BEFORE THE WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

PACIFICORP-MIDAMERICAN MERGER

DOCKET NOS. UE-051090

DIRECT TESTIMONY OF STEPHEN G. HILL (SGH-1T)

ON BEHALF OF

PUBLIC COUNSEL

November 18, 2005

DIRECT TESTIMONY OF STEPHEN G. HILL (SGH-1T)

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HILL EXHIBIT LIST

Exhibit No. ___ (SGH-2) Education and Employment History of Stephen G. Hill

Exhibit No. ___ (SGH-3) Historic and Compares Comparative Capital Structure

1 **I. INTRODUCTION / SUMMARY**

2 **Q. Please state your name, occupation and address.**

3 A. My name is Stephen G. Hill. I am self-employed as a financial consultant, and principal
4 of Hill Associates, a consulting firm specializing in financial and economic issues in
5 regulated industries. My business address is P.O. Box 587, Hurricane, West Virginia,
6 25526 (e-mail: sghill@compuserve.com).

7 **Q. Briefly, what is you educational background?**

8 A. After graduating with a Bachelor of Science degree in Chemical Engineering from
9 Auburn University in Auburn, Alabama, I was awarded a scholarship to attend Tulane
10 Graduate School of Business Administration at Tulane University in New Orleans,
11 Louisiana. There I received a Master's Degree in Business Administration. More
12 recently, I have been awarded the professional designation, "Certified Rate of Return
13 Analyst" by the Society of Utility and Regulatory Financial Analysts. This designation is
14 based upon education, experience and the successful completion of a comprehensive
15 examination. I have also been elected to the Board of Directors of that national
16 organization. A more detailed account of my educational background and occupational
17 experience appears in Exhibit No.__(SGH-2).

18 **Q. Have you testified before this or other regulatory Commissions**?

19 A. Yes, I have previously presented testimony in this jurisdiction and have testified on cost
20 of capital, corporate finance and capital market issues in more than 225 regulatory
21 proceedings before the following regulatory bodies: the West Virginia Public Service
22 Commission, the Texas Public Utilities Commission, the Oklahoma State Corporation
23 Commission, the Public Utilities Commission of the State of California, the Public
24 Service Commission of New Hampshire, the Georgia Public Service Commission, the
25 Public Utilities Commission of the State of Minnesota, the Ohio Public Utilities

1 Commission, the Insurance Commissioner of the State of Texas, the North Carolina
2 Insurance Commissioner, the Rhode Island Public Utilities Commission, the City Council
3 of Austin, Texas, the State of Maine Public Service Commission, the South Carolina
4 Public Service Commission, the Public Utilities Commission of the State of Hawaii, the
5 New Mexico Corporation Commission, the Wisconsin Public Service Commission, the
6 State of Texas Railroad Commission, the Public Service Commission of Utah, the Illinois
7 Commerce Commission, the Kansas Corporation Commission, the Indiana Utility
8 Regulatory Commission, the Virginia Corporation Commission, the Public Service
9 Commission of Maryland, the Pennsylvania Public Utilities Commission, the Montana
10 Public Service Commission, the Maine Public Utilities Commission, the Vermont Public
11 Service Board, the Federal Communications Commission and the Federal Energy
12 Regulatory Commission. I have also testified before the West Virginia Air Pollution
13 Control Commission regarding appropriate pollution control technology and its financial
14 impact on the company under review.
15 **Q. On behalf of whom are you testifying in this proceeding?**
16 A. I am testifying on behalf of the Public Counsel Section of the Washington State Attorney
17 General's Office (Public Counsel, or PC).
18 **Q. What is the purpose of your testimony?**
19 A. Public Counsel has requested that I review the financial aspects of the pending purchase
20 of PacifiCorp by MidAmerican Energy Holdings Company (MEHC), in order to
21 determine if they are in the public interest and will promote a fair balance of the interests
22 of MEHC's investors and Washington ratepayers. In March of 2005, PacifiCorp's current
23 parent, Scottish Power, PLC, entered into a definitive agreement to sell all of
24 PacifiCorp's common stock to MECH for $9.4 Billion. That purchase price is to be
25 comprised of $5.1 Billion in cash plus the assumption of $4.3 Billion in net debt and

1 preferred stock currently outstanding at PacifiCorp.[1] MEHC's $5.1 Billion cash
2 investment in PacifiCorp is to be financed with $3.4 Billion of common stock or zero
3 coupon preferred stock of MEHC and $1.7 Billion in long-term unsecured debt of
4 MEHC. I have reviewed the testimony and exhibits provided by the company
5 representatives as well as documents available in the electronic data room created by
6 MEHC and responses to data requests submitted by Public Counsel and other parties in
7 the proceeding.

8 **Q. Have you prepared any exhibits to accompany your testimony?**

9 A. Yes, I have prepared one exhibit, Exhibit No.__(SGH-3), which is attached to my
10 testimony and is correct to be best of my knowledge and belief.

11 **Q. Please provide a brief summary of your findings and recommendations?**

12 A. MEHC is a diversified holding company that contains unregulated as well as regulated
13 utility operations. The unregulated operations have more business risk than an integrated
14 electric utility operation like PacifiCorp. MEHC finances its operations with considerably
15 more debt and less equity than average for an electric utility operation, and MEHC's
16 purchase of PacifiCorp is financed in a manner that contains greater leverage (debt) than
17 normal for an electric utility operation.

18 In purchasing PacifiCorp, MECH is providing $3.4 Billion in equity capital,
19 assuming $4.5 Billion of PacifiCorp's debt and preferred stock and issuing an additional
20 $1.7 Billion of new, unsecured debt. Therefore, of the total purchase price for PacifiCorp,
21 MEHC's equity investment represents only 35% of the total capital ($3.4 B/ $9.6 B).

22 The mix of capital MEHC is using for the purchase of PacifiCorp is actually less
23 leveraged than the manner in which MEHC is currently capitalized. According to the
24 testimony of MEHC witness Goodman, at page 5 of his direct testimony (PJG-1T),

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[1] "Net debt" is PacifiCorp's actual debt and preferred ($4.5 Billion) less PacifiCorp's cash ($200 Million); Company response to Public Counsel Data Request No. 37.

1 MEHC was capitalized with approximately 22% common equity and 78% debt and
2 preferred stock as of March 31, 2005.[2] Also, following the purchase of PacifiCorp,
3 MEHC is expected to see only a slight reduction in its overall leverage. Mr. Goodman
4 indicates that the pro forma, post-PacifiCorp-purchase capital structure of MEHC will
5 consist of about 28.5% common equity and 71.5% debt and preferred stock.
6 Because of the use of an additional layer of debt at the prospective parent
7 company (MEHC) level, I am concerned that this additional financial risk will negatively
8 affect the regulated subsidiary (PacifiCorp) and be detrimental to the long-term interests
9 of Washington ratepayers. I am also concerned that the use of normal utility-type
10 capitalization at PacifiCorp for ratemaking purposes will allow MEHC to capitalize its
11 mix of regulated and unregulated companies more inexpensively (i.e., with more debt
12 capital) that it otherwise would be able to do. This effectively requires Washington
13 ratepayers to provide financial cross-subsidization to MEHC's portfolio of companies.
14 My final concern is that, with the additional layer of debt, the issue of the
15 appropriate return to be allowed the regulated subsidiary (PacifiCorp) is in question. If,
16 for example, this Commission determines that investors require a 10% return on their
17 equity investment in integrated electric utilities like PacifiCorp, and they allow that return
18 in rates, MEHC (the investor in PacifiCorp's equity) will be afforded an opportunity to
19 earn a return higher than 10% because its equity investment in PacifiCorp is funded
20 partly with debt capital. I do not make a recommendation in this testimony to address this
21 particular concern regarding the pending transaction because I do not believe it is
22 necessary to resolve this issue at this time. However, it will be an important factor in this
23 Commission's future dealings with PacifiCorp as a subsidiary of MEHC and, as such,
24 deserves mention here.

[2] MEHC's S.E.C. Form 10-Q indicates a slightly lower common equity ratio (see Exhibit No.__(SGH-3), p. 3 of 3).

1 In its commitments offered in support of the purchase MEHC has included many
2 measures that support operational and financial separation between the unregulated
3 parent (MEHC) and the regulated subsidiary (PacifiCorp). Those measures are known in
4 the current lexicon as “ring-fencing.” Included in the commitments MEHC has made to
5 facilitate the financial separation between it and PacifiCorp are:

6 - all non-utility investments by MEHC will be held in separate subsidiaries;
7 - PacifiCorp will maintain separate debt ratings, separate financial records and
8 employees;
9 - PacifiCorp will provide unrestricted access to all written information provided
10 to rating agencies;
11 - PacifiCorp will not make any distributions to its parent that would reduce its
12 common equity ratio below 40% of capital (excluding short-term debt);
13 - PacifiCorp will not guarantee any debt of MEHC or its affiliates; and,
14 - a single-purpose entity (PPW Holdings LLC) will be created between MEHC
15 and PacifiCorp which will have an independent director.

16 Public Counsel believes that all of the ring-fencing commitments offered by
17 MEHC to facilitate its purchase of PacifiCorp are necessary and agree that similar
18 commitments have, in other jurisdictions, worked to successfully support a higher bond
19 rating for regulated subsidiaries than for the riskier MEHC, which is the intent of the
20 ring-fencing. However, Public Counsel also believes that those commitments do not go
21 far enough in separating the financial risk of MEHC and PacifiCorp and ultimately
22 protecting the public interest of maintaining a financially healthy electric utility operation
23 at the local level. This is especially true in light of the loss of a significant level of
24 ratepayer protection from unregulated diversification by holding companies at the Federal
25 level—the Public Utility Holding Company Act (PUHCA), which has recently been

1 repealed and will cease to exist in February of 2006.

2 Public Counsel recommends the following amendments to the ring-fencing
3 conditions offered by MEHC:

- 4 Both MEHC and PacifiCorp will provide the Commission with unlimited
5 access to all written information provided to credit rating agencies that
6 pertains to PacifiCorp and MEHC (or any affiliate that exercises control over
7 PacifiCorp). For purposes of this condition, 'written' information includes but
8 is not limited to any written and printed material, audio and video tapes,
9 computer disks and electronically-stored information.
- 10 If the common equity ratio of PacifiCorp equals 40% or less of total capital
11 (common equity, preferred stock, preferred securities, long-term debt and
12 short-term debt) or if the common equity ratio of MEHC equals 35% or less of
13 total capital, PacifiCorp will not make any distribution to PPW Holdings LLC
14 or MEHC without prior approval of the Washington Utilities and
15 Transportation Commission. The Commission and PacifiCorp may reexamine
16 this minimum common equity percentage as financial conditions or
17 accounting standards change, and may request that it be adjusted.
- 18 PacifiCorp will not, without the approval of the Commission, assume any
19 obligation or liability as guarantor, endorser, surety or otherwise for MEHC or
20 its affiliates or Berkshire Hathaway or its affiliates, provided that this
21 condition will not prevent PacifiCorp from assuming any obligation or
22 liability on behalf of a subsidiary of PacifiCorp. MEHC or Berkshire
23 Hathaway will not pledge any of the assets of the regulated business of
24 PacifiCorp as backing for any securities which MEHC or Berkshire Hathaway
25 or their affiliates (but excluding PacifiCorp and its subsidiaries) may issue.

- PacifiCorp will not own the common equity of MEHC or that of any of MEHC's subsidiaries, neither will PacifiCorp take any equity position in Berkshire Hathaway or any of that company's subsidiaries.
- MEHC will notify the Commission at least 30 days prior to 1) the transfer of more than 5% of PacifiCorp's retained earnings to MEHC or Berkshire Hathaway during a six-month period, 2) the declaration of any special cash dividend from PacifiCorp.
- PPW Holdings LLC will be the only corporate entity that exists between PacifiCorp and MEHC and PPW Holdings LLC will have no other subsidiaries other than PacifiCorp.
- PacifiCorp should have its own short-term debt facilities, commercial paper and revolving credit facilities, and not participate in any MEHC money-pool arrangement that co-mingles regulated and unregulated monies.

Q. How is your testimony organized?

A. I will first discuss the capital structure and operational risk differences between Mid American Energy Holding Company and PacifiCorp and how those differences can support financial cross-subsidization and ultimately lead to the necessity for ring-fencing. Second, I will discuss ring-fencing as it is viewed by the investment community and certain aspects which strengthen financial separation. In that context, I will review the ring-fencing commitments made by MEHC and recommend additional measures that I believe enhance the financial separation of PacifiCorp from MEHC and better support the public interest. Finally, I will discuss what ultimately will be an important ratemaking issue related to parent company leverage that will arise for this Commission and PacifiCorp if the pending transaction goes forward.

1 **II. CAPITAL STRUCTURE DIFFERENCES AND RELATIVE RISK**

2 **Q. What are the respective capital structures of MidAmerican Energy Holding**
3 **Company and PacifiCorp, currently?**

4 A. As shown on page 1 of Exhibit No. __(SGH-3) attached to my testimony, over the five
5 quarter period ending in March 2005, PacifiCorp was capitalized with 43.85% common
6 equity, 1.27% preferred stock, 51.05% long-term debt and 3.83% short-term debt.[3]
7 PacifiCorp's capital structure is similar to the electric utility industry averages, shown on
8 page 2 of Exhibit__(SGH-3). The average common equity ratio for the electric industry
9 in October 2005, based on total capital, is 42%.

10 Page 3 of Exhibit No.__(SGH-3) is drawn from MEHC's quarterly reports to the
11 Securities and Exchange Commission and shows that its average consolidated capital
12 structure over the five-quarter period ending in March 2005 consisted of 19.81%
13 common equity, 0.60% preferred stock, 79.53% long-term debt and 0.06% short-term
14 debt. That capital structure, containing approximately 20% common equity capital, is
15 substantially more leveraged than that of either PacifiCorp or the average electric utility
16 operation.

17 **Q. MEHC has a much higher leverage ratio (more debt and less equity) than**
18 **PacifiCorp. Does MEHC also have substantially lower operational risk than**
19 **PacifiCorp?**

20 A. No. MEHC's holding company contains several business platforms, some of which
21 (electric distribution and pipeline operations) carry less operational risk than an
22 integrated electric utility and some of which (unregulated generation in foreign countries)
23 carry more risk than PacifiCorp. However, on average, S&P awards MEHC a "business
24 position rank of "5" which is average risk for an integrated electric utility operation like

[3] Those capital structure data were obtained in PacifiCorp's current rate case proceeding before this Commission, Docket No. UE-050684.

1 PacifiCorp.
2
3 MEHC's business profile is a '5' on Standard & Poor's
4 scale of '1' to '10'. (Business profiles are categorized from
5 '1' (strong) to '10'(weak)). The business risk score reflects
6 the wide mix of businesses that MEHC operates, including
7 rather low-risk pipeline and transmission and distribution,
8 the medium-risk integrated utility , and the higher –risk
9 unregulated electric generation in the U.S. and Philippines
10 and its cyclical real estate services.
11
12 (Standard & Poor's, Ratings Direct, Research: Summary: MidAmerican Energy Holdings
13 Co., March 8, 2005, p. 1).

14 **Q. What does the relative business risk of a firm have to do with its capital structure?**

15 A. The manner in which a firm is most economically capitalized is a function of the
16 volatility of the income stream generated by the assets of the firm or, in other words, the
17 firm's operating (business) risk. For example, if a firm has an income stream that is not
18 volatile and which can be predicted with near certainty, then a capital structure consisting
19 of even 100% debt would not be problematic or risky. In fact, it would be the most cost-
20 effective capital structure in that instance because debt is the least expensive form of
21 investor-supplied capital for a firm and, without the possibility of operating income being
22 insufficient to meet the debt service requirements, a 100% debt capital structure would be
23 the prudent choice.

24 As the income stream of a firm becomes more volatile (more risky), financial
25 theory holds that the amount of debt used should decline in order to avoid a default event
26 (the failure to meet the required debt service costs). Although the reduction of lower-cost
27 debt and the addition of higher-cost common equity will raise the firm's overall cost of
28 capital, that increase is appropriate and economically efficient because it more
29 appropriately matches the firm's financial risk with the increase in business risk. In that
30 way, given an increased level of business risk, the cost of capital is minimized and the
31 financial health of the firm is better assured.

1 An example of how the amount of debt in the capital structure varies with the
2 operational or business risk of a firm is found in a recent publication by Standard &
3 Poor's regarding utility business risk. A June 2004 publication by Standard & Poor's, in
4 which that bond rating agency re-aligned its business risk profile scores for utility
5 companies, indicates that the companies with higher business risk are required to have a
6 lower debt ratio (less debt, more equity) in order to earn the same bond rating as a firm
7 with lower business risk.[4]
8 For example, Standard & Poor's indicates that energy merchant/marketing
9 companies have high business risk. On a scale of 1 to 10 with, 10 representing the highest
10 risk, energy trading companies have an average business risk profile score of 9. In order
11 to achieve a bond rating of "BBB", companies with a business risk profile of 9, according
12 to Standard & Poor's, should have a total debt ratio ranging between 40% and 50% of
13 total capital. (A debt ratio between 40% and 50% corresponds to an equity ratio between
14 50% and 60%.)
15 In contrast, fully-integrated combination utilities, like PacifiCorp, have lower
16 business risk than energy trading companies, and have an average risk profile score of
17 about 5. According to Standard & Poor's, in order to achieve a "BBB" bond rating, those
18 companies should be capitalized with a total debt ratio between 50% and 60% of total
19 capital (or an equity ratio between 40% and 50% of total capital). Therefore, companies
20 with lower business risk (like utility operations) are effectively capitalized with more
21 debt and less equity than companies with higher business risk (like energy trading
22 companies).
23 **Q. Why is it of concern that MEHC has similar business risk to PacifiCorp but a more**
24 **highly leveraged capital structure?**

[4] Standard & Poor's Ratings Direct, New Business Profile Scores Assigned for U.S. Utility and Power Companies: Financial Guidelines Revised, June 2, 2004.

1 A. There are two reasons. First, MEHC's more highly leveraged capital structure imparts
2 additional financial risk to the parent company. That additional financial risk could, in the
3 event of some unforeseen negative event at the parent company level, be transferred to
4 PacifiCorp and its ratepayers if MEHC has to draw on PacifiCorp's relative financial
5 strength for support. Also the potential for such an occurrence could restrain (i.e., lower)
6 the bond rating that PacifiCorp might otherwise achieve, imparting additional debt cost
7 that would be recovered from ratepayers.

8 Also, while MEHC's business risk is currently on balance with that of a fully-
9 integrated electric utility like PacifiCorp, MEHC is an unregulated entity and there are no
10 guarantees that, in the future, that it will not expand its unregulated generation or energy
11 merchant businesses and increase its operational risk relative to PacifiCorp. Rating
12 agencies recognize that unregulated operations carry greater risk than unregulated
13 operations.

14

15 In general, regulated utilities offer lenders some of the
16 lowest business risks seen amongst corporate entities.
17 However, many of the companies in question may also be
18 active in unregulated businesses, such as speculative
19 trading with exposure to unhedged commodity prices,
20 which can be highly risky and may lead to serious financial
21 difficulties despite the presence of a regulator.

22

23 Moody's framework for rating regulated electric utilities is
24 constructed around a number of credit risk factors rather
25 than on any on particular metric such as a financial ratio.
26 The *first step* is to assess the extent of a "regulated"
27 company's exposure to unregulated businesses. The
28 strongest position is enjoyed by those companies operating
29 in a wholly regulated business.

30

31 (Moody's Investors Service, Global Credit Research, Rating Methodology: Global
32 Regulated Electric Utilities, March 2005, pp. 1, 4, emphasis added).

33 Second, a more highly leveraged capital structure at the parent company level,
34 even with similar levels of operational (business) risk, constitutes financial cross-

1 subsidization of the unregulated parent (MEHC) by the ratepayers of the regulated entity
2 (PacifiCorp).

3 **Q. Please explain what you mean by financial cross-subsidization and why this**
4 **Commission should be concerned.**

5 A. Cross-subsidization of a parent company's unregulated operations by its regulated
6 subsidiary operations can occur in many forms. For example, the unregulated firm could
7 provide services to the utility at above-market rates or, conversely, the utility could
8 provide services to its unregulated affiliates at rates below that which would prevail in an
9 arms-length transaction.

10 Financial cross-subsidization occurs when the capital structure of the utility
11 operation provides financial strength to the holding company, which, in turn, allows the
12 parent to capitalize its consolidated operations with more debt and less equity (i.e., more
13 cheaply) than they would otherwise be able to do. In other words, the utility (and,
14 thereby, utility ratepayers) shoulders some of the financial risk of the unregulated
15 affiliates by allowing the holding company to be capitalized in a manner which would not
16 prevail in a stand-alone situation.

17 One way that MEHC can maintain a stronger financial profile and offset the
18 increased risks of its unregulated operations, is to set rates with a high common equity
19 ratio for its regulated utility operations while simultaneously financing its unregulated
20 operations with a higher percentage of debt capital than would otherwise be possible.
21 That is the essence of financial cross-subsidization. The tangible result of that action is a
22 common equity ratio for PacifiCorp that is below that of MEHC.

23 **Q. Can the bond rating of a regulated subsidiary be constrained by a financially**
24 **weaker parent company?**

25 A. Yes, according to publications by the rating agencies. Standard & Poor's, for example, is

1 quite frank about the ability of parent companies, in complying with their fiduciary duty
2 to the stockholders of the parent, to take advantage of the stronger finances of a
3 subsidiary.
4
5 Standard and Poor's takes the general position that the
6 rating of an otherwise financial healthy, wholly owned
7 subsidiary is constrained by the rating of its weaker parent.
8 The basis for this position is that a weak parent has both the
9 ability and the incentive to siphon assets out of its
10 financially healthy subsidiary and to burden it with
11 liabilities during times of financial stress. The weak parent
12 might also have an economic incentive to filing the
13 subsidiary into bankruptcy—if the parent itself were forced
14 into bankruptcy—regardless of the subsidiary's "stand-
15 alone" strength. Experience suggests that insolvent
16 corporations will often jointly file with their subsidiaries—
17 even those subsidiaries not themselves experiencing
18 financial difficulty.
19
20 (Standard & Poor's Ratings Direct, Ring-Fencing a Subsidiary, October 19, 1999, p. 1).
21 **Q. Are there steps that can be taken to insulate a regulated subsidiary from the**
22 **financial risk imposed by a weaker parent company?**
23 A. Yes. The methods used to protect the financial status of subsidiaries in the even of
24 financial stress at the parent are, in today's terminology, called ring-fencing. It is
25 important to understand that even though ring-fencing has proven to be effective in
26 protecting regulated subsidiaries from financial problems at the parent company level, it
27 is not a guarantee of financial separation:
28
29 In Fitch's view, ring-fencing techniques rarely provide total
30 insulation of a U.S. utility from problems relating to an
31 insolvent parent. Furthermore, even if affiliates are
32 segregated in numerous ways, the presence of a single
33 important unifier, such as a large intercompany loan or an
34 intercompany supply contract critical to continuing
35 operations, may nullify all other ring-fencing efforts.
36
37 (Fitch Ratings, Corporate Finance, Rating Linkage Within U.S. Utility Groups: Ring-
38 Fencing Mechanisms, Utilities, Holding Companies and Affiliates, April 8, 2003, p. 1).

1 **III. RING-FENCING**

2 **Q. How is ring-fencing defined?**

3 A. Fitch Ratings, in its April 2003 publication, Rating Linkage Within U.S. Utility Groups:
4 Ring-Fencing Mechanisms, provides a succinct definition of ring-fencing:
5
6 Ring-fencing mechanisms are techniques employed to
7 isolate credit risks of an issuer from the risks of affiliate
8 issuers within its corporate group. Depending on the nature
9 of the ring-fence methods employed, Fitch Ratings may
10 evaluate various affiliated issuers as a single consolidated
11 entity, as separate entities with distinct but related ratings,
12 or, in special cases, as distinct entities (e.g., a special-
13 purpose entity or an affiliate in a different sovereign
14 jurisdictions). The maximum independence among
15 affiliated issuers results from concurrent deployment of
16 numerous ring-fencing methods.
17
18 (Fitch Ratings, Corporate Finance, Rating Linkage Within U.S. Utility Groups: Ring-
19 Fencing Mechanisms, Utilities, Holding Companies and Affiliates, April 8, 2003, p. 1).

20 **Q. What are the inter-company arrangements that constitute ring-fencing?**

21 A. The inter-company structures that work to separate the financial risks of affiliated firms
22 include legal separation through the creation of a separate subsidiary with its own
23 financial records, restriction of the ability of the parent to use the subsidiary's assets to
24 collateralize any loans to other affiliates, restrictions on cash transfers from the subsidiary
25 to the parent, and the creation of a "limited purpose entity" between the parent and
26 subsidiary with an independent director to prevent the parent from forcing the subsidiary
27 into bankruptcy without the consent of the independent director. Standard & Poor's
28 makes clear that it considers the creation of a special purpose entity central in the
29 separation of financial risk between holding company and subsidiary:
30
31 As noted above, parent/subsidiary linkage is prompted, in
32 page, by two concerns:
33
34 • That a healthy subsidiary's assets may be
35 consolidated with those of its insolvent parent: and

> - That the parent will have the ability to cause the subsidiary to file itself into bankruptcy, despite the fact that the subsidiary is not itself experiencing financial difficulty. Ensuring that the subsidiary is a limited-purpose operating entity, somewhat similar to the "special purpose entity" (SPE) found in a securitization, may mitigate this bankruptcy risk.
>
> While the SPE is, strictly speaking, a creature of securitization, its operating asset analogues are found in the limited-purpose operating entities employed in industrial-based or project-financed transactions. In the context of a 'ring-fenced' transaction, Standard & Poor's expects that such limited-purpose entity will:
>
> - Be 'single-purpose';
> - Incur no additional debt (beyond that sized into the rating and necessary for routine business purposes. Such as trade debt and ordinary working-capital facilities to prestated levels);
> - Not merge or consolidate with a lower-rated entity;
> - Not dissolve; and
> - Have an 'independent director.'
>
> In the context of a 'ring-fenced' transactions, the operative feature is the independent director.

(Standard & Poor's Ratings Direct, Ring-Fencing a Subsidiary, October 19, 1999, pp. 1, 2).

Q. Does the merger proposal by MEHC include the creation of a single-purpose entity with an independent director between PacifiCorp and MEHC?

A. Yes. As shown in Exhibit No. __(PJG-3), page 1 attached to the Direct Testimony of Company witness Goodman, the organizational structure chart of MEHC shows PPW Holdings LLC as the single purpose entity between MEHC and PacifiCorp, with an independent director included in the ring-fencing structure.

Q. Has MEHC also offered to include other ring-fencing measures to protect the financial position of PacifiCorp from that of MEHC?

1 A. Yes. MEHC has committed to maintaining PacifiCorp's accounts and records separately,
2 holding additional diversified companies in separate ring-fenced subsidiaries,
3 maintaining separate bond ratings for PacifiCorp, pledging that PacifiCorp will not
4 guarantee the debt or MEHC or its affiliates and maintaining a minimum 40% common
5 equity ratio at PacifiCorp.
6 All of those conditions are, I believe, reasonable and necessary to maintaining the
7 separation of the financial condition of PacifiCorp from that of its weaker would-be
8 parent company, MEHC.
9 **Q. Do you believe those conditions are sufficient to protect the financial integrity of**
10 **PacifiCorp and to ensure that ratepayers are not harmed by the proposed sale of**
11 **PacifiCorp to MEHC?**
12 A. No.
13 **Q. Please explain why not.**
14 A. First, ring-fencing measures that are based solely on corporate promises or agreements
15 are not as strong from a credit-protection aspect as are measures that are enforced by
16 regulatory bodies, as the rating agencies make clear:
17
18 Transactions involving electric, water, natural gas and
19 telephone utilities may be subject to regulatory supervision.
20 In the context of the weak-subsidiary linkage, the utility
21 usually represents the strong subsidiary. Regulatory
22 approval, influence, or mandate may well have a positive
23 effect on credit quality.
24
25 (Standard & Poor's Ratings Direct, Ring-Fencing a Subsidiary, October 19, 1999, p. 4).
26
27 Consideration is given to the substance of a regulatory ring-
28 fence including restrictions on dividends, restrictions on
29 capex and investments, separate financings, separate legal
30 structure, and limits on the ability of the regulated entity to
31 support its parent company. *There is more credit uplift if*
32 *these provisions are contained within a license or clear*

> *regulatory rules rather than in financing documents that can be renegotiated….*
>
> Regulatory ring-fencing for utilities may include minimum equity requirements, limitations of the movement of funds from regulated entities to unregulated entities, and prohibitions against credit support by regulated entities for unregulated entities. This may exist by statute, but most typically takes the form of rules that are established by the regulator.
>
> Regulators often have wide discretion to impose new restrictions on regulated entities when the utility appears to be threatened by weakness of its unregulated affiliates. For example, the state regulatory commission in Oregon established tight limitations on any movement of funds by Portland General to its parent company when the parent company filed for bankruptcy protection. These ring-fencing protections were a key reason that Portland General did not default or experience substantial financial distress while its parent was in bankruptcy.

(Moody's Investors Service, Global Credit Research, Rating Methodology: Global Regulated Electric Utilities, March 2005, pp. 4, 5 and 12 emphasis added).

> Restrictions imposed by state and federal authorities can be valuable sources of ring-fencing protection for regulated utilities….
> *Financial restrictions imposed solely through internal corporate policies are a weaker method of isolating issuer risks relative to those mandated by law, regulation or contract because the corporation may adjust its policies at will.*

(Fitch Ratings, Corporate Finance, Rating Linkage Within U.S. Utility Groups: Ring-Fencing Mechanisms, Utilities, Holding Companies and Affiliates, April 8, 2003, pp. 1, 2, emphasis added).

Second, with the recent repeal of the Public Utility Holding Company Act of 1935 (PUHCA) an important Federal restraint on the ability of holding companies to diversify has been lost. With PUHCA in tact, the Securities and Exchange Commission regulated the actions of utility holding companies, which served to limit unregulated event risk

1 exposure to regulated utility subsidiaries. That ability to restrict the amount of
2 unregulated investment at the Federal level was cited by bond rating agencies as rationale
3 for credit differentiation between holding companies and utility operations.
4
5 > The most significant piece of legislation governing utility
6 > holding companies at the federal level is the Public Utility
7 > Holding Company Act, more commonly known as
8 > PUHCA. The Act was passed in 1935 to regulate interstate
9 > utility holding companies in response to the financial
10 > collapse of a number of such holding companies following
11 > the stock market crash of 1929. When utilities in different
12 > states combine or merge under a holding company, the new
13 > entity becomes registered under PUHCA, which provides
14 > for SEC regulation of their financing activities, including
15 > the sale a purchase of securities and assets. PUHCA gave
16 > the SEC the power to exercise broad oversight over
17 > business combinations that result in functional or
18 > geographic diversification of utilities.
19
20 > Historically, the SEC has severely restricted the
21 > types of business activities in which registered holding
22 > companies may engage. The National Energy Policy Act of
23 > 1992 (NEPA) eased some of the regulatory restrictions
24 > imposed by PUHCA allowing registered holding
25 > companies to establish non-utility generation subsidiaries
26 > and to purchase foreign utilities without seeking prior SEC
27 > approval. However, registered holding companies are still
28 > prohibited from owning both electric and gas operations or
29 > possessing unregulated businesses without SEC approval.
30 > Although there have been a number of attempts over the
31 > last few years to repeal PUHCA, most recently as part of a
32 > comprehensive energy legislation considered but not passed
33 > in 2003, it remains a key federal regulatory constraint and
34 > limitation for those holding companies registered under
35 > PUHCA.
36
37 (Moody's Investors Service, Global Credit Research, Rating Methodology: Global
38 Regulated Electric Utilities, March 2005, pp. 18, 19).
39
40 > Holding companies (holdcos) engaged through subsidiaries
41 > in more than on estate in the electric utility business or in
42 > the retail distribution of natural gas are subject to regulation

1 under PUHCA. PUHCA is intended to limit abuses by
2 holdocs and prevent cross-subsidization of nonregulated
3 businesses by regulated entities. Holdcos are regulated on
4 matters including company structure, intercompany loans,
5 reporting, acquisitions and issuance and sale of securities.
6
7 (Fitch Ratings, Corporate Finance, Rating Linkage Within U.S. Utility Groups: Ring-
8 Fencing Mechanisms, Utilities, Holding Companies and Affiliates, April 8, 2003, p. 2).
9
10 Note that even as late as March of 2005, Moody's cited PUHCA as a means of
11 protecting regulated utilities from the financial risks of holding company diversification.
12 However, ratepayers no longer enjoy the protection from multi-state utility holding
13 company diversification at the Federal level cited by the bond rating agencies because
14 PUHCA has been repealed. Accordingly, because holding companies like MEHC are no
15 longer restricted in any fashion from the sort of unregulated businesses into which they
16 might diversify, ratepayers are more in need of State utility commission overt action to
17 protect the financial health of the utility operations under their purview.
18 **Q. What are your recommended amendments to the list of commitments offered by**
19 **MEHC?**
20 A. My initial concern is the flow of funds from PacifiCorp to MEHC, the primary artery of
21 which is dividend payments. MEHC has offered to maintain a minimum common equity
22 ratio of 40% based on capital amounts excluding short-term debt. I don't disagree with
23 that target common equity ratio, although I think it should be based on all investor-
24 supplied capital including an average level of short-term debt. This Commission often
25 uses short-term debt in its ratemaking capital structure to reflect all of the sources of
26 capital available to the regulated firm and, thus, its true cost of capital.
27 However, I believe that the 40% common equity ratio commitment should be a
28 regulatory requirement, not merely a promise. As such it will offer stronger protection to
29 PacifiCorp and greater separation of the financial risks of PacifiCorp and MEHC. I

1 recommend that when the common equity ratio of PacifiCorp (based on total capital)
2 equals 40% or less, PacifiCorp will be required to seek WUTC approval to issue
3 dividends to PPW Holdings LLC or to MEHC.

4 Because the distribution of dividends is the primary conduit of monies from
5 PacifiCorp to the holding company, I believe it is also reasonable to require that
6 PacifiCorp notify the WUTC at least thirty days prior to 1) the transfer of more than 5%
7 of PacifiCorp's retained earnings to PPW Holdings LLC or to MEHC during any six-
8 month period and 2) the declaration of any special cash dividend from PacifiCorp to any
9 other entity.

10 Finally, because a primary concern is the amount of leverage in use at the parent
11 company (MEHC) level and the financial risk that could impart to PacifiCorp, I believe it
12 is reasonable to set a dividend approval requirement for the regulated entity based on the
13 capital structure of the unregulated parent (MEHC). If the capital structure of MEHC is at
14 35% of total capital or below, PacifiCorp must receive permission from this Commission
15 prior to paying dividends to PPW Holdings LLC or to MEHC.

16 **Q. The Company has offered to make available to the Commission written information**
17 **supplied to bond rating agencies regarding PacifiCorp. Do you believe this is**
18 **sufficient?**

19 A. No. First, it is my experience in working before this Commission that bond rating
20 presentations are routinely requested and provided as part of rate proceedings, therefore
21 this commitment simply maintains the status quo. However, a primary reason for the
22 ring-fencing recommendations is the relative financial risk of MEHC and the impact it
23 may have on PacifiCorp. Therefore I believe it is reasonable for the Company to provide
24 access not only to PacifiCorp's bond rating agency presentations but also those of
25 MEHC.

1 **Q. The Company has offered to restrict the ability of MEHC to be able to use the assets**
2 **of PacifiCorp as collateral for debt incurred by MEHC or any of its subsidiaries. Do**
3 **have additional restrictions to recommend?**
4 A. Yes. I believe that the prohibition on PacifiCorp's assuming any obligation or liability as
5 a guarantor, endorser or surety or otherwise for MEHC or its affiliates should be
6 extended to the super-parent corporation, Berkshire Hathaway. At the time PUHCA
7 expires (February 2006), Berkshire Hathaway will own 80% of the common stock of
8 MEHC (Joint Application, pp. 3, 4) Berkshire Hathaway will control MEHC and the
9 prohibition against PacifiCorp guaranteeing any debt of MEHC should also be extended
10 to Berkshire Hathaway and any of its affiliates.
11 Finally on this point, it is important to note that even though this condition would
12 prevent PacifiCorp's assets from being used to directly secure the debt of MEHC,
13 Berkshire or any of their other subsidiaries, the assets and the income stream they
14 produce indirectly do provide support for debt at the parent company level. As noted
15 previously, although MEHC has similar overall business risk to PacifiCorp, it is
16 capitalized with considerably less equity and more debt that would be possible for that
17 company on a stand-alone basis. The reliable dividend payments provided by MEHC's
18 regulated operations provides the basis on which the holding company is able to issue
19 additional debt to further lever those income streams. It is the additional leverage at the
20 holding company level that causes the potential for additional financial risk for the
21 regulated subsidiary. Therefore, while it is important to ensure that PacifiCorp does not
22 have any legal responsibility for liabilities incurred by MEHC, Berkshire or any of their
23 subsidiaries, other measures are necessary to help ensure the financial well-being of
24 PacifiCorp.
25 **A. Are there additional conditions that you wish to add to those proposed by MEHC?**

1 A. Yes. I believe PacifiCorp should be restricted not only from directly securing any debt
2 issued by MEHC, Berkshire or their subsidiaries, but also from investing in the common
3 equity of any of those operations. My concern in this regard arises from my involvement
4 with the Western Resources attempt a few years ago to "spin off" its unregulated
5 operations, taking all the equity capital and leaving the regulated utility with only its debt
6 outstanding. Kansas regulators were able, ultimately, to halt that transaction and prevent
7 the depletion of the regulated utility's common equity balances. However, the parent-
8 holding company was able to avoid regulatory scrutiny on both the State and Federal
9 level by having the subsidiary own shares of the parent company. With one firm owning
10 shares of the other, the parent company was able to engineer "shareholder agreements"
11 that effectuated the planned spin-off and which were extremely advantageous to the
12 unregulated operations and disadvantageous to the regulated utility. Moreover, as long as
13 those shareholder agreements were disclosed to the S.E.C. there was no requirement that
14 State regulators be informed of the nature or substance of any of those agreements.
15 Moreover, the S.E.C.'s primary concern was that there was sufficient disclosure of the
16 agreements, and not that the result of the outcome might be financial disastrous for the
17 regulated utility. Therefore, while I do not believe that MEHC has any such intentions
18 with regard to PacifiCorp, I believe it is still prudent to include as a condition of
19 approving the sale that PacifiCorp be prohibited from owning the common equity of
20 MEHC, Berkshire or any of its affiliates.
21 Finally, I believe that PacifiCorp should have its own short-term debt facilities,
22 issue its own commercial paper and forge its own credit agreements with banks that are
23 not related to any inter-corporate money pool structure managed by MEHC. Holding
24 company money pools, where companies deposit or borrow cash on a daily basis
25 provides a linkage between the financial operations of regulated and unregulated firms in

1 the holding company. For example, a cash-rich utility operation could lend the holding
2 company money pool $50 million and a cash-poor competitive generator could borrow
3 that same $50 million from the money pool, at a short-term debt rate. In effect, the
4 regulated utility is lending money to the unregulated operation even though there is no
5 security or pledge of assets offered by the utility. Such a transaction, I believe, would also
6 pass muster with regard to a prohibition of lending to MEHC or its affiliates because in
7 the action I've described, PacifiCorp's $50 million contribution could be characterized as
8 "simply participating in the corporate money pool" and not specifically lending to any
9 entity directly. Such a characterization would not be untrue but would mask the actual
10 financial linkage of the regulated and unregulated subsidiaries.

11 **Q. Does this conclude your suggested amendments and additions to the commitments**
12 **offered by MEHC to support the merger?**

13 A. Yes.

14 **IV. RATE IMPACT OF LEVERAGE AT THE PARENT COMPANY**

15 **Q. You noted earlier in your testimony that the existence of additional leverage at the**
16 **parent company presents ratemaking concerns at the regulated subsidiary level.**
17 **Why?**

18 A. On of the many tasks before regulators in the process of setting rates is to determine the
19 market-based cost of common equity capital. In order to determine the cost of capital
20 regulators most often rely on econometric models like the Discounted Cash Flow model
21 or the Capital Asset Pricing Model. Such models are designed to provide estimates of the
22 returns investors require for assuming the risk associates with owning a share of utility
23 stock.

24 Regulators use the investors' required return as the allowed profit for the
25 regulated firm when determining the appropriate revenue requirement. In so doing,

1 regulators are providing the utility an opportunity, under efficient management, to earn a
2 return that is commensurate with the risk assumed by the investor, which will allow the
3 firm to continue to attract the capital necessary to fulfill its public service obligations.
4 If, for example, the investors' required return on equity is determined to be 10%,
5 that capital cost is included in rates as the allowed profit. The intent of ratemaking is to
6 provide the regulated firm an opportunity to earn that allowed return so that it can be
7 passed on to the firm's equity investors through dividends and stock price growth.
8 However, in a holding company situation, when the stockholder finances the
9 investment in the common equity of the utility with both equity and debt, it is able to
10 increase its realized return to something greater than the return allowed to the regulated
11 firm—in our example, 10%.
12 **Q. Can you explain in more detail why additional debt leverage at the parent company**
13 **level works to raise the realized equity return above what is allowed the regulated**
14 **subsidiary?**
15 A. Yes. Let's assume that the regulated subsidiary is capitalized with $50 of equity and $50
16 of debt. The cost of equity is 10% and the cost of debt is 5%. A weighted-average overall
17 cost of capital for our hypothetical utility would be calculated as shown below:
18
19 **Subsidiary Cost of Capital**

	Amount	Percent	Cost	Weighted Avg. Cost
Equity	$50	50%	10%	5.00%
Debt	$50	50%	5%	2.50%
	$100	100%		7.50%

20 We now assume that our utility is owned by another company—a parent company. The
21 utility is its only asset and the parent has financed its $50 equity investment in the utility
22 with $20 of its own equity and $30 of its own debt. If the utility is allowed a 10% ROE,
23 and earns an overall return of 7.50%, that return then flows up to the parent. However,

1 because of the additional layer of debt at the parent level, the equity return for the parent
2 is higher than the allowed 10%, as shown below:
3
4 **Parent Company Earned Return**

	Amount	Percent	Cost	Weighted Avg. Cost
Equity	$20	20%	**16%**	**3.20%**
Parent Debt	$30	30%	6%	1.80%
Util. Debt	$50	50%	5%	2.50%
	$100	100%		**7.50%**

5 The table above shows that if the parent company earns the 7.50% overall return
6 allowed its regulated subsidiary, and out of that return pays the weighted cost of utility
7 debt (2.50%) and its own debt, which we have assumed is more costly due to increased
8 leverage at the parent (1.80%), the residual weighted return on equity is 3.20%. That
9 amount divided by the actual equity ratio of the parent (20%), indicates that with an
10 overall return of 7.50% the parent company earns a 16% return on its utility equity
11 investment, not the 10% allowed by regulators.

12 **Q. The parent company is more leveraged, so why wouldn't a 16% return be**
13 **reasonable for that Company?**

14 A. While it is reasonable to believe that the cost of equity capital for the parent would be
15 somewhat higher that that of the regulated utility due to the financial risk related to the
16 additional debt at the parent level, the cost of capital would be increased to the extent
17 indicated in the example above. In other words, there is an advantage to leveraging
18 regulated subsidiary returns that is beneficial to the parent company. In the example
19 above the parent company's cost of equity would be higher than the 10% appropriate for
20 the utility but below the 16% earned through leveraging the utility's income stream.
21 If there were no rate of return advantage to the parent holding company of the
22 additional leverage, why would MEHC elect to assume the additional risk of another

1 layer of debt in order to finance its purchase of PacifiCorp? If its profitability is not
2 enhanced by the additional leverage, and the overall return is the same over a broad range
3 of capital structures, then why not finance its purchase of PacifiCorp with the same
4 percentages of debt and equity currently in use by PacifiCorp?
5 Clearly, there is an advantage to debt at the parent company level and through that
6 additional debt the parent company has an opportunity to earn an equity return higher
7 than that allowed in rates for the regulated subsidiary. This is an issue the Commission
8 should be aware of and which will eventually be an issue in future rate proceedings if the
9 proposed purchase of PacifiCorp by MEHC is allowed to proceed.
10 **Q. Does this conclude your Direct Testimony, Mr. Hill?**
11 A. Yes, it does.