BEFORE THE WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

PACIFICORP-MIDAMERICAN MERGER

DOCKET NO. UE-051090

DIRECT TESTIMONY OF JAMES R. DITTMER (JRD-1T)

ON BEHALF OF

PUBLIC COUNSEL

November 18, 2005

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TABLE OF CONTENTS

Page

TABLES

Table A	PacifiCorp's Stand Alone Capital Structure at March 31, 2005	27
Table B	MEHC's Pre-Acquistion Consolidated Capital Structure	28
Table C	MEHC Post Closing Consolidated Capital Structure	29
Table D	PacifiCorp Utility Asset Financing When Considering Additional Layer at MEHC Parent-Company Debt	30

DITTMER EXHIBIT LIST

Exhibit No. ___ JRD-2 Statement and Qualifications

1 **Q. Please state your name and address.**
2 A. My name is James R. Dittmer. My business address is 740 Northwest Blue Parkway,
3 Suite 204, Lee's Summit, Missouri 64086.
4 **Q. By whom are you employed?**
5 A. I am a Senior Regulatory Consultant with the firm of Utilitech, Inc., a consulting
6 firm engaged primarily in utility rate work. The firm's engagements include review
7 of utility rate applications on behalf of various federal, state and municipal
8 governmental agencies as well as industrial groups. In addition to utility intervention
9 work, the firm has been engaged to perform special studies for use in utility contract
10 negotiations.
11 **Q. On whose behalf are you appearing?**
12 A. Utilitech, Inc. has been retained by the Public Counsel Section of the Office of the
13 Attorney General of the State of Washington ("Public Counsel") to review the joint
14 application of MidAmerican Energy Holdings Company ("MEHC") and PacifiCorp
15 d/b/a Pacific Power & Light Company ("PacifiCorp") to receive an order from the
16 Washington Utilities and Transportation Commission ("WUTC") or ("Commission")
17 authorizing a proposed transaction whereby MEHC would acquire all the
18 outstanding common stock of PacifiCorp and PacifiCorp would thereafter become an
19 indirect wholly owned subsidiary of MEHC.[1] I would also note that I am working
20 on an identical docket filed by the Joint Applicants before the Oregon Public Utilities
21 Commission on behalf of the Citizens' Utility Board of Oregon ("CUB").
22 **Q. What is the purpose of your testimony?**
23 A. Within this testimony I will describe the transaction being proposed by the
24 Applicants, discuss some the claimed benefits of the transaction, as well as describe

[1] Hereinafter MEHC and PacifiCorp will sometimes be referred to as "Applicants" or "Joint Applicants."

1 the disadvantages and risks of the proposed transactions. I also discuss why without
2 proper safeguards, I believe the transaction exposes ratepayers to potential
3 detriments, and therefore, in the absence of adoption of such safeguards should be
4 rejected by the WUTC. Finally, I recommend a number of conditions that should be
5 considered before approval of the transaction occurs.

6 **Q. Have you prepared an exhibit which sets forth your qualifications?**

7 A. Yes. Attached as Exhibit No. ___ (JRD-2) is a statement of my qualifications.

8 **Q. Could you please summarize the more significant conclusions and**
9 **recommendations that you are presenting within this prefiled direct testimony?**

10 A. Some of my more significant findings upon a review of MEHC testimony as well as
11 responses to discovery in this case include:

12 - MEHC cites many claimed "benefits" of the proposed acquisition. However,
13 upon review, most claimed benefits are not unique to MEHC ownership, and in
14 fact, should be expected from any PacifiCorp management or owners. Further,
15 of the few claimed benefits that arguably could be considered unique to MEHC
16 ownership, I believe some are suspect, some will be difficult to quantify or
17 prove at a later date, and in any event, such claimed economic benefits are de
18 minimus to PacifiCorp's system wide revenue requirement.
19 - There is exposure to detriments resulting from MEHC and ultimately
20 Berkshire Hathaway ownership, including without limitation, potential cross
21 subsidization of other MEHC or Berkshire Hathaway holdings, potential
22 premature or excessive investment in PacifiCorp's infrastructure without
23 regard to timely need or rate impact, potential exposure to aggressive
24 regulatory or statutory proposals that may be advocated by a large and diverse
25 super parent multi-state holding company such as Berkshire Hathaway, and

1 potential exposure to cost of service rate development that considers a capital
2 structure that does not reflect the *true* or *actual* capital costs or income tax
3 costs of MEHC financings that underlie the purchase of PacifiCorp assets.

4 - The transaction should only be approved if conditions are imposed that
5 safeguard utility ratepayers from many of the potential detriments identified
6 above. Specifically, approval of the transaction should be conditioned upon:
7 - A commitment that no Berkshire Hathaway ownership or operating costs
8 will ever be pushed down to MEHC or PacifiCorp. In the alternative, if
9 unwilling to make such a commit and therefore ever desires to push down
10 ownership or operating costs to MEHC and ultimately PacifiCorp,
11 Berkshire Hathaway should commit to make personnel, books and records
12 available to the extent that MEHC is required to make its personnel, books
13 and records available for inquiry and inspection.
14 - Asymmetrical pricing guidelines should be followed with regard to
15 PacifiCorp transactions with MEHC, other MEHC subsidiaries, as well as
16 any Berkshire Hathaway controlled subsidiary.
17 - *Positive* time sheet reporting should be required of any MEHC or MEHC
18 subsidiary's officers or employees who routinely or occasionally work on
19 activities that benefit PacifiCorp.

20 **Q. Please describe the more significant elements and characteristics of the**
21 **proposed acquisition?**

22 A. As this Commission is well aware, currently ScottishPower owns 100% of
23 PacifiCorp's common stock.[2] Under the transaction as proposed, ScottishPower will

[2] In actuality, all PacifiCorp common stock is held by PacifiCorp Holdings, Inc., which in turn is wholly owned by ScottishPower. Therefore it is technically more accurate to state that ScottishPower indirectly owns 100% of PacifiCorp's common stock.

1 sell all common stock which it holds to MEHC for a value of approximately $9.4
2 million, consisting of approximately $5.1 billion in cash plus retention of PacifiCorp-
3 specific net debt and preferred stock totaling approximately $4.3 billion. I note at
4 this point that MEHC is a majority-owned (83.75%) subsidiary of Berkshire
5 Hathaway, Inc. which also owns regulated and non-regulated energy subsidiaries.
6 Finally, Berkshire Hathaway is a holding company owning subsidiaries engaged in a
7 number of business activities, with controlling ownership held by Warren Buffet.
8 **Q. Please expand upon MEHC's business structure and business platforms.**
9 A. MEHC is a privately-held global Company engaged in a number of regulated and
10 unregulated energy ventures. The details of the six major business platforms are
11 described and discussed in greater detail in the direct testimony of MEHC's
12 president and chief operating officer Mr. Gregory Abel. That said, I would
13 emphasize herein simply a few of MEHC's major "energy business" holdings.
14 First, one of MEHC's major holding consists of Mid-American Energy
15 Company which is a vertically integrated electric and natural gas utility,
16 headquartered in Des Moines, Iowa, providing regulated electric and gas service in
17 the states of Iowa, Illinois, Nebraska and South Dakota. Another significant holding
18 of MEHC consists of CalEnergy Generation, which owns geothermal and natural gas
19 generating stations in the United States and the Philippines. Finally, I note that
20 MEHC owns two interstate natural gas pipelines providing service from Texas to the
21 upper Midwest (Northern Natural Gas Company) as well as from Wyoming to
22 Southern California (Kern River Gas Transmission Company). As I will discuss in
23 an ensuing section of testimony, ownership of such related energy business arguably
24 presents opportunities for "synergies" as well as the sharing of intellectual

1 properties, but also present the dangers of affiliate abuse through self-dealings
2 between companies that have a common parent.
3 According to the direct testimony of MEHC witness Mr. Patrick J. Goodman,
4 MEHC's consolidated capital structure as of March 31, 2005 – obviously prior to the
5 planned acquisition of PacifiCorp stock – consisted of 77.1% long-term debt, 0.6%
6 preferred securities of MEHC's subsidiaries, and 22.3% of stockholders' equity. As
7 discussed in greater detail by Mr. Stephen Hill, another consultant appearing on
8 behalf of Public Counsel, such capitalization is debt leveraged to a much greater
9 extent than typical regulated energy utilities.
10 **Q. You stated in an earlier answer that 87% of MEHC was owned by Berkshire**
11 **Hathaway, Inc. While perhaps many readers know of the business activities of**
12 **Berkshire Hathaway, for completeness of the record, could you please expand**
13 **upon the business activities of Berkshire Hathaway?**
14 A. Berkshire Hathaway, Inc. is a holding company wholly-owning, or in some instances
15 holding a majority ownership interest in, numerous subsidiaries with diverse
16 business operations. A significant number of such holdings include businesses
17 engaged in reinsurance as well as direct insuring of property and casualty risks.
18 Berkshire Hathaway also wholly owns businesses engaged in the manufacture of
19 carpet, paint, industrial coatings, insulation, building products, engineering software,
20 and foot ware. Other diverse business holdings include: training of aircraft and ship
21 operators, home furnishing retailers, fine jewelry retailers and business and
22 consumer lending institutions.
23 While Berkshire Hathaway is also a non-majority owner of a number of
24 common stocks (much like a typical mutual stock fund) it has a history of, and stated
25 goal to, acquire "whole companies" *for the long term.* Finally, at the risk of stating

1 what is commonly known, Warren Buffet – the world's second richest man – is the
2 Chairman of Berkshire Hathaway with a controlling ownership interest. To say the
3 least, Berkshire Hathaway is a very large, diverse and unique business with a long
4 and interesting history – controlled by one man.

5 **Q. What are the MEHC and PacifiCorp claimed benefits or advantages of the**
6 **proposed transaction?**

7 A. The joint application makes the following claim of "benefits" the transaction will
8 produce for customers:
9

10 - $812 million investment in emissions reduction technology for existing coal
11 plants which, when coupled with the use of reduced emissions technology for
12 new coal-fueled generation, would be expected to reduce the SO_2 emissions
13 rate by more than 50%, to reduce the NOx emissions rate by more than 40%, to
14 reduce the mercury emissions rate by nearly 40%, and to avoid an increase in
15 CO_2 emissions rate;
16
17 - 78 million investment in a Path C transmission upgrade to increase the transfer
18 capability between PacifiCorp's east and west control areas;
19
20 - at least a 10 basis point reduction for five years (cumulatively $6.3 million in
21 claimed interest cost savings) in the cost of PacifiCorp's issuances of long-
22 term debt;
23
24 - at least a $30 million reduction (over five years) in corporate overhead costs;
25
26 - consideration of reduced-emissions coal technologies such as IGCC and super-
27 critical;
28
29 - affirmation of PacifiCorp's goal of 1400 MW of cost-effective renewable
30 resources, including 100 MW of new wind energy within one year of the close
31 of the transaction and up to 400 MW of new wind energy after the
32 transmission line projects are completed;
33
34 - reduction in sulfur hexafluoride emissions;
35
36 - $1 million shareholder-funded system-wide study designed to further demand-
37 side management and energy efficiency programs where cost effective;

- a 2-year extension of the customer service standards and performance guarantees;

- a commitment of MEHC's resources and involvement, in cooperation with the PacifiCorp states, to look into transmission projects beneficial to the region, such as the Rocky Mountain Area Transmission Study ("RMATS") and the Frontier transmission line project;

- uniform application of the commitments from the prior PacifiCorp transaction in all six states; and

- offering a utility own/operate option for consideration in renewable energy RFPs.

Q. Do you concur with MEHC's and PacifiCorp's claims that the above-delineated events constitute "benefits" or "advantages" of the proposed transaction?

A. All but three of the noted "advantages" or not unique to, nor can they credibly be linked to, consummation of the transaction and ownership by MEHC. Specifically, all above-noted indications of willingness to invest in – or "consideration" to invest in – are not a "benefit" or "advantage" unique to MEHC ownership. If the suggested investments are prudent and economic, it should be expected that PacifiCorp, even under continued ScottishPower ownership, would engage in such investments. Other non-investment "considerations" or "offerings" could and should be undertaken by PacifiCorp under continued ScottishPower ownership if such actions are deemed efficient, reasonable or prudent. Finally, I do not believe the "extension" of *existing* customer service standards and performance guarantees reasonably rises to the status of a "benefit" or "advantage" of the transaction inasmuch as they are – be definition – already *existing*.

Q. In your previous answer you indicated that "all but three" of the MEHC/PacifiCorp-claimed advantages of the transaction were *not* unique to

1 **MEHC ownership. Please expand upon the three claimed benefits that you**
2 **appear to agree are unique to MEHC ownership of PacifiCorp stock.**
3 A. First, the promise of *at least* a 10 basis point reduction in the cost of new debt
4 issuances, would appear to be a "benefit" unique to the transaction. Similarly, the
5 promise of at least a $30 million reduction, over a five-year period, in corporate
6 overhead costs would also appear to be a "benefit" unique to the transaction.
7 Finally, the promise of a $1 million shareholder-funded system-wide study
8 designated to further demand-side management and energy efficiency programs
9 where cost effective, would also appear to be a "benefit" that might only be
10 reasonably expected to occur with MEHC ownership.
11 **Q. Do you agree that the three noted events can be legitimately characterized as**
12 **"benefits" attributable solely to MEHC's acquisition?**
13 A. I believe that viewed in isolation the promise of $6.3 million in long term debt
14 interest cost savings, over a five-year period, assuming such savings can be
15 accurately quantified, could qualify as a legitimate economic benefit uniquely
16 resulting from the transaction. I believe it is debatable whether true and accurate
17 interest cost savings can be quantified. More importantly, however, I note the
18 savings promised – a PacifiCorp-system-wide average of a little more than $1
19 million per year – are de minimus to PacifiCorp's system-wide revenue requirement
20 determination. Such amount will not be felt by ratepayers as it will essentially be
21 lost in the rounding. Similarly, the promise of a one-time $1 million shareholder-
22 funded study of demand-side management and energy efficiency programs, while
23 appealing from a public relations stand point, is also de minimus to PacifiCorp
24 ratepayers in the grand scheme of things.

1 Turning to the claimed benefit of $30 million of corporate overhead costs, I
2 first note that what MEHC is claiming is that ScottishPower parent-company
3 overhead costs being pushed down to PacifiCorp will be reduced by approximately
4 $6 million per year for the next five years. However, according to PacifiCorp, such
5 ScottishPower parent-company costs only first began to be pushed down to
6 PacifiCorp beginning in Fiscal Year 2005. I do not know to what extent such
7 recently-imposed ScottishPower costs have been historically, or might in the future
8 be, reflected within PacifiCorp's retail rates. However, in order to make a claim of
9 parent-company overhead cost savings, it would seem that MEHC/PacifiCorp would
10 have to declare with certainty that all such newly-imposed ScottishPower costs either
11 have been, or shortly will be, reflected within the development of PacifiCorp's retail
12 rates. I do not observe where any such claim has been made, and accordingly, both
13 the existence and magnitude of such claimed savings is at least suspect.
14 In summary with regard to the point of MEHC/PacifiCorp claimed
15 "benefits," as previously discussed, the majority of such events cannot be
16 legitimately claimed as events or outcomes unique to MEHC ownership. Further,
17 regarding the three claimed benefits that arguably are unique to MEHC ownership, I
18 submit that such claimed benefits are suspect, maybe difficult to quantify, and in any
19 event, are de minimus relative to the magnitude of the transaction and PacifiCorp's
20 retail rate levels.
21 **Q. Thus far we have discussed MEHC-*claimed* and/or *potential* benefits of MEHC**
22 **ownership. Are there potential detriments to MEHC ownership?**
23 A. Yes. I would first reference the testimony of Mr. Stephen Hill who discusses the risk
24 involved when utility assets are ultimately debt leveraged to a significant extent –
25 such as MEHC is proposing in this transaction. Beyond the financial risks associated

1 with high levels of debt leverage discussed by Mr. Hill, I believe there exists
2 significant *potential* detriment through ultimate ownership by the super-parent
3 Berkshire Hathaway. Such detriments can exist in the form of the sheer economic
4 and political influence that can be wielded by an entity with the size and diversity of
5 Berkshire Hathaway. Further, detriments can result for PacifiCorp ratepayers in the
6 form of utility rates that could subsidize the operating results of other businesses
7 owned by MEHC or Berkshire Hathaway.
8 **Q. Please expand upon the claim that ratepayers could be harmed through the**
9 **payment of utility rates that contain subsidies for other businesses owned by**
10 **MEHC or Berkshire Hathaway.**
11 A. Utility ratepayers could end up paying excessively high rates that, intentionally or
12 unintentionally, are subsidizing Berkshire Hathaway's or MEHC's non-utility
13 business ventures. The means by which subsidization of non-utility operations can
14 occur are many and varied.
15 First, subsidies can arise when the utility is not fully or adequately
16 compensated for utility resources which are used by, or shared with, unregulated
17 non-utility operations. Examples may include free or under priced use of office
18 space, interest free or below-market-rate loans, credit guarantees and free or under
19 priced use of customer data which was accumulated through the utility's billing
20 procedures.
21 Subsidization can also occur through unfair transfer prices charged for goods
22 or services sold/purchased in and among the utility and its unregulated affiliates.
23 Historically in the regulated communications industry, utility regulators were
24 confronted with issues concerning the appropriate and equitable price that telephone
25 equipment manufacturing affiliates should charge regulated telephone operations.

1 Similarly, electric utility regulators have been confronted with pricing issues
2 surrounding sales of coal by a wholly owned coal mining subsidiary to an affiliated
3 utility company.
4 Where personnel, facilities and other resources are "shared," inequitable
5 allocation methods to distribute joint or common costs can also lead to ratepayer
6 subsidization of non-utility operations. It is not uncommon for diversified utilities to
7 share a number of "services" including accounting systems, billing systems, human
8 resources, risk management, finance/treasury functions, information systems
9 (computer hardware and software support), telecommunication systems and support,
10 marketing, as well as senior executive management. When many services are
11 shared, inequitable allocation procedures can lead to subtle but persistent
12 subsidization.
13 Finally, subsidization may occur when risks are inappropriately shifted from
14 the non-utility affiliate to the utility subsidiary. Examples could include utility
15 loans and credit guarantees to non-utility operations -- where interest rates charged
16 do not reflect the difference in risk between the utility and non-utility operations.
17 Similarly, insurance policies that cover utility and non-utility operations need to
18 appropriately consider the risk exposure being imposed by the utility versus non-
19 utility operations.
20 **Q. Your prior answer provided fairly generic concerns of subsidization that could**
21 **occur under nearly any ownership structure when utilities and**
22 **unregulated/non-utility businesses are commonly owned. Are the problems**
23 **you suggest to be *possible* a real threat in the instant case?**
24 A. Very much so. First, it needs to be understood that the very dangers of which I
25 spoke in my prior answer were, to a significant extent, limited by utility ownership

1 restrictions contained within the Public Utility Holding Company Act of 1935
2 ("PUHCA"). This extensive and far reaching piece of legislation that has been in
3 effect for 70 years was passed following a litany of utility ownership abuses that
4 occurred from the beginning of the 20th century until passage of the noted
5 legislation. Specifically, prior to passage of PUHCA, utilities that were owned by
6 holding companies that also owned unregulated businesses were being charged
7 exorbitant prices for goods and services being provided by unregulated affiliates.
8 With the passage of PUHCA, holding companies were limited to owning energy
9 utilities for which operations were confined to a single state -- unless they were
10 willing to be registered as a multi-state holding company subject to extensive
11 reporting requirements and numerous other operating restrictions. With the recent
12 repeal of PUHCA, many of the reporting requirements and ownership limitations
13 that have for 70 years provided utility ratepayer protection are now gone.
14 Accordingly, state regulators will need to be ever more vigilant in establishing rules
15 and conditions that will attempt to provide the same consumer protection that
16 PUHCA has historically provided. But specifically in answer to the question posed
17 herein, PacifiCorp ownership by MEHC and ultimately by MEHC's *super*
18 *conglomerate parent* Berkshire Hathaway again raises the risk for the affiliate
19 abuses that predated the passage of PUHCA.

20 All the foregoing having been stated, I believe it is reasonable to point out
21 two facts regarding the instant case. First, MEHC and PacifiCorp have already
22 volunteered a number of reporting requirements and conditions that should help
23 detect and restrict potentially abusive transactions – at least with regard to dealings
24 between PacifiCorp, MEHC and other MEHC-owned subsidiaries. Further, while I
25 am hardly well studied in Warren Buffet's or Berkshire Hathaway's business

1 practices, I would simply state that over the years the various articles and accounts I
2 have read have been complimentary of Mr. Buffet's business successes as well his
3 business ethics. That said, we all know things change. Well intentioned and
4 honorable management can be, and occasionally have been, replaced by executives
5 with a much shorter time horizon for success, a much higher target in terms of
6 achieving reasonable financial success (i.e., returns), and certainly less honorable
7 characteristics. If the regulators are inclined to allow this transaction to occur, they
8 should not forget the lessons well-learned in the first third of the 20th century (prior
9 to passage of PUHCA). The regulators should not assume that even if there is little
10 evidence to suggest that Mr. Buffet or Berkshire Hathaway have historically
11 "misbehaved," there is no certainty that the next person or persons in charge of
12 Berkshire Hathaway will share Mr. Buffet's ethics. It goes without saying that Mr.
13 Buffet, who is in his mid-70s, will not be in charge of Berkshire Hathaway for too
14 many more years. And finally, it should be noted that Warren Buffet is but one man
15 – he does not individually manage or control all the numerous subsidiaries owned
16 by Berkshire Hathaway. Accordingly, if the proposed transaction is to be approved,
17 it should only be done with conditions required by the Commission that will enable
18 regulators to identify and prohibit abusive affiliate transactions while preserving the
19 financial integrity of the regulated utility. Or in other words, it should only be
20 approved with conditions that would prohibit "detriments" to ratepayers.

21 **Q. What conditions and reporting requirements have MEHC and PacifiCorp**
22 **already volunteered in efforts to allay the parties' concerns over potential**
23 **affiliate abuse?**

24 A. On Exhibit No.___(BEG-2) attached to the direct testimony of MEHC witness Mr.
25 Brent Gale are listed a number of commitments that MEHC has made with regard to

1 its acquisition of PacifiCorp. In the interest of not unduly expanding and
2 duplicating the record, I will not list each of the numerous MEHC-offered
3 commitments herein, nor will I discuss the need or propriety of MEHC/PacifiCorp-
4 offered commitments with which I agree – or certainly do not take exception to.
5 Suffice it to say, unless I specifically take an exception with, or suggest an
6 expansion to an already-volunteered commitment, I believe MEHC's commitments
7 are good if not absolutely necessary before WUTC approval of the transaction is
8 granted.

9 **Q. Please proceed by discussing the modifications or expansions that you would**
10 **advocate be adopted before WUTC approval of the transaction.**

11 A. First, I note that MEHC has agreed too many MEHC and PacifiCorp reporting
12 requirements. MEHC has agreed to allow Commission (and presumably Public
13 Counsel and intervenor) "access" to MEHC and PacifiCorp books and records, as
14 well as to make MEHC and PacifiCorp employees, officers, agents, etc. available to
15 testify before this Commission and "to provide information relevant to matters
16 within the jurisdiction of the Commission." Further, MEHC and PacifiCorp agree to
17 notify the Commission of proposed acquisitions and changes in effective control of
18 PacifiCorp by virtue of merger, combination, or transfer of stocks or assets.

19 As a general proposition, many of these reporting, notification and "access"
20 commitments should be extended and elevated to the Berkshire Hathaway super-
21 parent level. The need for, relevance of, and level of detail and access to documents
22 and individuals at the Berkshire Hathaway level could be fluid over time and perhaps
23 controversial in this and future proceedings. Yet, given the degree of control that
24 Berkshire Hathaway ultimately holds indirectly over MEHC/PacifiCorp, as well the
25 potential abuse which could occur through transactions between MEHC and/or

1 PacifiCorp and other existing or future businesses owned and controlled by
2 Berkshire Hathaway, it is imperative that regulators have knowledge of, and access
3 to, at least certain records of Berkshire Hathaway, as well as the ability to query
4 knowledgeable Berkshire Hathaway representatives of at least relevant events or
5 transactions.

6 **Q. Are you suggesting that regulators have unfettered access to Berkshire**
7 **Hathaway books and records, as well as representatives knowledgeable of**
8 **transactions actually or potentially affecting PacifiCorp's operations?**

9 A. Ideally, yes. However, I am cognizant that given the size and complexity of
10 Berkshire Hathaway, it is not necessary or practical for regulators to be
11 knowledgeable of all transactions and events occurring at the Berkshire Hathaway
12 super parent level. Further, so long as Berkshire Hathaway is not pushing down
13 parent-company costs to MEHC and ultimately PacifiCorp – as I believe are
14 Berkshire Hathaway's current intentions -- there is little to fear in the way of
15 excessive super parent-company *ownership* or *overhead* costs being charged to
16 PacifiCorp ratepayers. On this latter point, if Berkshire Hathaway commits to here
17 and forever more to *not* direct charge or allocate down any ownership or overhead
18 cost to MEHC, then I do not see a need to demand access to Berkshire Hathaway's
19 books and records that deal with the super parent's ownership and operating costs.
20 However, if that commitment is not made in this case, then the regulators should
21 have access to all of Berkshire Hathaway's books and records – to the same extent
22 that MEHC has volunteered access to MEHC's books and records.

23 **Q. Thus far you have only addressed *potential* Berkshire Hathaway parent-**
24 **company charges that might at some point be pushed down to MEHC and**
25 **ultimately PacifiCorp. Do you also have concerns regarding transactions that**

1 **might arise between PacifiCorp and other MEHC holdings, or between**
2 **PacifiCorp and other Berkshire Hathaway holdings?**
3 A. Yes. Other than corporate governance services, the purchase of goods and services
4 from other MEHC or Berkshire Hathaway subsidiaries represent a large exposure for
5 the ratepayer to affiliate abuse. As previously noted, prior to the passage of PUHCA,
6 utilities were purchasing products from commonly-owned non-utility affiliates at
7 exorbitant prices – that were in turn being passed on to captive utility customers in
8 the form of higher rates. PacifiCorp's ownership by Berkshire Hathaway, with its
9 many and varied business holdings, again creates an environment for cozy
10 relationships that could lead to non-competitive pricing of goods and services being
11 purchased by PacifiCorp from other businesses owned and controlled by Berkshire
12 Hathaway.
13 **Q. How should goods or services purchased by a regulated utility such as**
14 **PacifiCorp from unregulated affiliates be priced?**
15 A. Whenever a good or service is provided by an affiliate to the utility company or by
16 the utility company to an affiliate, an attempt should be made to identify a market
17 price, the fully allocated cost of providing/producing each good or service, as well as
18 any relevant tariff price when applicable. If a state commission or the Federal
19 Energy Regulatory Commission ("FERC") tariff has been approved, such tariff price
20 should serve as the transfer price. In the absence of an authoritative tariff price, if
21 the good or service is provided *by the subsidiary or affiliate to the utility*, the transfer
22 price should be established at *the lower of cost or market.* Conversely, if the good or
23 service is provided *by the utility to the subsidiary or affiliate*, the transfer price
24 should be at *the higher of cost or marke*t.

1 **Q. Why should the price a utility receives for providing a good or service to a**
2 **subsidiary or affiliate be established at the higher of cost or market?**
3 **A.** Utility ratepayers should never be detrimentally impacted by a utility company's
4 diversification or acquisition undertakings – or by ownership arrangements above the
5 utility subsidiary level. To that end, regardless of any market prices which may be
6 observed for any non-tariffed good or service being provided by the utility to the
7 affiliate, the utility should never charge less than its fully allocated cost of providing
8 or producing such good or service. Obviously, if the utility charges less than its fully
9 allocated cost of providing the good or service, utility ratepayers could be asked to
10 pay for the shortfall in producing such good or service. To avoid this subsidization,
11 goods and services should never be provided by the utility to any affiliate or parent
12 holding company(ies) at a price which is less than its fully allocated cost of
13 providing the good or service. On the other hand, if the market value of a
14 service/good provided by the utility exceeds its cost, the utility should not be denied
15 such higher value which could be realized from a non-affiliate purchaser.
16 As a practical matter, it is unlikely that over the long run a utility company
17 would ever continuously provide a good or service to an affiliate for which its fully
18 allocated cost of producing/providing the good or service would be higher than an
19 available market price. This is a logical expectation inasmuch as management
20 should quickly realize that it only makes good economic sense to "buy" the good or
21 service from a non-affiliate rather than have the utility provide or produce the good
22 or service above-market price. However, imposition of such a price "floor" would
23 eliminate even temporary inequities that may arise for whatever reasons.
24 **Q. It is pretty obvious why a utility should never charge an affiliate or a parent**
25 **holding company a price which is less than its fully allocated cost of providing a**

1 **good or service. Why should a utility be required to charge affiliates a market**
2 **price whenever an observed market price exceeds its fully allocated cost of**
3 **providing/producing such a good or service?**
4 **A.** Utility companies have an obligation to provide utility service at the lowest long run
5 cost of producing such service – consistent, of course, with reasonable and prudent
6 safety standards. To that end, a utility should maximize its profits by charging a
7 market price which exceeds its cost of providing/producing a non-tariffed good or
8 service in order that it can utilize such profits to lower the cost of providing utility
9 service to ratepayers. Just as, for instance, a utility can be expected to maximize
10 margins realized from renting space on its poles to non-affiliate cable companies,
11 similarly, it should be expected to maximize profits (lower its cost of service) by
12 charging market prices to affiliates whenever such market price exceeds its fully
13 allocated cost of providing/producing the good or service.
14 Furthermore, there is an important competitive market equity issue.
15 Specifically, firms that compete with the non-utility offerings of a utility affiliate
16 may be harmed or disadvantaged if the utility provides goods/services to its affiliates
17 based upon costs which are below market value.
18 **Q. Why should this transfer price condition be reversed for affiliate sales to the**
19 **utility?**
20 **A.** In cases where an unregulated affiliate is providing a good or service to the utility
21 company, the transfer price should be established at the lower of cost or market.
22 Such a transfer pricing policy would insure that utility ratepayers do not pay a price
23 which exceeds a given market value – thus meeting the "no detriment" standard.
24 Conversely, in those instances where an affiliate's cost may be below the market
25 price for a product or service it is providing to the utility, the benefits of

1 diversification will be maximized for ratepayers by charging the lower cost of
2 providing the good/service (i.e., the "positive benefits" standard is met).
3 Furthermore, contentious arguments regarding the existence and level of a "market
4 price" can be reduced if a lower "cost" to produce the utility affiliate's goods/services
5 can be determined.

6 **Q. Is the requirement that a utility sell to affiliates at the higher of cost or market**
7 **and buy from affiliates at the lower of cost or market mandated by any federal**
8 **regulation?**

9 **A.** Yes. In the telecommunications industry, where considerable utility diversification
10 has resulted in numerous complex affiliate relationships, the Federal
11 Communications Commission has imposed transfer pricing rules based upon this
12 standard whenever assets are transferred and no tariff price or prevailing market
13 price held out to the general public is available or applicable. (CFR Ch. 1, §32.27)

14 **Q. Has the National Association of Regulatory Commissioners also endorsed the**
15 **asymmetrical pricing guidelines that you have described?**

16 **A.** Yes, on July 23, 1999 asymmetrical pricing standards were endorsed after two years
17 of thought and discussion. The relevant portion of the noted NARUC guidelines are
18 delineated below:

19 D. AFFILIATE TRANSACTIONS (NOT TARIFFED)
20 The affiliate transactions pricing guidelines are based on two
21 assumptions. First, affiliate transactions raise the concern of self-
22 dealing where market forces do not necessarily drive prices. Second,
23 utilities have a natural business incentive to shift costs from non-
24 regulated competitive operations to regulated monopoly operations
25 since recovery is more certain with captive ratepayers. Too much
26 flexibility will lead to subsidization. However, if the affiliate
27 transaction pricing guidelines are too rigid, economic transactions
28 may be discouraged.
29

> The objective of the affiliate transactions' guidelines is to lessen the possibility of subsidization in order to protect monopoly ratepayers and to help establish and preserve competition in the electric generation and the electric and gas supply markets. It provides ample flexibility to accommodate exceptions where the outcome is in the best interest of the utility, its ratepayers and competition. As with any transactions, the burden of proof for any exception from the general rule rests with the proponent of the exception.
>
> 1. Generally, the price for services, products and the use of assets provided by a regulated entity to its non-regulated affiliates should be at the higher of fully allocated costs or prevailing market prices. Under appropriate circumstances, prices could be based on incremental cost, or other pricing mechanisms as determined by the regulator.
>
> 2. Generally, the price for services, products and the use of assets provided by a non-regulated affiliate to a regulated affiliate should be at the lower of fully allocated cost or prevailing market prices. Under appropriate circumstances, prices could be based on incremental cost, or other pricing mechanisms as determined by the regulator.
>
> 3. Generally, transfer of a capital asset from the utility to its non-regulated affiliate should be at the greater of prevailing market price or net book value, except as otherwise required by law or regulation. Generally, transfer of assets from an affiliate to the utility should be at the lower of prevailing market price or net book value, except as otherwise required by law or regulation. To determine prevailing market value, an appraisal should be required at certain value thresholds as determined by regulators.
>
> 4. Entities should maintain all information underlying affiliate transactions with the affiliated utility for a minimum of three years, or as required by law or regulation.

The asymmetrical pricing guidelines were endorsed as the "generally" preferable transfer pricing standard notwithstanding formidable opposition by industry representatives who argued that the guidelines imposed would present undue burdens as well as create competitive issues.

1 **Q. Do you believe it will always be possible to identify a market price to compare to**
2 **the fully allocated cost associated with providing a good or service?**
3 **A.** I think it may be difficult at times to obtain an uncontroverted market price for a
4 product, good or service being sold/purchased in and among PacifiCorp,
5 PacifiCorp's immediate parent – namely, MEHC, as well as all of the subsidiaries
6 controlled by Berkshire Hathaway. While I am somewhat sympathetic to this
7 argument or concern, I nonetheless believe a reasonable effort should be made to
8 adhere to the pricing principles set forth above -- particularly for large individual or
9 recurring transactions. If the Commission is concerned that the "burden" and
10 "controversy" associated with the implementation of the above noted transfer pricing
11 guidelines may exceed the benefits of such policies, I recommend that it establish a
12 minimum threshold transaction amount that would trigger the search for a market
13 price to compare to the fully allocated cost of the good or service. Specifically, I
14 recommend that when the annual or one-time payments for *each type* of non-tariffed
15 good or service exceeds $500,000 that PacifiCorp automatically be required to obtain
16 market price data and solicit bids to compare to the fully allocated cost of
17 producing/providing the good or service from any affiliate. Such efforts to
18 determine a market price should be well documented – and such documentation
19 should be retained between rate cases for potential regulatory review.
20 Finally, I would concede that it may be difficult to determine a market price
21 for administrative corporate services being provided by parent MEHC and
22 potentially from super parent Berkshire Hathaway (assuming Berkshire Hathaway
23 declines to commit to *never* push down any ownership or operating being incurred at
24 such super parent level). In the absence of a definitive market price I would concede

1 that it will often be necessary to directly assign and/or allocate the fully distributed
2 cost of such "joint" or "common" ownership services.
3 **Q. Is rigid adherence to the asymmetrical pricing guidelines likely to result in**
4 **excessive regulatory oversight, or perhaps worse, driving PacifiCorp away from**
5 **having any transactions with any Berkshire Hathaway subsidiaries that might**
6 **actually be able to provide the most competitive product or service?**
7 A. No, I think one needs to consider the practical implications of adherence of the
8 asymmetric pricing guidelines for PacifiCorp, MEHC and any Berkshire Hathaway
9 subsidiary. First, realistically, PacifiCorp's primary service that any
10 MEHC/Berkshire Hathaway affiliate might purchase is limited to regulated electric
11 service. As such, the price for such service will be the tariff rate. Arguably there
12 could be opportunities for PacifiCorp to rent poles to a cable subsidiary that might
13 currently or in the future be owned by Berkshire Hathaway. But those situations or
14 opportunities should be rare – the unique exception rather than the rule.
15 The more probable scenario will more likely arise if PacifiCorp desires to
16 purchase a good or service from a Berkshire Hathaway controlled subsidiary. In this
17 situation, under asymmetrical pricing, PacifiCorp should be expected to obtain
18 competitive market prices from affiliated as well as non-affiliated companies, and
19 compare such competitive market prices to the cost that PacifiCorp might incur to
20 produce or provide the good or service being sought. Now, if for instance,
21 PacifiCorp seeks to buy furniture for its corporate offices, and Berkshire Hathaway's
22 wholly owned subsidiary Nebraska Furniture Mart desires to compete for such
23 business, competitive bids for such furniture should be sought from non-utility
24 affiliates furniture retailers as well as Nebraska Furniture Mart (with the possible
25 exception if this Commission establishes a minimum threshold under which this

1 requirement might be waived). Receiving competitive bids should be standard utility
2 business practice – seeking to receive the best value for the quality and quantity of
3 goods and services being acquired. In other words, utilities should be expected to
4 receive competitive bids for service – whether dealing with affiliated or non-
5 affiliated companies. With regard to the requirement that the utility should,
6 theoretically, also quantify the *potentially lower* cost of producing the furniture itself,
7 I believe a simple statement by the utility that it does not engage in the manufacture
8 or retailing of furniture, and therefore could never compete with furniture
9 manufacturers or retailers, would suffice.
10 If, on the other hand, a utility is seeking engineering services or perhaps a
11 long term coal supply with specific qualifications, I believe it is very reasonable, and
12 indeed it would be expected, that PacifiCorp would evaluate owning or providing
13 these services itself. For instance, in the case of the engineering support sought,
14 PacifiCorp should be able to document that outsourcing the services to an affiliate or
15 non-affiliate is more economical than hiring additional employees to undertake the
16 work. Similarly, PacifiCorp should be expected to evaluate the option of simply
17 owning a coal lease and mining the coal itself versus buying coal from an affiliate or
18 non-affiliate.
19 Thus, in summary on this point, the asymmetric pricing guidelines that I am
20 proposing as a condition for approval of the transaction, are not envisioned to be
21 unduly burdensome nor lead to burgeoning regulation. Rather, they are simply
22 intended to prevent affiliate pricing abuse, and generally speaking, should be adhered
23 to in the normal course of prudently carrying out PacifiCorp's normal business
24 operations.

1 **Q. Do you have any concerns about the reporting and accounting requirements**
2 **that have been agreed to by MEHC and PacifiCorp as a condition of the**
3 **transaction?**
4 A. I believe at least one element of the MEHC proposed time reporting needs to be
5 defined and/or expanded. By way of background I would first note that with the
6 repeal of PUHCA, MEHC does not intend to establish a separate "Service Company"
7 subsidiary to carry out many administrative or governance functions of MEHC that it
8 intends to, in turn, push down to PacifiCorp as well as its other subsidiary holdings.
9 Under PUHCA, MEHC as a multi-state registered holding company, would have
10 been required to effectively establish a not-for-profit service company to carry out
11 joint administrative functions of MEHC. With the repeal of PUHCA, the
12 requirement for establishment of such Service Company is eliminated. While
13 MEHC touts the elimination of the requirement to establish a Service Company
14 subsidiary as a benefit by virtue of less complexity, I believe the establishment of
15 such a Service Company subsidiary did tend to better define which employees were
16 working generally for the good of all commonly owned subsidiaries versus which
17 employees are working for the exclusive benefit of specific subsidiaries.
18 According to the testimony of MidAmerican Energy Company ("MEC")
19 witness Mr. Thomas Specketer, the same functions that would have taken place at
20 the Service Company level under PUHCA will, with the repeal of PUHCA, be
21 carried out either at the MEHC parent-company level, or at the MEC subsidiary
22 level. As a result of this planned organization change, PacifiCorp will be receiving
23 direct charges and presumably *allocated* charges from both MEHC and sister
24 subsidiary MEC. Receiving direct or allocated charges from each parent/affiliate is

1 not necessarily inequitable, inefficient or avoidable. It does, however, present
2 another complexity to the regulatory process.
3 On Table I included in Mr. Specketer's testimony (TBS-1T), page 13, under
4 the topic of "Cost Allocations," MEHC offers the following condition:
5 MEHC will have in place a time reporting system adequate to support
6 the allocation of costs of executives and other relevant personnel to
7 PacifiCorp
8 In my opinion, this condition should be better defined or perhaps expanded.
9 Specifically, I would recommend any employee or officer of MEHC or MEC that
10 routinely, or even occasionally, works for the specific and exclusive benefit of
11 PacifiCorp, and thus ends up direct charging his loaded payroll costs to PacifiCorp's
12 operations, should be required to adhere to *positive* time sheet reporting rather than
13 merely *exception* accounting.
14 **Q. What do you mean by "exception" time reporting?**
15 **A.** "Exception" time reporting occurs when an employee's time is charged to a "home"
16 or normal responsibility center *except for* when the employee charges his or her time
17 to a different company, function or responsibility center. *Positive* time sheet
18 reporting, on the other hand, requires employees and officers to account for all
19 activities undertaken in some detail for all hours of the day – not just the *exception* to
20 those hours charged to the officer's or employee's normal responsibility center.
21 **Q. Why do you recommend that "exception" time reporting not be accepted?**
22 **A.** "Exception" time reporting makes it very easy for employees to forget or overlook
23 minor jobs performed outside his or her home responsibility center. Indeed, I have
24 observed situations where some diversified company employees did not write down
25 minor hours devoted to areas outside their normal responsibility center -- arguing

1 that they must complete their "normal" work in addition to any special projects
2 assigned.
3 Additionally, with "exception" time reporting non-productive time may end
4 up, by default, being charged to the normal or "home" responsibility center rather
5 than being equitably allocated to all subsidiaries who benefit from that employee's
6 efforts. By *non-productive time* I am referring to events such as training, vacation,
7 sick leave, holidays, etc.
8 Finally, without a requirement for positive time sheet reporting, it becomes
9 virtually impossible to verify that employees are accurately and equitably assigning
10 their time. "Exception" time sheet accounting is virtually unauditable inasmuch as
11 there is little or no trail to investigate how an employee is spending time that is being
12 charged to a home responsibility center by default.
13 **Q. Does the employee time sheet reporting and other corporate reporting**
14 **requirements which you have outlined insure that there will be little or no**
15 **controversy surrounding the assignment or allocation of parent-company,**
16 **service company or utility company resources between utility and non-utility**
17 **business lines?**
18 **A.** No. However, implementation of such requirements should, at a minimum, highlight
19 events or areas that require additional investigation. Furthermore, the various
20 reporting requirements should provide documentation, or an audit trail, for the rate
21 case auditor to use if and when an area of concern is identified.

1 **Q. Has MEHC proposed a method for assigning or allocating "common," "shared"**
2 **or "ownership" costs between MEHC, MidAmerican Energy Company and**
3 **PacifiCorp?**
4 A. First, MEHC appears to advocate *direct* assignment of any costs that are incurred for
5 the exclusive or unique benefit of a benefiting MEHC subsidiary, including
6 PacifiCorp. Mr. Specketer also addresses the allocation of common or shared costs.
7 Specifically, Mr. Specketer advocates employment of a two-factor formula that
8 considers benefiting subsidiaries' assets and payroll for purposes of allocating
9 MEHC and MEC "shared costs" that were not directly assigned to any benefiting
10 subsidiary. I do not, at this time, take exception to the two-factor approach
11 suggested by Mr. Specketer. That said, I believe the issue of allocating "common"
12 or "shared services" costs should be eligible for review and challenge, based upon
13 relevant facts and circumstances at the time of future rate proceedings. In other
14 words, adoption of the two-factor formula should not be binding upon this
15 Commission in future rate proceedings.
16 **Q. What is the approximate capitalization of PacifiCorp at this point in time?**
17 As taken from Table 1 of MEHC witness Mr. Patrick Goodman (PJG-1T),
18 PacifiCorp's stand alone capital structure as of March 31, 2005 consisted of the
19 following components:
20 **Table A**

PacifiCorp's Stand Alone Capital Structure at March 31, 2005		
Capital	$ in millions	% of Total Capital
Total Long Term Debt	$3,629.0	51.41%
Preferred Securities of subsidiaries	52.5	0.74%
Shareholders' Equity	3,377.1	47.84%
Total Capitalization	$7,058.6	100.00%

1 **Q. What is MEHC's consolidated capital structure *prior to* the planned PacifiCorp**
2 **acquisition?**
3 A. As also shown on Table I of Mr. Goodman's testimony, MEHC's pre-acquisition
4 capital structure consists of the following:
5 **Table B**

MEHC's Pre-Acquisition Consolidated Capital Structure		
Capital	$ in millions	% of Total Capital
Total Long Term Debt	$10,718.3	77.10%
Preferred Securities of subsidiaries	89.3	0.64%
Shareholders' Equity	3,093.7	22.25%
Total Capitalization	$13,901.3	100.00%

6 **Q. How does MEHC intend to fund the acquisition?**
7 A. The purchase price of the PacifiCorp common stock is expected to be $5.1 billion.
8 MEHC expects to fund this purchase through an equity infusion provided by
9 Berkshire Hathaway in the form of common stock or zero-coupon convertible non-
10 voting preferred stock in the amount of $3.4 billion. According to the direct
11 testimony of MEHC witness Mr. Patrick Goodman, the remaining $1.7 billion
12 purchase price is expected to be funded with long term unsecured debt, preferred
13 stock, or other securities with equity characteristic to third parties to be issued by
14 MEHC. That stated, Table I included within Mr. Goodman's direct testimony shows
15 the entire $1.7 billion of additional MEHC funding for the purchase of PacifiCorp
16 common equity to be raised through "Long term senior unsecured debt of MEHC."
17 **Q. Does the proposed transaction retain the existing PacifiCorp debt within the**
18 **utility while adding substantial new indebtedness at the MEHC parent level?**
19 A. Yes. All of PacifiCorp's pre-acquisition stand alone debt will remain. But
20 additionally, a significant portion of PacifiCorp's common stock purchase will be

1 financed with additional debt at the MEHC parent-company level. Thus, after the
2 closing, MEHC's consolidated capital structure is envisioned to consist of the
3 approximate amounts shown on the table below:[3]

4 **Table C**

MEHC Post Closing Consolidated Capital Structure		
Capital	$ in millions	% of Total Capital
Total Long Term Debt	$16,057.1	70.6%
Preferred Securities of subsidiaries	183.1	0.80%
Shareholders' Equity	$6,513.4	28.6%
Total Capitalization	$22,753.6	100%

5 **Q. Considering the MEHC parent debt, how will PacifiCorp assets ultimately be**
6 **capitalized after the planned transaction?**
7 A. When one considers the MEHC parent-company debt that is ultimately funding a
8 good portion of PacifiCorp's stand alone common equity, PacifiCorp's utility assets
9 will ultimately be funded in the approximate following manner:
10
11 / /
12 / / /
13 / / / /
14 / / / / /
15 / / / / / /
16 / / / / / / /
17 / / / / / / / /
18 / / / / / / / / /

[3] From Table 1 included within the direct testimony of Patrick Goodman (PJG-1T), page 5. However, it is noted that such balances and percentages do not include expected ScottishPower equity infusions net of PacifiCorp dividends expected to be paid to ScottishPower, nor do they reflect debt issuances and retirements by PacifiCorp and other MEHC holdings expected to occur between March 31, 2005 and March 31, 2006.

1 **Table D**

PacifiCorp Utility Asset Financing When Considering Additional Layer of MEHC Parent-Company Debt		
Capital	$ in millions	% of Total Capital
Total Debt & Preferred Stock[4]	$5,810	68.92%
Actual Shareholders' Equity Underlying PacifiCorp's Original Cost Investment[5]	$2,620	31.08%
Total Capitalization	$8,430	100%

2 **Q. Does the price being paid by MEHC for all the common equity of PacifiCorp**
3 **represent a "premium" over PacifiCorp's "book" equity?**

4 A. Yes. According to the direct testimony of MEHC witness Patrick Goodman, the
5 anticipated purchase price of the common stock will exceed the book equity of
6 PacifiCorp by approximately $1.2 billion. Such nominal premium payment equates
7 to approximately a 30 percent premium over PacifiCorp's expected book equity at
8 the time of closing.[6]

9 **Q. Is it unusual for utilities to sell for prices above book value?**

[4] From MEHC's response to Public Counsel Data Request No. 37 MEHC estimates $4.5 million of PacifiCorp stand alone debt and equity to be outstanding just prior to acquisition. Additionally, per P. Goodman revised direct testimony, page 8, approximately 33% of PacifiCorp's acquisition will be funded with MEHC parent-company debt. Multiplying the 33% of MEHC debt financing underlying the acquisition times PacifiCorp stand alone equity of $3.9 billion results in an additional amount of debt underlying the utility equity in the amount of $1.310 billion – for a total debt financing of PacifiCorp book value assets of $5.810 billion ($4.5 billion stand alone debt/preferred stock plus $1.310 billion of MEHC parent-company debt equals total debt underlying PacifiCorp assets of $5.810 billion.

[5] Total purchase price for PacifiCorp book equity is estimated to be $5.129 billion per P. Goodman direct testimony, page 5. The premium being paid is approximately $1.2 billion per P.Goodman's testimony (PJG-1T), page 11. Thus, the estimated stand alone PacifiCorp book equity prior to the transaction is estimated to be $3.929 billion. The calculated PacifiCorp book equity is, in turn, estimated to be funded 33% by MEHC debt and 67% by MEHC equity being infused by Berkshire Hathaway. Thus, PacifiCorp's book equity that is actually funded by MEHC "true" equity is approximately $2.6 billion (PacifiCorp's estimated book equity of $3.9 billion times MEHC's equity percentage underlying the purchase of 67% equals $2.6 billion).

[6] Per public rebuttal testimony filed by MEHC witness Brent Gale in California Public Utilities Commission Docket No. A-05-07-010.

1 A. No. In recent years is has not been unusual for reasonably healthy energy utilities to
2 sell at a premium – and sometimes a significant premium – above book value.
3 However, generally speaking, absent the achievement and retention by the
4 purchasing entity of merger synergies or other savings not achievable by the utility
5 on a stand alone basis, or other compelling strategic benefits, one would not expect a
6 purchaser to pay a large premium over the utility's book value.

7 **Q. Does regulation tend to limit the valuation of utility businesses to a price tied to**
8 **book value?**

9 A. Yes. As this Commission is well aware, regulated utility rates are generally based
10 upon *cost of service.* And since a utility's cost of service is generally determined to
11 include all reasonable and prudently incurred operating expenses plus a reasonable
12 return on the utility's *original* net depreciated investment, all other things held equal
13 and constant, the purchaser would be expected to only be willing to pay an amount
14 approximately equal to book value. Any payment above book value creates a risk to
15 the buyer that the premium amount being paid may be difficult or impossible to
16 recover.

17 **Q. Does the MEHC application anticipate any synergies or other costs savings that**
18 **might be achieved and retained by MEHC that serve to justify a purchase price**
19 **above PacifiCorp's book equity value?**

20 A. Since the business operations of PacifiCorp will not be merged with the operations of
21 any other MEHC businesses, Applicants are claiming virtually no synergy savings to
22 result from the acquisition. In fact, to the contrary, except for a very modest
23 expectation of some avoided ScottishPower parent-company costs that MEHC has
24 already agreed to pass along to PacifiCorp ratepayers, MEHC's "due diligence"
25 study does not really address expected or predicted operational savings stemming

1 from its ownership of PacifiCorp. On this latter point, MEHC's application stands in
2 fairly stark contrast to previous merger/acquisition applications that I have reviewed
3 in the past that *always* claimed some form of expected *synergy savings* and/or *best* or
4 *better practices promise* that the then-current (i.e., prior to proposed utility
5 merger/acquisition) ownership or management purportedly could not or would not
6 produce or provide under its current ownership arrangement. Frankly, I have always
7 viewed other utility applicants' claimed acquisition/merger savings with a very
8 skeptical eyes as being significantly overstated, but would nonetheless emphasize the
9 complete void in the instant case of *any* promised operational improvements, implied
10 purchasing power savings stemming from economies of scale, or savings attributable
11 to anticipated new-found or soon-to-be-implemented *best practices* of the acquiring
12 owners and managers.

13 **Q. If MEHC is not asserting synergy savings that it desires to retain as justification**
14 **for the premium being paid above book value for PacifiCorp equity, what is**
15 **driving the purchase price of the PacifiCorp common equity above the book**
16 **value?**

17 A. The premium anticipated to be paid would appear to be justified by 1) attempted
18 retainage of interest cost savings being realized at the MEHC parent level that
19 MEHC does not intend to reflect in the development of PacifiCorp's retail rates,
20 and/or 2) planned but yet undisclosed relatively aggressive changes to existing
21 regulatory or statutory rate recovery plans.

22 **Q. Please explain how the premium payment might be justified, or recovered, as a**
23 **result of cost savings generated by retaining parent debt financial leverage**
24 **occurring a the MEHC level.**

1 A. As previously noted, MEHC anticipates financing approximately $1.7 billion (33%)
2 of the purchase price of PacifiCorp's book equity with long term debt instruments. If
3 this Commission regulates PacifiCorp's utility operations employing PacifiCorp's
4 stand alone, relatively equity thick capital structure that does not reflect the
5 economic reality of an additional layer of lower cost and interest-deductible MEHC
6 parent-company debt ultimately underlying PacifiCorp's assets, MEHC will achieve
7 a much higher equity return on the actual equity capital underlying PacifiCorp's
8 assets than what this Commission would have targeted for PacifiCorp's stand alone
9 equity capitalization. Or in other words, MEHC would ultimately be able to earn a
10 much higher return on its *actual* equity investment in PacifiCorp's assets if it can
11 persuade the regulators to establish a common equity return on PacifiCorp's "stand
12 alone" common book equity that is, in fact, financed to a significant extent by lower
13 cost, and interest-deductible debt financing at the MEHC parent-company level. Not
14 only will the MEHC parent-company debt likely have a considerably lower rate of
15 interest than the equity return being granted for PacifiCorp common equity, such
16 higher equity return would also have an attendant federal income tax lug that would
17 not be applicable to the tax deductible MEHC parent-company interest expense. By
18 substituting higher cost capital in the ratemaking formula than what truly exists in
19 reality at the MEHC parent-company level, MEHC has the opportunity to recover all
20 or a portion of the premium that it is paying for the PacifiCorp common book equity.
21 **Q. Are you able to estimate what amount of equity return PacifiCorp will be able**
22 **to achieve on the *actual* equity investment in original cost utility investment?**
23 A. MEHC has not projected the interest rate it expects to pay on debt issued to third
24 parties that will underlie a portion of the purchase price it is paying for PacifiCorp's
25 book equity. Nonetheless, one can estimate the real return on MEHC's *true* or

1 *actual* equity investment in PacifiCorp's original cost investment by utilizing
2 realistic, if not conservative, estimates of interest rates on the MEHC debt to be
3 issued, as well as PacifiCorp's realized return on its stand alone book equity.
4 Specifically, as shown below, utilizing an assumed interest rate of 6.5% for the
5 MEHC parent-company debt underlying the purchase of PacifiCorp's book equity,
6 and an assumed common equity return of 9.0% on PacifiCorp's stand alone book
7 equity, one can calculate an expected equity return of 11.4% on the actual level of
8 MEHC equity underlying PacifiCorp's stand alone equity balance.
9

Line	Description	($000's)
11–14	PacifiCorp's Estimated Stand Alone Book Equity Immediately Preceding The Planned MEHC Acquisition (see fn. 5)	$3,929,500
15		
16–17	Assumed Return on PacifiCorp's Stand Alone Book Equity	9.0%
18		
19	Return on PacifiCorp's Stand Alone Book Equity	$353,655
20		
21–22	Tax Multiplier to Consider Federal Corporate Income Tax Rate of 35% [1/(1-35%)]	1.53846
23		
24–26	Total Equity Return Revenue Requirement (the Before-tax return on PacifiCorp's stand alone Equity Investment)	$544,085
27		
28–30	MEHC's Long Term Debt Underlying the Purchase of PacifiCorp's Book Equity (see Footnote 3 explanation for derivation)	1,309,808
31		
32	Assumed Cost of MEHC Long Term Debt	6.5%
33		
34–35	MEHC interest on Long Term Debt Underlying the Purchase of PacifiCorp's Book Equity	$85,138
36		
37	PacifiCorp's Stand Alone Total Equity Return	

Revenue Requirement less Interest Cost Associated With MEHC Debt Underlying PacifiCorp's Book Equity Investment	$458,947
Federal Income Tax Rate	35.0%
Federal Income Taxes Associated with MEHC Taxable Income After Deducting Interest on MEHC Debt Underlying PacifiCorp Equity Purchase	$160,631
After Tax MEHC Equity Return Return on MEHC Equity Underlying PacifiCorp's Stand Alone Book Equity Assuming 9% Return On PacifiCorp's Stand Alone Book Equity and 6.5% Interest Rate on MEHC Debt Underlying The Purchase	$298,316
MEHC Equity Underlying PacifiCorp's Stand Alone Book Equity	$2,619,692
Return on Actual Equity Supporting PacifiCorp's Assets	11.4%

Q. Are you also able to calculate the amount of federal income taxes that will be collected if PacifiCorp's retail rates are developed considering PacifiCorp's stand alone capital structure that will never actually be paid to the federal government?

A. On a PacifiCorp system-wide basis, if retail rates are established utilizing PacifiCorp's stand alone capital structure, and assuming a 9.0% return on equity with MEHC parent-company underlying debt being issued at a rate of 6.5%, the amount of *phantom* federal income taxes that would never be paid to the United States

1 government would be approximately $30 million, calculated as follows:

Description	($000s)
Before Tax Return on PacifiCorp's Stand Alone Equity (again assumes PacifiCorp will earn 9% On its Stand Alone Book Equity – as calculated Above)	$544,085
Federal Income Tax Rate	35%
Federal Income Tax Expense Collected within PacifiCorp's System-wide Utility Rates	$190,430
Estimated MEHC Federal Income Taxes After Considering Tax Deductibility of Interest on MEHC Debt Underlying PacifiCorp's Stand Alone Book Equity (calculated above)	$160,631
Phantom Federal Income Taxes Collected in PacifiCorp's Rates That Would be Developed Utilizing a Stand Alone PacifiCorp Capital Structure that Would Never be Paid to the United States Government as a Result of PacifiCorp and MEHC Filing a Consolidated Federal Income Tax Return that Reflects a Deduction for MEHC Parent-Company Debt Underlying the PacifiCorp Purchase	$29,798

29 **Q. Do you believe it is MEHC's expectation to retain the "spread" between the**
30 **equity return with attendant federal income tax consequences that it hopes to**
31 **charge retail ratepayers through employment of a PacifiCorp stand alone**
32 **capital structure *and* its true or actual capital costs, which includes additional**
33 **debt leverage, at the MEHC parent-company level?**

34 A. Yes. MEHC testimony and data request responses repeatedly emphasize that
35 MEHC/PacifiCorp will not seek recovery of the acquisition premium being paid *so*
36 *long as the regulatory body does not impute benefits from the acquisition beyond*

1 *those being committed to in the Joint Application.* And since MEHC/PacifiCorp
2 have never acquiesced that they would be willing to be regulated based upon the
3 MEHC double leveraged capital structure, it is a given that MEHC intends to retain
4 the "spread" discussed and calculated above.

5 **Q. Should this Commission allow recovery of the acquisition premium being paid**
6 **either directly – or indirectly through means of retaining double leverage**
7 **capital structure savings – such as MEHC appears to be advocating?**

8 A. I would recommend that this Commission reject any direct *or indirect* attempts by
9 MEHC to recover the acquisition premium being paid. Or more specifically, I would
10 recommend that a condition for approval of the transaction be that
11 MEHC/PacifiCorp will never seek direct or indirect recovery of the acquisition
12 premium being paid. In many proposed acquisitions or mergers the joint applicants
13 often seek *indirect* recovery of an acquisition premium over book value being paid
14 through retention of all or a portion of claimed *synergy savings* that purportedly
15 could not be achieved under the status quo ownership arrangement. However, as
16 previously noted, MEHC is not predicting any significant costs savings attributable
17 to the acquisition. The only recovery of the premium being paid is apparently
18 through an attempted employment of a lower cost capital structure at the parent level
19 that MEHC does not desire to use for ratemaking purposes.

20 Achievement of lower costs through a lower cost/more-debt-leveraged capital
21 structure is not unique to MEHC ownership. Accordingly, if this Commission elects
22 to consider regulation of PacifiCorp utilizing the MEHC double leveraged capital
23 structure, with its lower costs for ratepayers, because such capital structure is
24 deemed reasonable and efficient, it should not, in turn, allow *direct* recovery of the
25 premium being paid – as MEHC appears to be posturing to propose. In short and in

1 sum on this point, a condition of the transaction should be that MEHC/PacifiCorp
2 will not seek direct or indirect recovery of the acquisition premium being paid.
3 **Q. In your earlier answer you alluded to the possibility that MEHC could attempt**
4 **to recover the acquisition premium it is paying for PacifiCorp common equity**
5 **through aggressive regulatory or statutory rate recovery plans. Does MEHC or**
6 **PacifiCorp have any planned changes for rate recovery and/or implementation**
7 **of new legislation that could facilitate greater than existing recovery of**
8 **PacifiCorp's cost of service?**
9 A. No such plans have been identified in testimony or discovery. That stated, this
10 Commission should be cognizant of the economic and political clout that an owner
11 of the size and diversity of Berkshire Hathaway can undoubtedly wield should it be
12 motivated to change things.
13 Further, I note that MEHC has been enjoyed the implementation of
14 *alternative regulatory plans* currently in place in its two primary retail jurisdictions
15 of Iowa and Illinois. According to MEHC, a threshold return on equity must be
16 exceeded before the mechanisms are triggered, and further, that there are no
17 traditional authorized returns for the services subject to the alternative regulatory
18 plans. These alternative regulatory plans have apparently worked very well for
19 MidAmerican Energy Company as evidenced by the overall and common equity
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returns achieved in recent years shown below:[7]

Year	Overall Earned Return	Earned Return on Equity
2000	9.73%	11.59%
2001	9.32%	11.09%
2002	10.31%	12.99%
2003	10.47%	13.88%
2004	10.43%	13.93%

I would note and emphasize that the returns shown above are at the MidAmerican Energy Company subsidiary level. As noted previously, MEHC funds a portion of its equity investment in its subsidiary MidAmerican Energy Company with debt at the parent-company level. Thus, MEHC's achieved return on equity at the parent level would be higher than the reported equity returns on the thicker stand-alone common equity levels reported above at the MidAmerican Energy Company subsidiary level.

I would also point out that response to Washington Public Counsel Data Request No. 50, MEHC stated the following regarding the alternative ratemaking programs in place for its other retail jurisdictions:

> MEHC's experience with the ratemaking principles mechanism has been very positive and MEHC would encourage other state jurisdictions to consider adoption of similar statutory provisions. However, MEHC has no current plans to purchase this mechanism in Washington.

The points to be gleaned from such disclosures and discussions are: 1) MEHC/MEC have, for whatever reasons, been able to enjoy alternative regulatory plans that achieved higher equity returns in recent years than this Commission has determined

[7] MEHC response to Oregon Public Utilities Commission Staff Data Request No. 2 issued in Oregon Public Utilities Commission Docket No. UM-1209.

1 to be reasonable for retail regulated utility operations, 2) its is therefore reasonable to
2 assume that Berkshire Hathaway/MEHC have expectations of earning higher equity
3 returns – both at the stand alone PacifiCorp subsidiary level as well as at the more
4 debt leveraged MEHC parent-company level – than this Commission has historically
5 deemed necessary to attract investment capital at reasonable rates, and 3) it is
6 therefore simply reasonable to be wary of MEHC's/PacifiCorp's plans – both at the
7 retail regulatory level as well as through potential advocacy of state legislation – to
8 implement steps that could lead to returns that are not warranted by this
9 Commission's historical standards. And again, on this latter point, this Commission
10 should be cognizant of the pressures that can be wielded by an owner of the size and
11 diversity of Berkshire Hathaway.

12 **Q. In an earlier answer you listed the various investments that MEHC and**
13 **ultimately Berkshire Hathaway are willing - if not intending - to make in the**
14 **PacifiCorp system. Do you view either MEHC's or Berkshire Hathaway's**
15 **willingness to invest in PacifiCorp a "benefit" of the transaction?**

16 A. No. As I believe I alluded to earlier, such "willingness" or "intent" to invest in
17 PacifiCorp's infrastructure should not be viewed as a "benefit" unique to
18 MEHC/Berkshire Hathaway ownership. Further, this Commission should be
19 cognizant of the potential "detriment" when a utility is over zealous with regard to its
20 investment strategy in utility assets.

21 **Q. Please explain your latter concern.**

22 A. Utility rates and service can be detrimentally impacted when investment in utility
23 assets are *under* as well as *over* or *prematurely* funded. For example, if utility
24 management imprudently constrains investment in utility assets it exposes ratepayers
25 to service deterioration, higher operating costs (through inefficient substitution of

1 higher operating costs in lieu of more efficient capital deployment) as well as higher
2 costs through "catch up" investments at a later date.
3 However, utility rates can also be detrimentally impacted when management
4 aggressively or prematurely invests in utility assets, thus driving up utility rates
5 unnecessarily. In the late 1980s and throughout most of the 1990s there was a glut of
6 electric utility generating capacity over much of the United States that in many
7 instances were causing electric utility rates to be higher than necessary inasmuch as
8 the cost of much of the "excess" generating capacity was, nonetheless, considered in
9 rate development. I understand that many would argue that such excess capacity
10 resulted because of changes in circumstance that were beyond the control of utility
11 management that occurred after decisions had been made and significant investment
12 in new generating facilities had already occurred. Regardless whether the premature
13 investment was foreseeable or unforeseeable by utility management, the outcome in
14 many instances was the same – electric utility rates were established by considering
15 investment costs that were not necessary to be incurred to serve load existing at that
16 time or for many years thereafter.
17 A concern in the instant case is that MEHC appears to demonstrate not only a
18 *willingness* but also an *eagerness* to invest in PacifiCorp's infrastructure. This
19 Commission should not only welcome, but actually expect, prudent and timely
20 investment in PacifiCorp's infrastructure when such investment is required to meet
21 demands and deployed at levels and intervals designed to lower PacifiCorp's long
22 term cost of service while providing safe and dependable utility service. That said,
23 given the Berkshire Hathaway stated goal of desiring to make investments in utility
24 assets, this Commission needs to be aware that MEHC management may

1 *prematurely* invest, *over* invest or *imprudently/uneconomically* invest in PacifiCorp's
2 infrastructure.
3 More specifically, I note that MEHC is predicting that it will invest more in
4 PacifiCorp's infrastructure than what PacifiCorp is currently including within its
5 long term business plan. In the absence of any evidence that PacifiCorp's current
6 investment forecast has been imprudently restrained, a detriment from the proposed
7 transaction exists in the form of MEHC over building or prematurely building
8 PacifiCorp's utility infrastructure.
9 **Q. Does that conclude your direct testimony?**
10 **A. Yes, it does.**