERED?**

4 A. Obtaining a rating was first considered in late 2002 in connection with the analysis of the
5 financing alternatives I described above.

6 **Q. WOULD A RATING HAVE BEEN NECESSARY TO EXECUTE THE**
7 **FINANCING UNDER CONSIDERATION IN LATE 2002?**

8 A. Yes. In order for TGN to access the capital markets, the investment banking firm we
9 were working with (not Citi) believed that we would need to get TGN or its subsidiary,
10 Texas Genco, LP, rated. As I noted earlier, the financing that was being discussed at that
11 point would have been complex and expensive.

12 **Q. DID TGN'S LIQUIDITY SITUATION CHANGE AFTER EARLY 2003?**

13 A. Yes. Increases in the forward curve for gas began to translate into improved sales prices
14 for capacity at TGN. This caused us to re-examine the specific type of financing we had
15 previously considered for TGN. We still thought that a capital markets component
16 might be reasonable (though one not having as restrictive terms as what we had looked at
17 originally) so in April 2003 we did contact the rating agencies and formally requested
18 ratings for Texas Genco, LP.

19 **Q. WHAT WAS THE RESULT OF YOUR REQUEST FOR A RATING?**

20 A. Assigning a rating to the debt at TGN proved challenging for the rating agencies. Texas
21 Genco's prospects were definitely brightening, but TGN remained basically a merchant
22 generator. It had sold base load capacity forward, but only for a relatively short period.
23 In addition, the rating agencies knew that TGN was likely to be sold in 2004, so there

1 was more than normal change-of-control risk. Finally, the agencies had not previously
2 undertaken the sort of in-depth plant-by-plant analysis of TGN of the type they might
3 normally expect to do when rating a merchant generator. All of this translated into a
4 long process.

5 **Q. WHY DID THE RATING AGENCIES NOT ASSIGN DEBT RATINGS AFTER**
6 **RECEIVING REQUESTS FOR RATINGS?**

7 A. As time (months) went by and TGN's capacity sales continued to lock in strong margins,
8 we again re-examined TGN's needs. By then it seemed that TGN would in fact be
9 generating amounts of cash sufficient to pay off all of the intercompany debt owed to
10 CNP. That being the case, there seemed to be no reason to raise significant funds in the
11 debt capital markets from an operational standpoint. So we instead decided to put
12 together a small revolving bank credit facility for Texas Genco. Importantly, since we
13 were only going to arrange a small working capital bank facility with a handful of banks
14 that know us well, we did not need to get Texas Genco rated. Therefore, we told the
15 rating agencies to stand down.

16 **Q. WHY NOT JUST CONTINUE TO SEEK TO HAVE TGN RATED THEN, SINCE**
17 **WORK HAD BEEN DONE ON THIS?**

18 A. There were several reasons. First, there was no longer a foreseeable need to have TGN
19 rated, particularly given the expected sale. Second, TGN would have had to pay fees to
20 the agencies if it were assigned ratings. Third, it was not clear how long it would take the
21 rating agencies to decide how to evaluate TGN, or what analytic approach each would
22 ultimately adopt. But here is what to me was the most important reason: TGN was not
23 having any difficulty in its day-to-day operations from the standpoint of credit. The

1 counterparties with whom TGN contracted seemed comfortable with TGN's credit;
2 security or margin requirements were not a problem for TGN. If TGN had been rated
3 and the ratings from one or all of the agencies ended up being below investment grade
4 (for whatever reason), we could have well given some counterparties reason to feel less
5 comfortable than they had felt previously with their own credit analysis. We could not be
6 certain where the TGN ratings would come out, so why introduce a potential problem for
7 TGN (with a real cost) where there didn't seem to be an offsetting benefit?

8 **Q. WERE THERE ANY OTHER CONSIDERATIONS REGARDING RATING OF**
9 **TGN THAT THE COMPANY WAS MINDFUL OF DURING THE PERIOD OF**
10 **TGN'S FIRST TWO YEARS OF EXISTENCE?**

11 A. Yes, there was one other issue that existed because of CNP's status as a registered Public
12 Utility Holding Company under the 35 Act and TGN's status as a utility subsidiary.
13 Based upon orders we received from the SEC in 2002 and 2003, in order for TGN to
14 issue debt securities, if those securities were rated, the securities had to be rated
15 "investment grade" by at least one of the rating agencies or TGN would not be permitted
16 to issue them. Although the 2002 order did permit TGN to request approval to issue
17 below investment grade securities, the 2003 order removed that option. In any event, I do
18 not think it would have been possible to obtain approval from the SEC in 2002 to issue
19 below investment grade securities due to the many energy sector securities downgrades
20 during that time.

21 The investment grade rating requirement was an over-arching consideration that varied in
22 terms of its potential effect on TGN based on the evolving financing plan. For example,
23 it is not at all clear that TGN would have received an investment grade rating in 2002.

1 This could have precluded TGN from issuing debt in the capital markets. By mid-2003,
2 the same TGN business factors that caused us to believe that we might be able to access
3 the capital markets (assuming that we could get an investment grade rating) also had us
4 feeling more bullish that one or more of the agencies might assign TGN an investment
5 grade rating. But by then we were also thinking more in terms of the revolving credit
6 facility, which did not need to be rated. This investment grade rating requirement existed
7 from the time of TGN's formation until TGN's receipt of EWG status in October 2003.
8 After that time, the investment grade rating requirement that applied to TGN while it
9 remained a "utility" ceased to apply.

10 **Q. FINALLY, DO YOU THINK THAT HAVING RATINGS AND WRITE-UPS**
11 **FROM THE RATING AGENCIES WOULD HAVE SOMEHOW ENHANCED**
12 **TGN'S SHAREHOLDER RELATIONS PROGRAM, AS MR. MITTAG HAS**
13 **TESTIFIED?**

14 **A.** Not very much in terms of TGN's equity. Ratings and credit in general may be factors in
15 an equity investor's over-all assessment of the Company, but typically fixed income
16 analysts and equity investors are looking at different things. If Mr. Mittag is referring to
17 how it might have helped with TGN's debt holders, TGN has no public debt outstanding,
18 as has been covered in detail above.

19 VII. CONCLUSION

20 **Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**

21 **A.** Yes, it does.

AFFIDAVIT

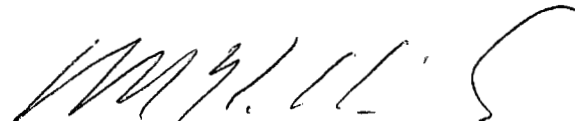
STATE OF TEXAS §
 §
COUNTY OF HARRIS §

BEFORE ME, the undersigned notary public, on this day personally appeared Marc Kilbride, to me known, who being duly sworn according to law, deposes and says:

"My name is Marc Kilbride. I am of legal age and a resident of the State of Texas. The foregoing testimony offered by me and the opinions stated therein are, in my judgment and based upon my professional experience, true and correct."


Further the Affiant sayeth not.

Executed this 4 day of June, 2004.

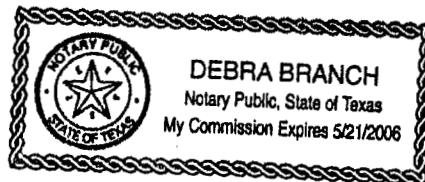


Marc Kilbride

Subscribed to and sworn before me on this 4 day of June, 2004.



Notary Public, State of Texas



CERTIFICATE OF SERVICE
PUC Docket 29526

I hereby certify that a true and correct copy of the foregoing document was hand delivered, electronic mail or sent by overnight delivery or United States first class mail to all parties this 14th of June, 2004.

Bunny Browning