

1 Q. Please state your name, business address, and position with PacifiCorp (the
2 Company).

3 A. My name is William E. Peressini. My business address is 825 N.E. Multnomah, Suite
4 1900, Portland, Oregon 97232. I am employed by PacifiCorp as Vice President and
5 Treasurer and report directly to PacifiCorp's Executive Vice President – Finance and
6 Administration

7 Q. Mr. Peressini, please briefly describe your education and business experience.

8 A. I received a Bachelor of Arts degree in finance from the University of Illinois in May,
9 1978. I also received a Masters in Business Administration with a major in finance
10 from DePaul University in Chicago in February, 1982. I have been employed by
11 PacifiCorp for 15 years, the first 10 years working in PacifiCorp's financial services
12 unit. I was elected Treasurer of PacifiCorp in October 1993, and commenced, at that
13 time, my responsibilities in PacifiCorp's regulated electric operations.

14 Q. Please describe your present responsibilities.

15 A. I am responsible for the Company's corporate finance, treasury, credit, investment
16 management and property risk management activities. As it relates to this matter, I'm
17 responsible for the Company's borrowed liabilities, the development and maintenance
18 of commercial bank and investment banking relationships, rating agency and
19 regulatory staff relations as it relates to capital structure and financing matters.

20 **Purpose of Testimony**

21 Q. What is the purpose of your testimony?

22 A. The purpose of my testimony is to present the Company's position regarding the
23 return PacifiCorp should earn on its rate base in Washington with specific

1 recommendations on capital structure. In addition, I will analyze the embedded cost
2 of long-term debt and preferred stock supporting PacifiCorp's electric operations in
3 the state of Washington for the period ended December 31, 1998.

4 Q. Will you please summarize your testimony?

5 A. Using the capital structure sponsored in Section I, I applied the costs of common
6 equity, sponsored by Dr. Samuel Hadaway and the cost of long-term debt and
7 preferred stock in Section II, and concluded that a 9.10 percent return on rate base for
8 the test period is a fair and reasonable cost of capital as summarized in Exhibit ____
9 (WEP-1). That rate of return requirement is also consistent with the expectation of
10 the capital markets, including shareholders, bondholders and the credit rating
11 agencies, as well as being consistent with other regulatory findings across the United
12 States recently. In the testimony, I discuss the reasons why the capital structure for
13 the Company's electric utility operations should be developed independently of the
14 effects of PacifiCorp's non-regulated operations, continuing the long-held tenet that
15 Washington customers should be neither disadvantaged nor subsidized by
16 PacifiCorp's non-regulated business activities.

17 **I. Capital Structure**

18 Q. What factors influence the mix of debt and equity in the capital structure?

19 A. The capital structure mix is a tradeoff between cost and risk and, as a result, debt and
20 equity. Debt typically has a lower cost than equity, although the incremental cost of
21 debt will increase as the amount of debt in the capital structure increases, assuming
22 interest rates remain constant. Debt requires a contractual repayment of principal and
23 interest and has priority over preferred and common dividend payments. Failure to

1 meet those contractual obligations means default, penalties and perhaps the loss of
2 property and other assets to creditors. Interest payments to bondholders have priority
3 over dividends to equity holders.

4 Payments to equity holders are not contractually committed. If the capital
5 structure contained only common stock and cash flows were not sufficient to pay a
6 dividend to common shareholders, common shareholders could not force bankruptcy.
7 Also, there is no contractual obligation to repay the principal amount of the equity
8 investment as there is with debt investments. To accept the uncertainty of dividends,
9 as well as an uncertain future investment value associated with common stock,
10 shareholders expect to earn a higher return than bondholders.¹

11 The Company attempts to balance its capital structure and the resulting mix of
12 debt and equity with the needs of all of its constituents, including its customers,
13 stockholders and bondholders. The balance between debt and equity is a delicate one.
14 Generally speaking, the greater the percentage of equity in the capital structure, the
15 higher the Company's bond rating, and the greater the ease of access to the capital
16 markets. The cost of this relatively higher equity component is a higher absolute
17 after-tax cost of capital for the Company. Conversely, the more relative debt in the
18 capital structure (assuming it stays within reasonable bounds), the lower the after-tax
19 cost of capital for the Company. While the absolute costs may be lower, the benefits
20 might be illusory because with the lower bond ratings, the Company's access to
21 capital market could be restricted.

¹Preferred stockholders represent somewhat of a hybrid between debt and common equity. Preferred shareholders generally have their rate of return "capped" by their dividend rate but the failure of the issuer to pay preferred dividends does not create an acceleration right, only a right to vote on the directors (i.e. the senior management) and other matters of consequence normally reserved for the common shareholder.

1 The appropriate levels of debt in a capital structure should be a function of the
2 Company's cash flow and its ability to pay the interest costs associated with that debt.
3 As a general rule, the more consistent and predictable the Company's cash flow, the
4 more debt it can support in its capital structure. Utilities possess generally stable cash
5 flow patterns and typically have a greater amount of debt than an industrial company
6 with comparable risk characteristics. The opposite of a utility company might be an
7 internet service provider wherein customers can and do change service providers at a
8 moment's notice. Those businesses, which have had a spectacular run in the stock
9 market based upon previously unheard of valuations, also possess capital structures
10 that are almost 100 percent equity, reflecting the volatile and unpredictable nature of
11 their cash flow.

12 Although there is no single optimal capital structure for a company, the
13 Standard & Poor's (S&P) credit rating agency has published benchmark capital ratios
14 required for utilities to maintain specified credit rating, which is a measure of its
15 credit quality. A company's overall credit rating is a combination of many factors.
16 The average electric utility today has an "A3" credit rating according to Moody's
17 Investors Services *Industry Outlook* dated, October 1999. Moody's has recently
18 indicated however that they expect greater dispersion around that industry rating
19 based upon electric utility specific business strategies. S&P, which has a similar
20 credit outlook currently for the electric utility industry credit rating, has historically
21 been more prolific in publishing financial benchmarks for different rating categories.
22 Depending upon S&P's qualitative assessment of a company's competitive position,
23 the debt to capitalization percentage of an "average" rated utility could range from a

1 low of 41 percent for a poorly-positioned company to 52 percent for a well-positioned
2 company. The remaining equity capital could be a mix of preferred stock and
3 common equity with the preferred stock component (as defined) typically not
4 exceeding eight percent of total capitalization.

5 Q. What credit rating does PacifiCorp target?

6 A. In 1994, PacifiCorp established capital structure policies for PacifiCorp and its non-
7 regulated subsidiaries. At the time these policies were established, the Company
8 anticipated a changing marketplace and based upon the experience of other industries
9 that deregulated, namely telephone, airline and gas companies, assumed that the
10 general credit profile of the industry would decline, an assessment with which many
11 other industry observers agreed. Based upon a desire to both enter and emerge from
12 this period of change in a position of strength, PacifiCorp established an “A” bond
13 rating target.

14 Q. What capital structure do you recommend for setting electric prices in these
15 proceedings?

16 A. I recommend a capital structure comprised of 47.4 percent long-term debt, 3.8 percent
17 preferred stock, and 48.8 percent common equity, the average capitalization of
18 comparable electric utilities utilized to develop the return on equity recommendation.
19 For these purposes, the comparable group of companies includes utilities that have a
20 similar business and financial profile to that of PacifiCorp. The list includes electric
21 utilities that have at least a “single A” credit rating from both Moody’s and S&P’s
22 and generate at least 75 percent of their total revenues from their U.S. regulated
23 electric business. In addition, these are companies for which complete and reliable

1 data is available. The parameters used to determine this comparable list of currently
2 twenty companies and calculation methodology is consistent with what the Company
3 used when the Washington Utilities and Transportation Commission (WUTC) last
4 examined PacifiCorp's capital structure. This information is contained in Exhibit
5 ____ (WEP-2).

6 Q. How does your recommendation compare with the electric industry average
7 capitalization?

8 A. According to *Value Line*, at year-end 1998, the electric utility industry capitalization
9 had 47.5 percent debt, 5.0 percent preferred stock, and 47.5 percent common equity.
10 In other words, my recommended capitalization for the Company also reflects the
11 capitalization of the overall electric utility industry.

12 Q. Why do you recommend using the average capitalization of comparable companies
13 for PacifiCorp's electric utility?

14 A. There are a number of reasons. In the past, the use of average capitalization of
15 comparable companies was appropriate because of PacifiCorp's historical
16 involvement with non-regulated businesses and the resulting influence those
17 businesses had on the balance sheet of PacifiCorp. Although the Company has
18 narrowed its strategic focus for the future, PacifiCorp's non-regulated businesses still
19 influence the Company's reported capital structure. These other businesses have
20 different capital structure requirements, which is much more a reflection of their
21 industries (and the associated cash flow patterns) than any management directive. As
22 a result, when a corporation is involved in a number of different ventures with
23 different risk profiles, its capital structure would tend to represent an amalgamation of

1 the different capital structures appropriate to the different lines of business. Only by
2 coincidence would the consolidated capital structure of the corporation represent the
3 appropriate capital structure for one of its component parts.

4 In the context of setting utility rates, the use of the Company's consolidated
5 capital structure creates a risk that utility customers will pay too high a return if the
6 non-utility operations are unnecessarily increasing the required equity ratio or,
7 conversely, shareholders are being denied a reasonable return on utility rate base if
8 non-utility operations are permitting a more highly leveraged capital structure. Using
9 a comparable company average capital structure assures that over time neither
10 customers nor shareholders are unfairly impacted by the changing risk profiles of
11 PacifiCorp's various regulated and non-regulated operations.

12 Finally, because of the impending ScottishPower merger, the costs of common
13 equity cannot be measured directly, but must be calculated based upon the common
14 equity costs of comparable electric utilities. Use of the average capital structure of
15 these same comparable electric utilities thus avoids a mismatch between the
16 comparable common equity costs the capital structures from which the comparable
17 common equity costs are derived.

18 **II. Cost of Debt and Preferred Stock**

19 Q. How does PacifiCorp finance its electric utility operations?

20 A. PacifiCorp historically has financed the cash flow requirements of its regulated U.S.
21 utility operations utilizing a reasonable mix of debt and equity securities designed to
22 provide a competitive cost of capital and predictable capital markets access.

23 Q. How does PacifiCorp meet its non-equity common financing requirements?

1 A. Historically, PacifiCorp has relied on a mix of first mortgage bonds, secured debt, tax-
2 exempt debt, unsecured debt and preferred stock to meet its long-term debt and
3 preferred stock financing requirements.

4 The Company has concluded the majority of its long-term financing utilizing
5 secured, first mortgage bonds issued under PacifiCorp Mortgage Indenture dated
6 January 9, 1989. As of June 30, 1999, PacifiCorp had \$2,486.47 million of first
7 mortgage bonds outstanding, with an average cost of 7.811% and average maturity of
8 6.81 years. Please see Exhibit ____ (WEP-3). All of PacifiCorp's first mortgage
9 bonds bear interest at fixed rates. Proceeds from the issuance of the first mortgage
10 bonds (and other financing instruments) are used to finance the combined utility
11 operations and are not allocated on a divisional basis.

12 Prior to the Utah Power & Light and Pacific Power & Light merger in 1989,
13 each company had its own first mortgage indentures. Those indentures were assumed
14 by PacifiCorp and, in addition, a new PacifiCorp indenture was established at the
15 time of the merger. In 1996, PacifiCorp restructured the mortgage arrangements,
16 which led to the extinguishment of the Pacific Power and Utah Power mortgages.
17 This action reduced administrative requirements and associated expense and greatly
18 simplified the Company's mortgage financing arrangements.

19 Although the Company's power plant construction program has slowed from
20 the previous two decades, another important source of financing has been the tax-
21 exempt financing associated with certain qualifying equipment at PacifiCorp's power
22 generation plants. Under arrangements with the local counties and other tax-exempt
23 entities, PacifiCorp borrows the proceeds and guarantees the repayment of their long-

1 term debt in order to take advantage of their tax-exempt status in financings. As of
2 June 30, 1999, PacifiCorp had \$732.23 million of such borrowings outstanding with
3 an average maturity of 19.77 years. Because short-term, tax-exempt interest rates
4 have been the lowest cost capital available in the U.S. capital markets, the Company
5 manages the significant majority of this debt (88.71 percent) in a variable rate mode.
6 As of June 30, 1999, PacifiCorp's tax-exempt portfolio has an average cost of 4.708%
7 (which includes the cost of issuance, credit enhancement and the effect of interest rate
8 swaps).

9 Aggregating the before mentioned debt instruments, PacifiCorp's total long-
10 term debt portfolio had an outstanding balance of \$3,218.70 million as of June 30,
11 1999. The cost of this portfolio was 7.134%. Please see Exhibit ____ (WEP-3).

12 PacifiCorp allocates up to 10 percent of its regulated utility capitalization to
13 preferred stock or subordinated debt to take advantage of their "lower than equity"
14 cost and the equity credit typically afforded these securities by the credit rating
15 agencies. To the extent the credit rating agencies provide less equity credit for
16 preferred stock and subordinated debt in the future, PacifiCorp would expect to
17 refinance these obligations over time maintaining a relatively balanced portfolio of
18 investment-grade debt and equity. As of June 30, 1999, PacifiCorp had \$769.18
19 million of preferred stock and subordinated debt outstanding with an aggregate cost
20 of 6.017%. Excluding the perpetual preferred stock that PacifiCorp has issued in the
21 past, the average remaining maturity is 28.6 years. All of these obligations were in a
22 fixed rate mode at June 30, 1999. Please see Exhibit ____ (WEP-4).

1 Q. How did you determine the amount of debt and preferred stock to be included in your
2 calculation of the Company's embedded costs of debt and preferred stock?

3 A. For both debt and preferred stock, I used the rates and amounts outstanding at June
4 30, 1999 that I have previously referred to in this testimony.

5 Q. How did you calculate the Company's embedded costs of long-term debt and
6 preferred stock?

7 A. The embedded costs of debt and preferred stock were calculated using the
8 methodology prescribed by the Federal Energy Regulatory Commission.

9 Q. Please explain the cost of debt calculation.

10 A. I calculated the cost of debt by issue, based on each debt series' interest rate and net
11 proceeds at the issuance date, to produce a bond yield to maturity for each series of
12 debt. It should be noted that in the event a bond was issued to refinance a higher cost
13 bond, the pre-tax premium and unamortized costs, if any, associated with the
14 refinancing were subtracted from the net proceeds of the bonds that were issued. The
15 bond yield was then multiplied by the principal amount outstanding of each debt issue
16 resulting in an annualized cost of each debt issue. Aggregating the annual cost of
17 each debt issue produces the total annualized cost of debt which, when divided by the
18 total principal amount of debt outstanding produces the weighted average cost for all
19 debt issues and is the Company's embedded cost of long-term debt.

20 Q. How did you calculate the embedded cost of preferred stock?

21 A. The embedded cost of preferred stock was calculated by first determining the cost of
22 money for each issue. This is the result of dividing the annual dividend rate by the
23 per share net proceeds for each series of preferred stock. The cost associated with

1 each series was then multiplied by the stated value or principal amount outstanding
2 for each issue to yield the annualized cost for each issue. The sum of annualized
3 costs for each issue produces the total annual cost for the entire preferred stock
4 portfolio. I then divided the total annual cost by the total amount of preferred stock
5 outstanding to produce the weighted average cost of all issues. This is the
6 Company's embedded cost of preferred stock.

7 Q. Exhibit ____ (WEP-4) includes references to QUIDS and QUIPS. Please briefly
8 describe QUIDS and QUIPS.

9 A. QUIDS and QUIPS are acronyms for direct or indirect subordinated debt securities
10 sold typically to individual investors. Because of their subordination and interest
11 deferral provisions, the credit rating agencies assign some equity credit for purposes
12 of assessing balance sheet strength. For issuers, the after-tax cost is attractive
13 because, as a debt security, the interest is tax deductible.

14 Q. The footnotes in Exhibit ____ (WEP-4) describe that the QUIDS and QUIPS amounts
15 represented in the calculation are after-tax numbers. Since these securities appear to
16 be debt equivalents, why do they get reflected in the Company's embedded cost of
17 preferred stock?

18 A. Fundamentally these securities are debt. Therefore, I calculated their embedded costs
19 in the same manner used for each series of debt described above. However, because
20 the Company believes that these QUIDS and QUIPS are equivalent to preferred stock
21 for regulatory accounting purposes, given the equity credit they receive from the
22 major credit rating agencies, I chose to reflect their cost as part of the Company's
23 embedded cost of preferred stock. For your reference, the Company has previously

1 received WUTC approval to utilize QUIDS securities (UE-93-0634 and UE-95-0346)
2 and QUIPS securities (UE-96-0282 and UE-97-0252).

3 Q. Does this conclude your direct testimony?

4 A. Yes.