Exhibit No. ___(MPG-1T)
Docket No. UE-051090
Witness: Michael P. Gorman

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Joint Application of MIDAMERICAN ENERGY HOLDINGS COMPANY AND PACIFICORP d/b/a PACIFIC POWER & LIGHT COMPANY, For an Order Authorizing Proposed Transaction.	)	**Docket No. UE-051090**

DIRECT TESTIMONY OF MICHAEL P. GORMAN

ON BEHALF OF

THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES

November 18, 2005

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Michael Gorman, and my business address is 1215 Fern Ridge Parkway, Suite 208, St. Louis, MO 63141-2000.

Q. WHAT IS YOUR OCCUPATION?

A. I am a consultant in the field of public utility regulation and a principal in the firm of Brubaker & Associates, Inc., energy, economic, and regulatory consultants.

Q. PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.

A. These are set forth in Exh. No.__ (MPG-2).

Q. ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?

A. I am appearing on behalf of the Industrial Customers of Northwest Utilities ("ICNU").

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. I will comment on potential negative retail customer impacts created by MidAmerican Energy Holdings Company's ("MEHC") proposal to acquire PacifiCorp and its request for authorization of MEHC to exercise substantial influence over the policies and actions of PacifiCorp. MEHC is proposing to acquire from PacifiCorp Holding Companies, Inc. ("PHI"), all of PHI's outstanding shares of PacifiCorp common stock. The Applicants have executed a stock purchase agreement, and request specific actions related to the same.

Q. PLEASE IDENTIFY POTENTIAL RATEPAYER HARM CREATED BY THE PROPOSED ACQUISITION.

A. In reviewing the potential impact on PacifiCorp's retail customers, I assessed the proposed transactions in terms of the following:

1. Financial stability. This concerns PacifiCorp's ability to attract capital under reasonable prices, terms, and conditions to fund needed infrastructure investments and reliability and environmental improvements.

2. PacifiCorp's rate stability.

3. MEHC's ability to operate PacifiCorp.

4. PacifiCorp's cost of service and retail rates.

FINANCIAL STABILITY

Q. PLEASE IDENTIFY THE MAJOR CONSIDERATIONS IN A REVIEW OF THE FINANCIAL STABILITY OF THE PROPOSED TRANSACTION.

A. In assessing the potential impact on PacifiCorp's financial stability, I considered PacifiCorp's credit standing and ability to access both debt and equity capital. Toward this objective, I have reached the following conclusions.

- A significant threat to PacifiCorp's financial integrity under the proposed corporate structure is MEHC's weak credit rating and highly leveraged capital structure. MEHC's weak financial position creates a significant risk to PacifiCorp's financial stability.

- Berkshire Hathaway has made significant commitments to support MEHC, its utility affiliates, and PacifiCorp. However, this commitment is subject to change. Berkshire Hathaway's ownership of MEHC has resulted in significant benefits to MEHC and its existing operating utility affiliates that include significant capital investment commitments and, according to MEHC witnesses, a reduction in operating utility affiliates' cost of debt. This commitment, unfortunately, is subject to change. If Berkshire Hathaway's investment outlook changes and its commitment to MEHC is reduced or withdrawn, this could place significant uncertainty on PacifiCorp's long-term financial integrity. MEHC's stand-alone credit profile is not adequate to ensure PacifiCorp's long-term financial health.

Q. WILL PACIFICORP'S FINANCIAL STABILITY POTENTIALLY CHANGE AS A RESULT OF THE TRANSACTION?

A. Yes. ScottishPower has a stronger credit rating and a stronger balance sheet than does MEHC. ScottishPower's Standard & Poor's ("S&P") bond rating is A-, which is a full rating category higher than MEHC's BBB- S&P rating. Also, ScottishPower's common equity ratio of total capital (including short-term debt) is 48%. This common equity ratio is significantly higher than the 28.6% common equity ratio proposed for MEHC after its acquisition of PacifiCorp.[1/]

Consequently, to the extent PacifiCorp's credit rating is impacted by its affiliation with its parent company, its access to capital under MEHC ownership may be weaker, and its borrowing cost may be at higher prices and at terms and conditions that are not as favorable as they are under continued ScottishPower ownership.

Of course, Berkshire Hathaway's commitment to MEHC may mitigate this concern, but as noted above, and as described in more detail below, Berkshire Hathaway's long-term commitment is not backed by an irrevocable pledge or contractual obligation, and is therefore subject to change. As such, PacifiCorp's ability to attract capital over the long term may not be as favorable under the proposed transaction, and it may be at higher cost than under continued ownership by ScottishPower.

Q. PLEASE DESCRIBE WHY MEHC COULD THREATEN PACIFICORP'S FINANCIAL STABILITY IF THE TRANSACTION IS APPROVED.

A. Under the proposed transaction, MEHC represents PacifiCorp's only access to external common equity capital. Consequently, MEHC's financial health and access to capital is critical in a review of PacifiCorp's financial stability if the transaction is approved.

If MEHC is unable to attract capital on its own, it will not be able to provide PacifiCorp with equity infusions. An inability to attract additional external equity capital could cause PacifiCorp's own credit to erode and may prevent it from accessing external debt markets if it is not able to balance its capital structure with a reasonable mix of debt

[1/] Exh. No. __ (PGJ-1T) at 5 (Goodman Direct).

and equity capital. This, in turn, could prevent PacifiCorp from attracting capital needed to fund utility capital expenditures and debt retirements.

Q. WHY IS MEHC'S ACCESS TO CAPITAL A CONCERN?

A. MEHC is a highly leveraged holding company with minimum investment grade rating from all major credit rating agencies.[2/] MEHC's consolidated capital structure prior to its acquisition of PacifiCorp is composed of 77% debt.[3/]

MEHC's stand-alone ability to support PacifiCorp is tenuous, largely because of its highly leveraged capital structure and its minimum investment bond rating. In addition, MEHC and its subsidiaries are currently facing significant capital demands related to funding large capital expenditures in its existing utility subsidiaries and meeting significant debt retirements through 2009. All of these factors could significantly impede MEHC's stand-alone ability to provide adequate capital support to PacifiCorp.

MEHC's weak stand-alone financial condition is offset by a commitment by Berkshire Hathaway to make significant capital investments into MEHC. However, the long-term direction of Berkshire Hathaway's commitment to MEHC is unclear and does not provide adequate assurance that MEHC will be able to properly support PacifiCorp.

Q. PLEASE DESCRIBE MEHC'S NEAR-TERM CAPITAL OBLIGATIONS TO SUPPORT ITS EXISTING OUTSTANDING DEBT AND UTILITY OPERATIONS.

A. MEHC has other significant capital expenditure obligations at its operating utility subsidiaries. These financial obligations include funding capital expenditures, operating projects, and large construction programs of more than $2.0 billion in 2005.[4/]

[2/] Id. at 7.

Also, MEHC and its subsidiaries must fund over $5 billion of scheduled debt retirements through 2009.[5/] These capital commitments over the next five years total approximately 36% of MEHC's total long-term capital of $13.9 billion.[6/]

On a parent company stand-alone basis, MEHC also faces significant capital demands. Specifically, MEHC faces parent company debt retirements over the next five years of approximately $1.5 billion.[7/] Also, MEHC's acquisition capital is very expensive and creates a significant annual capital cost. MEHC's parent company's subordinated debt interest rate is as high as 11%, and these securities will not begin to retire until year 2010. MEHC has approximately $1.6 billion of acquisition-related capital in calendar year 2005.[8/] On a stand-alone parent company basis, MEHC faces significant debt retirements and capital servicing costs over the next five years.

MEHC's ability to produce revenue to service its debt retirements and capital cost is derived entirely by dividend receipts from its operating utility affiliates. Further, MEHC's consolidated financial statement shows that all the operating revenue produced at MEHC is derived entirely from its operating utility affiliates.[9/] Accordingly, MEHC's only ability to service parent company debt retirement obligations and to meet its expensive acquisition capital costs is derived from dividend payments from its operating utility affiliates.

MEHC's ability to access capital markets is critical for it to meet its obligations to its current operating utility affiliates and fund maturing debt.

3/ Id. at 5.
4/ Id. at 47.
5/ Exh. No. __ (PJG-4) at 81.
6/ Exh. No. __ (PJG-1T) at 5 (Goodman Direct).
7/ Exh. No. __ (PJG-4) at 51.
8/ Id. at 76.

Q. WOULD MEHC'S ABILITY TO MEET ALL THESE CAPITAL OBLIGATIONS BE IMPAIRED IF ITS BOND RATING WERE DOWNGRADED TO BELOW INVESTMENT GRADE?

A. Yes. A single negative credit rating downgrade of MEHC would push it to below investment grade. Losing an investment grade bond rating could severely impair MEHC's ability to attract capital, or at an absolute minimum, could significantly increase its cost of capital and require it to accept less favorable terms and conditions in security issuances. This is significant because MEHC currently plans to access debt markets to supplement internal cash flow in order to meet the capital expenditure and debt refinancing obligations noted above.[10/]

Concerning a possible credit downgrade, MEHC states that it does not have any credit agreements that require termination or material change in collateral requirements repayment schedules in the event of a downgrade in its credit ratings. However, it does note that in conjunction with its wholesale marketing and trading activities MEHC must meet credit quality standards required by counterparties. MEHC states that if its credit rating declines below investment grade, it may be required to post-cash collateral, letters of credit, or other similar credit support to facilitate ongoing wholesale marketing and trading activities. Under such a circumstance, MidAmerican estimates that its potential collateral requirements would be approximately $151 million[11/], which is more than twice the amount of its current letter of credit commitments.[12/]

9/ Exh. No. __ (PJG-4) at 40.
10/ Id. at 47.
11/ Id. at 50.
12/ Id. at 74.

For all of these reasons, MEHC's current weak credit standing and significant capital obligations place it at significant risk of not being able to meet all of its capital obligations going forward without continued capital support from Berkshire Hathaway.

Q. PLEASE DESCRIBE THE CREDIT RATING AGENCY'S STATEMENTS CONCERNING MEHC'S CURRENT CREDIT STANDING.

A. S&P and Moody's have both expressed concern about MEHC's potential access to capital. Attached as Exhibit ICNU/202 (Exh. No.__(MPG-3)) is a September 2005 S&P Report that stated:

> Standard & Poor's ratings on MEHC reflect the company's ability to meet its financial obligations from dividend distributions from its diverse portfolio of energy assets. The company's creditworthiness is ultimately derived from the total quality of the residual distributions from these subsidiaries. Standard & Poor's has made this analytical judgment based on MEHC's extensive use of nonrecourse project financing, limited interdependency among the individual business units, **and the perception that MEHC would abandon equity investments when the economics of the stand-alone business unit so dictate**.
>
> MEHC will need to maintain its access to capital markets, as it has some large maturities to fund in the coming years. Maturities at the parent over the next five years include trust-preferred redemptions of $189 million in 2005 and $234 million each year through 2009. MEHC will also have debt maturities of $260 million in September 2005, zero in 2006, $550 million in 2007, $1 billion in 2008, and zero in 2009. MEHC has adequate cash on hand to fund these maturities. MEHC has no ratings triggers embedded in its financing documents.

In addition, in June 2005, Moody's affirmed its Baa3 senior unsecured rating for MEHC, and noted the following credit strengths and credit challenges facing MEHC:

> **OWNERSHIP AND BUSINESS ORGANIZATIONAL STRUCTURE PROVIDES DEGREE OF FINANCIAL AND OPERATIONAL FLEXIBILITY**
> Moody's views the increased investment by majority owner Berkshire Hathaway to be a favorable indication of the company's continuing commitment to MEHC and the energy sector. It is expected that additional equity down streamed to MEHC will represent a substantial majority of the cash requirements for the acquisition of PacifiCorp. In

> addition, the terms of the existing zero coupon convertible preferred stock, which was designed to prevent Berkshire Hathaway from becoming subject to the Public Utility Holding Company Act (PUHCA), provides for its conversion to common equity in the event that PUHCA were to be repealed by Congressional legislation. We also view the existing substantial investment by the majority owner in the form of parent company subordinated debt to be predominately equity-like given the unique characteristics of this instrument. The interest on the instrument is deferrable at MEHC's option for up to five years, and the ownership of the subordinated debt cannot be transferred.
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> * * *
>
> **HIGH CONSOLIDATED LEVERAGE AS A RESULT OF ACQUISITION ACTIVITY**
> The Baa3 senior unsecured rating also considers the large parent debt burden resulting from debt-financed acquisitions.
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> * * *
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> **LARGE CAPITAL EXPENDITURES AT MEC IN THE NEXT SEVERAL YEARS FOR GENERATION CONSTRUCTION**[13/]

Q. SHOULD THE COMMISSION BE CONCERNED ABOUT BERKSHIRE HATHAWAY'S LONG-TERM COMMITMENT TO MEHC?

A. Yes. I am not aware of any Berkshire Hathaway guarantees that it will provide MEHC with needed capital funding. However, Berkshire Hathaway's commitment to MEHC has been noted by credit rating agencies. Specifically, S&P has noted that since 2000, Berkshire Hathaway has invested nearly $3.4 billion into MEHC, and that Berkshire Hathaway's Chairman and CEO, Warren Buffett, has stated willingness to commit up to $10 to $15 billion in MEHC for investments in the U.S. electric industry. S&P also notes that Berkshire Hathaway is expected to make a large equity-like contribution to MEHC for its acquisition of PacifiCorp.[14/] If the Berkshire Hathaway equity investments are not

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13/ Exh. No. __ (MPG-3) at 5.
14/ Id. at 2.

made, MEHC's credit rating could be lowered to below investment grade, impairing MEHC's ability to meet its significant capital obligations.

Since Berkshire Hathaway's commitments are not firm or contractual, it would be speculative and inappropriate to count on these promises, especially since failure to follow through with the planned acquisition equity funding could severely impact MEHC's financial strength and its ability to support PacifiCorp.

Q. HOW COULD PACIFICORP BE IMPACTED IF MEHC IS NOT ABLE TO SUPPORT ITS CAPITAL PROGRAM?

A. S&P has already placed PacifiCorp's credit rating on watch with negative implications because of the proposed merger.[15/] Further, in reviewing MEHC's credit rating, S&P has stated clearly that it expects Berkshire Hathaway to make significant equity contributions to MEHC to allow MEHC to fund its acquisition of PacifiCorp. If Berkshire Hathaway does not meet these expectations, both MEHC's and PacifiCorp's credit ratings could be negatively impacted.

Concerns about the final financing arrangements for MEHC's proposed acquisition of PacifiCorp are significant because the Applicants have not finalized their funding plan to complete the transaction. The expectation is for Berkshire Hathaway to make a $3.4 billion equity infusion into MEHC (either common stock or preferred equity), and the remainder would be funded by $1.7 billion of debt (either third-party market debt issuance or Berkshire Hathaway loans), with the final funding plan and security issuances to be determined by the Applicants at the time of closing. Also of importance is the Applicants' acknowledgement that there is no contractual or legal obligation for Berkshire Hathaway to comply with the expected funding plan.

Accordingly, PacifiCorp's credit rating could be threatened at the outset of the proposed transaction if the funding plan used by MEHC to acquire PacifiCorp increases MEHC's leverage more than anticipated in the Company's filing.

If MEHC's credit rating is negatively impacted, its bond rating could fall to below investment grade, which could severely limit its liquidity at a time when it has significant capital obligations.

PacifiCorp could be detrimentally impacted by a below investment grade parent company because PacifiCorp currently has plans for over $1 billion a year of capital improvements to its utility systems.[16/] If PacifiCorp's credit rating is eroded and it cannot rely on equity capital from its parent company, PacifiCorp's ability to fund this significant capital expenditure program could be severely eroded or its cost of capital could increase, possibly significantly. Further, PacifiCorp may have to scale back its capital expenditures because its access to capital may be constrained by a credit-weak parent company and an inability to attract external equity capital and thus maintain a capital structure with a reasonable mix of debt and equity.

Q. HAVE CREDIT ANALYSTS EXPRESSED A CONCERN ABOUT POSSIBLE LONG-TERM CHANGES TO BERKSHIRE HATHAWAY'S CORPORATE CULTURE AND INVESTMENT STRATEGY?

A. Yes. In 2003, Moody's issued a reporting stating:

> **EXTRAORDINARY INFLUENCE OF CHAIRMAN DRIVES CORPORATE CULTURE**
>
> Berkshire Hathaway operates on a decentralized basis, with managers of the individual business units empowered to make operating decisions for their respective business. Warren E. Buffett, the chairman of Berkshire's Board of Directors, in consultation with Charles T. Munger, vice

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15/ Exh. No.__(MPG-4) at 1.
16/ Exh. No. __ (PJG-1T) at 13 (Goodman Direct).

> chairman of the Board, makes investment and capital management decisions for the group. Mr. Buffett, together with other members of his family, owns approximately 38% of Berkshire's stock (by aggregate voting power).
>
> **<u>Because of the substantial ownership interest and enormous influence of the Chairman, governance issues are of particular interest to creditors of the group</u>**. Moody's expects that the organization's historically conservative operating philosophy will prevail over the medium term, but we believe that **<u>succession to the chairman's position could have significant implications for the governance and future business strategy and, therefore, the rating of Berkshire Hathaway</u>**.[17/]

More recently, Fitch Ratings has also stated concern about the long-term management of Berkshire Hathaway, and its direction after Mr. Buffett retires. Specifically, Fitch Ratings states as follows:

> Berkshire's ratings are based primarily on Berkshire's exceptionally strong capitalization, as well as its diversified sources of earnings, substantial financial flexibility, and the strong operating performance of its primary insurance and noninsurance subsidiaries. **<u>The Negative Rating Outlook is driven by the very high level of "key person risk" at Berkshire, which is placing increasing pressure on its ratings, and, to a lesser extent, Berkshire's increased use of debt to fund finance subsidiaries</u>**. Fitch's ratings of Berkshire also consider current investigations by the New York Attorney General's Office and the SEC into nontraditional or loss mitigation insurance products (commonly called finite risk reinsurance).
>
> The ratings also consider Berkshire's catastrophe excess of loss exposures, as well as Berkshire's appetite for acquisitions.
>
> Berkshire has an outstanding long-term success record that Fitch attributes in great part to the talents of Mr. Buffett. Mr. Buffett's reputation with shareholders allows the company to adopt strategies and accumulate capital in ways that would generally not be accepted at other public companies. Such unique attributes include Berkshire's historic concentrated investments in a limited number of equity securities and its current maintenance of a $40 billion cash position. Although the 74-year-old Mr. Buffett is reportedly in good health and has expressed no intention of retiring, Fitch does not believe that Mr. Buffett's talents can be easily replaced, or that Berkshire's current strategies would be sustainable in his

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17/ Exh. No.__(MPG-5) at 2 (excerpt).

> absence. Thus, Fitch believes it is unlikely that Berkshire would be able to operate with the attributes that have historically allowed it to achieve 'AAA' ratings after the inevitable departure of Mr. Buffett. Berkshire has not made its succession plans public, **nor has it indicated if its operational, investment, acquisition, or capital strategies would change under the next generation of management**.[18]

MEHC'S COMMON EQUITY RATIO COMMITMENT TO PACIFICORP

Q. MEHC HAS COMMITTED THAT PACIFICORP WILL NOT PAY DIVIDENDS UP TO ITS PARENT COMPANY, IF ITS COMMON EQUITY RATIO FALLS BELOW 40%. WILL THIS COMMITMENT MITIGATE ANY OF THE FINANCIAL INTEGRITY IMPLICATIONS YOU DESCRIBED ABOVE?

A. No. While PacifiCorp may be able to retain earnings in order to meet common equity capital requirements, it would not provide PacifiCorp with an access to external common equity to meet potentially large capital expenditure requirements while maintaining a balanced PacifiCorp capital structure.

Q. CAN MEHC MANIPULATE THE COMMON EQUITY RATIO BENCHMARK IN ORDER TO HELP PACIFICORP TO CONTINUE TO PAY DIVIDENDS TO MEHC?

A. Yes. MEHC commits to precluding PacifiCorp from paying dividends up to its parent company in the event its common equity ratio falls below 40%. However, MEHC would measure the common equity ratio as the product of common equity capital, divided by total long-term capital, composed of preferred equity capital, long-term debt, and common equity.[19]

Notably missing from this equity ratio calculation is short-term debt. In the event MEHC needed cash distributions from PacifiCorp to satisfy its own capital demands, it could require PacifiCorp to begin using short-term debt to pay down long-term debt in

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[18] Id. at 7, 8-9 (emphasis added).
[19] Exh. No. __ (JPG-1T) at 15 (Goodman Direct).

order to artificially increase its common equity ratio calculated in accordance with MEHC's proposed formula.

Hence, I recommend that the Commission require a minimum common equity ratio target to be the product of common equity capital divided by total capital, including both short-term, long-term debt, preferred equity, and common equity. Further, to the extent the Company would rely on any other unconventional capital source to fund assets included in rate base or construction work in progress, these funding sources should also be included in the development of the minimum common equity ratio benchmark.

MEHC'S ABILITY TO RELIABLY OPERATE PACIFICORP

Q. HOW DOES MEHC PLAN TO ENSURE PACIFICORP'S RELIABLE OPERATION IF THE ACQUISITION IS APPROVED?

A. PacifiCorp's current CEO and president, Judi Johansen, states that MEHC intends to retain PacifiCorp's current management team.[20/] Accordingly, the reliable operation of PacifiCorp will largely be dependent on MEHC's ability to retain PacifiCorp's current management team or attract experienced utility managers that are capable of fulfilling this responsibility.

I recommend that the Commission direct MEHC to demonstrate its ability to retain PacifiCorp's current management team or replace it with an experienced and capable management team in order to ensure that PacifiCorp's operations are carried out in a safe, reliable, and competent manner. This is a critical disclosure to verify that MEHC will be able to competently and reliably operate PacifiCorp's utility system.

RATE STABILITY OF THE PROPOSED TRANSACTION

Q. IS MEHC PROPOSING FREQUENT RATE CHANGES FOR PACIFICORP'S CUSTOMERS UNDER THE PROPOSED TRANSACTION?

A. Ms. Johansen estimates that PacifiCorp's rate will have to increase by 4% for the foreseeable future in order to support PacifiCorp's increased cost of service, including its large capital expenditure program.[21]

Q. WILL PACIFICORP'S RETAIL CUSTOMERS POTENTIALLY EXPERIENCE GREATER RATE INSTABILITY OR GREATER RATE INCREASE PRESSURE UNDER MEHC OWNERSHIP AS COMPARED TO THE STATUS QUO?

A. Most likely, yes. While utility rates are typically set to fully recover the utility's cost of service, MEHC will have an added incentive to try to increase rates, and thus, ensure PacifiCorp can meet expected cash distribution to MEHC. This incentive would come from MEHC's very high debt leverage structure and the need to extract cash flows from its operating utility affiliates in order to service its significant debt obligations.

As noted above, MEHC's consolidated capital structure is projected to contain approximately 70% debt after the acquisition of PacifiCorp. Further, MEHC parent company debt retirement and cost of capital obligations are very significant. The cash flow available to MEHC to support this significant capital obligation is limited to dividend distributions from its utility affiliates. Accordingly, extracting significant cash from its operating utility affiliates to meet its significant debt service obligations is critical to MEHC. Thus, MEHC will have an incentive to aggressively increase retail rates in order to maximize its cash flow receipts from utility affiliates.

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[20] Exh. No. __ (JAH-1T) at 10 (Johansen Direct).
[21] Id. at 7.

Q. IF THE TRANSACTION IS APPROVED, SHOULD THE COMMISSION BE ESPECIALLY CONCERNED ABOUT HOW MEHC CAPITALIZES PACIFICORP?

A. Yes. As noted in the proposed acquisition funding plan, approximately $1.7 billion of the $5.1 billion required for purchase of PacifiCorp's equity will be funded by issuance of external debt. Thus, it is clear that MEHC will use debt financing to make equity contributions into PacifiCorp. This is of concern for at least two reasons. First, MEHC could effectively arbitrage a debt issuance by using the proceeds to make equity investments in PacifiCorp. Since PacifiCorp's authorized return on equity investments will almost certainly be higher than MEHC's cost of debt, MEHC could increase its profit by issuing debt securities to make equity contributions to PacifiCorp. For example, assume that MEHC's cost of debt is 4%, and it makes an equity contribution into PacifiCorp of $100 million. If PacifiCorp's authorized return on equity was 10%, then PacifiCorp would be permitted to earn after-tax earnings of $10 million, and MEHC's debt interest cost would be $4 million. Hence, using the debt proceeds to make equity infusions into PacifiCorp would increase cash flows available to MEHC by approximately $6 million.

Second, by increasing PacifiCorp's common equity ratio of total capital, MEHC could increase PacifiCorp's cost of service, retail rates, and cash flow from retail operations. Increasing PacifiCorp's overall cost of capital and internal cash flows could then increase PacifiCorp's cash distribution to MEHC, which would in turn support MEHC's significant debt obligations.

Consequently, while PacifiCorp's capital structure may not be managed to minimize its overall rate of return, it could be manipulated to enhance PacifiCorp's earnings and cash flows and its dividend distributions to MEHC. This is of course at odds with PacifiCorp's obligation to provide least cost, high quality utility service.

PACIFICORP'S COST OF SERVICE IMPLICATIONS

Q. PLEASE OUTLINE THE PROPOSED TRANSACTION'S POTENTIAL IMPACT ON PACIFICORP'S COST OF SERVICE.

A. Considerations for PacifiCorp's cost of service based on the proposed transaction include the following:

1. Under what circumstances will PacifiCorp attempt to seek recovery of the acquisition premium?
2. What is the potential impact on PacifiCorp's overall cost of capital?
3. What is the impact on PacifiCorp's allocated share of the parent company's affiliate service cost?
4. What is the potential impact on ensuring least cost public utility service coincident with Senate Bill 408 in the state of Oregon?

Q. HAS THE COMPANY PROPOSED TO SEEK RECOVERY OF THE ACQUISITION PREMIUM FROM PACIFICORP'S RETAIL CUSTOMERS?

A. Mr. Goodman states that MEHC will not propose to recover the acquisition premium, which is estimated to be $1.2 billion in PacifiCorp's retail rates, provided that in rate orders subsequent to the completion of the transaction, PacifiCorp's retail revenue requirements do not include merger-related benefits other than those pledged by MEHC. If PacifiCorp's revenue requirements <u>do</u> include other merger-related benefits, Mr. Goodman states that MEHC and PacifiCorp may request in rate hearings a symmetrical adjustment to recognize the acquisition premium in retail revenue requirements. This is in effect a hammer MEHC seeks to hold over customers in an attempt to limit their positions in rate cases.

Q. DO YOU BELIEVE IT IS APPROPRIATE UNDER THIS SO-CALLED MATCHING OR SYMMETRICAL ADJUSTMENT CONCEPT TO CHARGE RATEPAYERS FOR AN ACQUISITION PREMIUM OR GOODWILL?

A. Absolutely not. ScottishPower agreed to a condition of its acquisition of PacifiCorp that it will never seek to recover this premium from customers.[22/] Elimination of this condition, combined with the assertion that MEHC may, at some time, seek recovery of an acquisition premium, results in harm to customers.

Q. IS IT APPROPRIATE FOR MEHC AND PACIFICORP TO LEAVE OPEN ITS ABILITY TO SEEK RECOVERY OF THE $1.2 BILLION ACQUISITION PREMIUM IN RETAIL RATES?

A. No. I recommend that the Commission reject in this proceeding the concept of recovering any amount of the acquisition adjustment in future regulated rates. This is particularly true since neither MEHC nor PacifiCorp has identified any explicit verifiable long-term savings created by MEHC's proposed acquisition of PacifiCorp.

Further, the record in this case clearly establishes that the proposed acquisition is intended to enhance MEHC's value as part of Berkshire Hathaway's strategic focus to make significant investments in the U.S. electric utility industry. While this has strategic value to MEHC and its primary investor, Berkshire Hathaway, the proposed acquisition provides little or no overall benefits to PacifiCorp and its retail customers. In fact, given the double-leveraged nature of this transaction, as discussed above, I believe customers will be harmed under this transaction as compared to ownership under the status quo.

Therefore, MEHC and PacifiCorp should not be allowed the opportunity to complicate future rate cases by requesting to recover a significant acquisition premium in future rates. Consequently, if the Commission approves this acquisition, it should

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[22/] Re ScottishPower, WUTC Docket No. UE-981627, Fifth Supp. Order, Stipulation at 3 (Oct. 14, 1999).

explicitly reject MEHC's proposal to allow any portion of the acquisition premium to be recovered in rates from PacifiCorp's customers.

Q. IF THE COMMISSION APPROVES THE ACQUISITION, SHOULD IT CLEARLY STATE THAT MEHC AND PACIFICORP WILL NOT BE PERMITTED TO RECOVER INCOME TAX EXPENSE IN RETAIL REVENUE REQUIREMENTS TO THE EXTENT THOSE TAXES ARE NOT PAID TO STATE AND FEDERAL TAXING AUTHORITIES?

A. Yes. Retail customers should only be obligated to pay PacifiCorp's income tax expenses to the extent that PacifiCorp actually pays income tax to federal and state taxing authorities. If ScottishPower or MEHC implements legal tax sheltering financial corporate structures that reduce or eliminate PacifiCorp's income tax payable on the earnings produced from utility operations, then the revenue requirements establishing retail rates should not include income tax expense that will not be payable to taxing authorities.

Q. WHAT ARE MEHC'S PLEDGED BENEFITS OF THE TRANSACTION?

A. The primary revenue requirement benefits pledged to PacifiCorp include a five-year guaranteed ten basis point reduced cost of marginal debt. This claimed benefit amounts to savings of $6.3 million over five years.[23/] The second claimed benefit relates to reduced service company fees. MEHC asserts that reduced service company costs will lower PacifiCorp's cost of service by $5.0 million per year.[24/] MEHC estimates that PacifiCorp's customers will pay lower service company costs if the merger is approved.

[23/] Exh. No. __ (JPG-1T) at 9 (Goodman Direct).
[24/] Exh. No. __ (TBS-1T) at 11 (Specker Direct).

Q. WHY HAVE YOU CONCLUDED THAT MEHC'S PLEDGE OF A 10 BASIS POINT INCREMENTAL DEBT SAVINGS TO PACIFICORP IS NOT SIGNIFICANT?

A. MEHC and PacifiCorp's pledge in this respect does not establish whether there are any real savings to PacifiCorp created by the proposed merger. The relevant issue is whether PacifiCorp's cost of capital will be lower under MEHC ownership, not merely whether its cost of debt would be lower under the strict terms pledged by MEHC. In other words, the pledge is a red herring because it does not clearly establish any savings to PacifiCorp created by the proposed transaction.

Q. PLEASE EXPLAIN.

A. MEHC proposed that the debt interest savings pledge be measured as the difference between PacifiCorp's marginal cost of debt compared to the marginal cost of debt of other utility companies with similar bond ratings. However, the relevant issue here is whether PacifiCorp's bond rating will be maintained, improved, or weakened under MEHC's ownership relative to the status quo. If PacifiCorp's credit rating is at all negatively affected by the transaction, the credit erosion could have a much higher cost impact on PacifiCorp's cost of debt than the promised incremental debt cost savings.

Q. DOES MEHC WITNESS GOODMAN RECOGNIZE THAT THE PROPOSED ACQUISITION COULD CAUSE A REDUCTION IN PACIFICORP'S CREDIT RATING?

A. Yes. Mr. Goodman notes at page 10 of his testimony that S&P has placed PacifiCorp's credit rating on credit watch with negative implications. S&P is concerned about PacifiCorp's weaker stand-alone credit metrics. In a May 25, 2005 report, S&P Rating Service placed PacifiCorp on credit watch with positive implications and put MEHC on credit watch with positive implications due to the proposed acquisition announcement.

S&P states that PacifiCorp's credit rating is based on ScottishPower's consolidated credit profile, which is weaker than PacifiCorp's stand-alone credit metrics. S&P also states that PacifiCorp's credit rating following completion of the transaction will be assessed based on the financing structure of the acquisition and MEHC's resulting consolidated credit worthiness, the benefit of any ring-fencing mechanisms that MEHC structures around PacifiCorp, and the Utility's stand-alone credit metrics.[25/]

Q. HAS MEHC WITNESS GOODMAN RECOGNIZED THAT IF PACIFICORP'S CREDIT RATING IS DOWNGRADED BECAUSE OF THE ACQUISITION, THERE WILL BE AN INCREASE IN PACIFICORP'S COST OF DEBT?

A. Yes. Mr. Goodman estimates that a one-notch credit downgrade to PacifiCorp's credit rating would increase PacifiCorp's cost of borrowing by 10 to 15 basis points. He stated that if S&P alone downgraded PacifiCorp, that would increase PacifiCorp's cost of borrowing by approximately 5 basis points. Indeed, PacifiCorp's cost of debt could increase as a result of the proposed acquisition.

Furthermore, if PacifiCorp's credit rating is downgraded as a result of the acquisition, this could not only increase its marginal cost of debt relative to the status quo, but it could make PacifiCorp's borrowing terms and conditions more onerous. For example, a reduced credit rating may prevent PacifiCorp from issuing bonds that are callable or require it to issue bonds with a shorter term to maturity. The non-callable bonds will place PacifiCorp at greater risk of being locked out of a declining interest rate market. Moreover, issuing bonds with shorter maturities places PacifiCorp at greater risk of higher market interest costs. Hence, more onerous terms and conditions on bond issuance increases PacifiCorp's interest rate and refinancing risks.

[25/] Exh. No.__(MPG-4) at 1.

Q. IS THE PLEDGED DEBT INTEREST COST SAVINGS SIGNIFICANT?

A. No. MEHC estimates this savings to PacifiCorp to be $6.2 million over five years, or roughly $1.2 million per year. Still, this small annual savings will not be passed through to customers until after PacifiCorp changes its retail rates.

As described above, there is significant uncertainty as to whether MEHC can support PacifiCorp's long-term financial integrity. Hence, this potential risk to PacifiCorp far outweighs the very small debt cost savings estimated.

Q. CAN THE PLEDGED DEBT INTEREST SAVINGS BE VERIFIED IN A FUTURE RATE PROCEEDING?

A. No. It would be very difficult to verify whether PacifiCorp's actual cost of debt has declined due to the acquisition. Hence, it would be very difficult to determine whether MEHC has actually achieved its objective of reducing PacifiCorp's marginal cost of debt. PacifiCorp's cost of debt can be impacted by many factors, including the security's terms and conditions, duration, and call/put provisions. It would be an extremely difficult and very complicated analysis to review all debt issues issued by other similar rated utility companies to validate the claimed debt cost savings.

Q. IS MEHC'S CLAIM FOR REDUCTION IN SERVICE COMPANY FEES VALID?

A. The estimated reduction of PacifiCorp's service company fees was based on MEHC's understanding of ScottishPower's charges to PacifiCorp, in comparison to the capped charges proposed by MEHC. Importantly, MEHC has not undertaken a review of the amount of service company charges that have actually been permitted to be recovered in PacifiCorp's retail rates. Hence, MEHC has not established whether its proposed service company fees are lower than those built in PacifiCorp's retail rates. Accordingly, the Company's claim that retail ratepayers will benefit through reduced service company fees has not been clearly established, and this claimed benefit for PacifiCorp's retail customers is without merit.

Q. ARE THERE OTHER FACTORS THAT PLACE SIGNIFICANT DOUBT AND UNCERTAINTY ON MEHC'S PROPOSED REDUCTION IN PACIFICORP'S SERVICE COMPANY CHARGES?

A. Yes. First, the proposal to cap service company fees at $9 million over the next five years will not benefit retail customers unless retail rates are changed to reflect this alleged reduction in PacifiCorp's service company costs. Specifically, MEHC has not committed to a PacifiCorp rate reduction as part of this filing. Hence, customers will not receive any of this claimed five-year temporary service company benefit unless rates are changed to modify PacifiCorp's cost structure in retail rates.

Second, and more importantly, the temporary commitment is not a guarantee that MEHC service company charges to PacifiCorp will be lower than current charges after year five. The bottom line is that, over time, MEHC's service company costs may increase dramatically as it gains experience on exactly on what it is going to take to provide PacifiCorp the corporate services it needs for day-to-day executive, regulatory, accounting, planning, and legal services. As such, there may be little to no long-term savings of corporate service fees for PacifiCorp.

This is evident in the fact that MEHC's claimed reduction in corporate service company costs is a relatively small portion of the amount of service company fees currently built into PacifiCorp's retail rates. Specifically, as I understand it, retail rates in Oregon were based on $11.4 million service company fees, which is only approximately 20% higher than MEHC's estimated corporate service cost of just under $9.5 million.[26/]

[26/] Exh. No. __ (TBS-1T) at 11 (Specker Direct).

Also, the $11.4 million is not a net number; in other words, it does not reflect the revenue PacifiCorp receives from ScottishPower. Finally, MEHC has not factored in the portion of charges that would be attributed to PPM. Hence, MEHC's claimed reduction in corporate service costs is a rather meager reduction from PacifiCorp's actual service company fees recovered in retail rates. Again, as MEHC gains experience on what actually it's going to take to operate PacifiCorp, its estimated service fees may increase.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes.