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Research Update: PacifiCorp's First Mortgage Bonds Assigned 'A-' Preliminary Rating

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Credit Rating: A-/Watch Neg/A-2

Rationale

On Sept. 20, 2005, Standard & Poor's Ratings Services assigned its 'A-' preliminary rating to PacifiCorp's first mortgage bonds and its 'BBB+' rating to senior unsecured obligations under a mixed shelf registration filed by the company on Sept. 6, 2005. The filing permits the issuance of up to $700 million in senior secured and unsecured debt.

The 'A-' corporate credit rating on PacifiCorp reflects the consolidated credit quality of the utility's parent, ScottishPower PLC (A-/Stable/A-2). Ratings of PacifiCorp remain on CreditWatch with negative implications following the May 2005 announcement that the Oregon-based utility is to be sold to MidAmerican Energy Holdings Inc. (MEHC; BBB-/Watch Pos/--) for $9.4 billion, including $5.1 billion in cash, and the assumption of $4.3 billion in net debt and preferred stock. The purchase will be effectuated by the purchase of the outstanding shares of common stock of the utility, which is currently held by PacifiCorp Holdings Inc. (PHI; A-/CW Developing). PHI is the indirect holding company for ScottishPower's U.S. interests, which, in addition to PacifiCorp, include PPM Energy Inc., Pacific Klamath Energy, and PacifiCorp Group Holdings (PGHC).

PacifiCorp is a vertically integrated electric utility that serves about 1.6 million customers in portions of Utah, Oregon, Wyoming, Washington, Idaho, and California. Utah and Oregon accounted for about 70% of retail electric revenues in fiscal 2005 (ended March 31). The company is regulated by the state utility commissions in each of these states. PacifiCorp's satisfactory business profile score of '5' (on a 10-point scale, where '1' is the strongest) reflects a predominately coal-fired generation fleet that provided about 80% of energy requirements in fiscal 2005, low retail electric rates relative to other investor-owned utilities in the western U.S., and a regulatory profile that has been improving, although the utility lacks a fuel and purchased power adjustment mechanism in any of the jurisdictions it serves. However, persistently poor financial performance caused by a variety of factors, including the California power crisis, historic disallowances for purchased power, regulatory lag, issues with plant performance, and large capital expenditures prompted ScottishPower to sell PacifiCorp, which it acquired in 1999.

The CreditWatch with negative implications status reflects that the current 'A-' corporate credit rating on PacifiCorp is based on ScottishPower's consolidated credit profile, whose solid financial performance has compensated for its weaker U.S. utility, which constitutes about 45% of cash flows. On a stand-alone basis, PacifiCorp's debt leverage and cash coverage ratios are solidly in the 'BBB' category. For the first quarter ending June 30, 2005, funds from operations (FFO) to interest and FFO to total adjusted debt was 3.3x and 16.3%, respectively. Standalone debt to total capitalization was 58.9%, adjusted for PacifiCorp's purchased power obligations. Thus, how the acquisition is structured will materially affect PacifiCorp's ratings if the transaction closes. In regulatory filings, MEHC has stated its intent to create a limited liability company, PPW Holdings LLC, which will be a direct subsidiary of MEHC. MEHC has indicated that no new debt will be issued at PPW, and that existing utility debt of $3.9 billion and $86.3 million in preferred stock (both as of June 30) will reside at PacifiCorp.

PacifiCorp's cash flows have been volatile for an investor-owned utility, but have stabilized somewhat in recent years, with FFO reaching $805 million in fiscal 2005, in line with fiscal 2004. But due to steady increases in debt driven largely by rising capital expenditures, financial metrics deteriorated slightly in fiscal 2005 relative to fiscal 2004, but are significantly improved over performance from fiscals 2001 through 2003. In the first quarter of fiscal 2006, PacifiCorp issued $300 million in first mortgage bonds to pay down the utility's commercial paper balances. This increased leverage was partially offset by an equity contribution of $125 million from PHI made on June 30, 2005, as discussed further in the short-term ratings section below.

Capital expenditures are a substantial challenge for the utility, and largely account for the utility's negative free operating cash flow position of $141 million at year-end fiscal 2005, when capital expenditures totaled $852 million. The company estimates that for the next five years, more than $1 billion will be needed each year for new plant construction, emissions and environmental compliance, and investment in infrastructure, particularly in Utah, where retail customer growth is forecast to be about 3% per annum.

The transaction does face some regulatory risk; the Federal Energy Regulatory Commission and all six state commissions must approve the sale. However, the companies will not require Securities and Exchange Commission approval, which could have been a meaningful hurdle, because the Energy Policy Act of 2005 repealed the Public Utilities Holding Company Act (PUHCA) in August. ScottishPower shareholders approved the sale in July 2005.

PacifiCorp has asked the six commissions to rule by February 2006 to enable the transaction to close by the end of PacifiCorp's fiscal year ending March 31, 2006. The terms of the purchase provide that the sale must be completed by May 2006; however, if all conditions are satisfied except the regulatory approvals, either the buyer or seller may extend the purchase agreement until February 2007.

Short-term rating factors

The short-term rating on ScottishPower, Scottish Power U.K. PLC, and PacifiCorp is 'A-2'. ScottishPower's consolidated liquidity is good, owing to a steady, predictable net cash flow stream produced by regulated businesses, minimal debt maturities over the next few years, and good credit facility capacity. Cash and other short-term deposits, which amounted to about £1.75 billion ($3.2 billion) at March 31, 2005, are held in a variety of quickly accessible funds. Full capacity exists under a $1 billion revolving credit facility, split between a $625 million facility and a $375 million facility, both due in 2008. ScottishPower U.K. maintains a $2 billion Euro-commercial paper program, which is undrawn.

PacifiCorp provides for its own liquidity needs. Its cash and cash equivalent position was $168 million as of June 30, down from the $199 million as of year-end fiscal 2005. In addition, it has an $800 million commercial paper program that is backstopped by a currently undrawn revolving credit agreement that terminates in May 2007. Short-term debt balances totaled $314 million as of the same date. Regulatory authorities limit PacifiCorp from issuing more than $1.5 billion in short-term debt.

Additional cash will be provided in the coming year in the form of planned equity contributions from PHI. The purchase agreement specifies that ScottishPower via PHI make a common equity contribution to PacifiCorp in quarterly amounts that total $500 million per year for fiscal 2006, rising to $526 million in fiscal 2007. (The latter year amount will be refunded to PHI in terms of an increased sale price to ScottishPower if the transaction closes.) Net of dividends from the utility, which are capped in the acquisition agreement, in fiscal 2006 PHI/ScottishPower cash equity contributions to PacifiCorp will be roughly $285.2 million. In contrast, in fiscal 2005, PacifiCorp's dividends paid to PHI totaled about $195 million, and no equity investments were made.

Future maturities of $289 million in fiscal 2006 are in line with historic obligations. Affiliate transaction rules restrict PacifiCorp from lending to any of PHI's subsidiaries or U.K. affiliates.

Ratings List

PacifiCorp	
Corp credit rating	A-/Watch Neg/A-2
Ratings assigned	
First mortgage bonds	A-/Watch Neg
Senior unsecured obligations	BBB+/Watch Neg

Complete ratings information is available to subscribers of RatingsDirect, Standard & Poor's Web-based credit analysis system, at www.ratingsdirect.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com; under Credit Ratings in the left navigation bar, select Find a Rating, then Credit Ratings Search.