BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PACIFICORP d/b/a PACIFIC POWER & LIGHT COMPANY Respondent.	)	**Docket No. UE-050684** **Docket No. UE-050412** *(consolidated)*

SUPPLEMENTAL TESTIMONY OF

MICHAEL P. GORMAN

ON BEHALF OF

THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES

January 27, 2006

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. I am the same Michael Gorman who previously submitted direct testimony in this proceeding. I have included an updated version of my qualification in Exhibit No.__ (MPG-21).

Q. WHAT IS THE PURPOSE OF YOUR SUPPLEMENTAL TESTIMONY?

A. I will respond to the Washington Utilities and Transportation Commission's ("WUTC") request for information concerning the potential impact of PacifiCorp's cost of capital created by MidAmerican Energy Holdings Company's ("MEHC") proposed acquisition of PacifiCorp.

Second, I will respond to certain aspects of PacifiCorp witness Mr. James A. Vander Weide's direct testimony that was filed in January 2006.

COST OF CAPITAL

Q. WHAT IS THE POTENTIAL IMPACT OF PACIFICORP'S COST OF CAPITAL IF IT IS ACQUIRED BY MEHC?

A. The exact impact of PacifiCorp's cost of capital from being acquired by MEHC is not yet known. However, there are several factors that could significantly change PacifiCorp's cost of capital after it is acquired by MEHC, which could impact its cost of service during the period rates will be in effect. These factors include the following. First, PacifiCorp's reliance on short-term borrowings and its amount of off-balance sheet debt equivalence will be impacted. These are factors in dispute in this proceeding that concern PacifiCorp's capital structure. These factors may significantly change PacifiCorp's capital structure supporting its utility rate base after MEHC's acquisition, compared to the capital structure proposed by PacifiCorp in this proceeding. However, again, ultimate determinations of an appropriate capital structure for PacifiCorp post-acquisition cannot be made at this time.

Second, PacifiCorp's actual operating risk and affiliation risk will be impacted by the proposed acquisition.

Q. COULD THE ACQUISITION RESULT IN PACIFICORP'S RATEMAKING COST OF CAPITAL BEING HIGHER AS A RESULT OF ITS ACQUISITION BY MEHC?

A. No. In PacifiCorp and MEHC's stipulated settlement with the major stakeholders in Oregon and Washington, and included in commitments to all state jurisdictions under Commitment No. 21, MEHC and PacifiCorp have committed that PacifiCorp will not advocate for a higher cost of capital as compared to what PacifiCorp's cost of capital would have been using Commission standards absent MEHC's ownership. This commitment indicates that PacifiCorp's cost of capital for ratemaking purposes would not be higher than it otherwise would have been absent MEHC's acquisition of PacifiCorp. Hence, the major considerations here are whether there are aspects of the acquisition that would reduce PacifiCorp's cost of capital as a result of the acquisition.

Q. WHY DO YOU BELIEVE THAT PACIFICORP'S CAPITAL STRUCTURE SUPPORTING ITS UTILITY OPERATIONS MAY BE SIGNIFICANTLY IMPACTED BY THE ACQUISITION?

A. While it is not precisely known at this time, it is likely that PacifiCorp's capital structure and capital structure management could change after the acquisition. Indeed, based on the settlement agreements in Washington, MEHC will have the incentive to require PacifiCorp to place a greater reliance on short-term borrowings in the future than it has in the past, thus potentially driving down its ratio of common equity to total capital. This could impact PacifiCorp's ratemaking capital structure supporting its rate base and reduce its overall rate of return.

Further, this greater leveraged ratemaking capital structure would continue to support PacifiCorp's bond rating because the acquisition will also likely reduce PacifiCorp's off-balance sheet debt equivalence.

The bottom line is that these actions could reduce PacifiCorp's overall rate of return, while preserving its credit rating.

Q. PLEASE EXPLAIN WHY CERTAIN OF PACIFICORP/MEHC'S SETTLEMENT CONDITIONS WILL INCENT MEHC TO REQUIRE PACIFICORP TO USE GREATER AMOUNTS OF SHORT-TERM DEBT.

A. PacifiCorp's actual financing decisions after the acquisition are not yet known. However, in PacifiCorp/MEHC's settlement with the stakeholders in Washington, it made certain commitments applicable to all states, which was attached to the stipulated settlement as Appendix A. Commitment No. 18A of these commitments to all states include a ring fencing provision that requires PacifiCorp to maintain a common equity ratio greater than specified targets. If PacifiCorp fails to comply with equity ratio targets, it is precluded from making dividend payments to PPW Holdings LLC or MEHC.[1/] This minimum common equity ratio is calculated excluding short-term debt from the equation. Hence, PacifiCorp can significantly increase its reliance on short-term debt without eroding its common equity ratio to total capital and reducing its risk of being precluded from paying dividends to PPW Holdings and/or MEHC.

[1/] MEHC and PacifiCorp agree to maintain PacifiCorp's common equity ratio at 48.25% through 2008, with progressively decreasing common equity targets down to 44.0% after 2011.

Q. DOES MEHC HAVE AN INCENTIVE TO TAKE STEPS TO ENSURE IT RECEIVES DIVIDENDS FROM PACIFICORP?

A. Yes. MEHC is significantly leveraged, and its only source of cash flow to service its significant debt obligations are dividend receipts from its utility affiliate companies. Hence, MEHC has significant incentives to take measures that improve the likelihood that its utility affiliates will continue to pay dividends up to MEHC, thus, allowing it to service its debt obligations.

For these reasons, it is likely that MEHC would encourage PacifiCorp to use greater amounts of short-term debt to prevent PacifiCorp's common equity ratio from falling below the minimum common equity ratio, and then preclude PacifiCorp from paying dividends to MEHC.

Q. PLEASE EXPLAIN WHY PACIFICORP'S OFF-BALANCE SHEET DEBT EQUIVALENCE MAY DECREASE, THUS, PERMITTING PACIFICORP TO INCREASE ITS RELIANCE ON DEBT CAPITAL AFTER THE ACQUISITION.

A. Again, this determination cannot be made until after credit rating agencies assess PacifiCorp's off-balance sheet debt post-acquisition. However, there are numerous conditions of the transaction that will likely reduce PacifiCorp's off-balance sheet debt equivalence.

PacifiCorp's off-balance sheet debt equivalence is based on a present value analysis of its purchased power capacity payments and leased generation fixed costs. Due to certain conditions of the acquisition agreement, some of these capacity payments and lease payments will decline after the acquisition.

Specifically, in response to ICNU Data Request ("DR") No. 15.9, PacifiCorp explained that the West Valley lease cost will be reduced in response to Commitment No. 8. Exhibit No.__ (MPG-22). PacifiCorp has made a similar commitment in Washington as Washington Specific Commitment WA-3. This reduction in PacifiCorp's lease cost will reduce its present value off-balance sheet lease obligations and, thus, the debt equivalent of lease commitments.

Also, PacifiCorp is currently engaged in a lease arrangement with a subsidiary of an MEHC affiliate. It is very possible that S&P may assign a lower risk factor to this purchased power agreement once this contract is converted from a contract with a non-affiliated third-party supplier to an affiliated company. An affiliate company contract usually has less debt equivalent compared to a non-affiliated third-party supplier, because affiliated companies are more likely to negotiate contract revisions in times of financial stress.

Finally, MEHC has committed to make an equity contribution of the Blundell Plant to PacifiCorp. Currently, PacifiCorp has engaged in a 30-year steam purchase agreement with Intermountain and Geothermal Company, where PacifiCorp purchases steam resources from IGC from the Blundell geothermal plant. Exhibit No.__ (RJF-20) (PacifiCorp's response to ICNU DRs 17.1-17.3).

Reducing the lease payment of West Valley and the Blundell facility will reduce PacifiCorp's off balance sheet debt equivalence and PacifiCorp's credit metrics will improve.

Q. ARE SHORT-TERM DEBT AND OFF-BALANCE SHEET OBLIGATIONS AT ISSUE IN THE DEVELOPMENT OF PACIFICORP'S RATE OF RETURN IN THIS PROCEEDING?

A. Yes. In his rebuttal testimony, PacifiCorp witness Williams argues that short-term debt is currently used by PacifiCorp predominately to finance construction work in progress.

Therefore, he argues it should not be included in the ratemaking capital structure because CWIP is not included in rate base.

Further, PacifiCorp witnesses Williams and Hadaway both argue that off-balance sheet debt equivalence impacts PacifiCorp's credit rating financial metric calculations and should be considered in the assessment of an appropriate capital structure.

Since MEHC's acquisition of PacifiCorp will likely impact PacifiCorp's traditional use of short-term debt financing, in particular with respect to use in supporting rate base assets and reductions in purchased power capacity and leasing arrangements, the acquisition will likely reduce PacifiCorp's off-balance sheet debt equivalence.

Therefore, the acquisition will have an impact on PacifiCorp's argument in support of the ratemaking capital structure proposed by PacifiCorp in this proceeding. All of these issues will become more clear after the acquisition when PacifiCorp's post-merger financial risk, including off-balance sheet risk, are more clearly defined by credit rating agencies.

Q. IS THERE ANY EVIDENCE THAT SUGGESTS THAT PACIFICORP'S OPERATING RISK WILL DECREASE AFTER THE ACQUISITION?

A. Yes. Recent credit rating reviews of PacifiCorp by S&P noted that its credit rating weaknesses include:

> PacifiCorp Holdings Inc.'s (PHI) strategic focus on increasing the non-regulated operations of PacifiCorp's affiliate, PPM Energy Inc., which consists of renewable and gas-fired generation as well as gas storage operations, coupled with nonregulated activities at two of PHI's other subsidiaries.

Exhibit No. 139 (MPG-19) at 3. After the acquisition, PacifiCorp will no longer be affiliated with PHI's high risk PPM Energy Inc. This will likely have a positive impact on PacifiCorp's risk as both equity and credit security analysts are very concerned about a utility's affiliation with merchant power developers and power traders, such as PPM Energy Inc.

Q. DO YOU HAVE ANY COMMENTS CONCERNING PACIFICORP WITNESS DR. VANDER WEIDE'S DIRECT TESTIMONY FILE JANUARY 2006 CONCERNING "PHANTOM" INCOME TAX INCLUSION IN REVENUE REQUIREMENTS?

A. Yes. Dr. Vander Weide has constructed an analysis that suggests that permitting PacifiCorp to develop a revenue requirement based on the Commission authorized return on equity, and the income tax associated with that return, is fair and reasonable irrespective of whether that tax expense is actually paid to taxing authorities. Dr. Vander Weide opines that in developing utility revenue requirements on capital structure, a fair return on equity and synchronized income tax expense provides the holding company a fair return on equity considering its more leveraged capital structure.

Q. DOES DR. VANDER WEIDE'S ANALYSIS DEMONSTRATE THAT PHANTOM TAXES SHOULD BE INCLUDED IN A UTILITY'S REVENUE REQUIREMENT?

A. No. I agree with Dr. Vander Weide that the standards for the determination of the fair and reasonable rate of return for PacifiCorp relates to the investment risk of the utility, and the utility's ability to attract capital.

As part of this fair return determination, the Commission should develop revenues that provide the utility an opportunity to earn a fair after-tax return on equity. What is key to that, is whether the earnings produced by the utility will be subject to income tax expense. To the extent a utility's taxable income is reduced through a consolidated financial structure, then it would not be appropriate or reasonable to permit the utility to recover income tax expense that will never be payable to federal, state and local taxing authorities.

To do so is inconsistent with a fair rate of return and comparable risk standards, and is also inconsistent with setting a utility's revenue requirement based on its actual cost of providing service. Income tax should be treated like other operating expenses. If the utility actually incurs tax expense and pays it to the taxing authorities, then the cost should be included in revenue requirements. Conversely, if the utility can avoid or reduce tax expenses through legal means, then the actual tax expense, not a hypothetical inflated tax expense, should be included in the development of revenue requirements.

Q. ARE THERE CUSTOMER COST AND BENEFIT ASPECTS ASSOCIATED WITH INCLUDING INCOME TAXES IN THE UTILITY'S REVENUE REQUIREMENT THAT ALSO SUPPORT YOUR POSITION THAT INCOME TAX EXPENSE SHOULD ONLY BE INCLUDED IN THE UTILITY'S REVENUE REQUIREMENT TO THE EXTENT IT IS ACTUALLY PAID TO FEDERAL, STATE AND LOCAL TAXING AUTHORITIES?

A. Yes. If the utility is permitted to recover income tax expense, and the tax expense is paid to taxing authorities, then it is reasonable to conclude that customers will receive a benefit for paying the income taxes on the utility's taxable income. Specifically, utility tax payments to federal, state and local taxing authorities provide government revenues to support governmental services, security and environmental compliance, among other things. These government services benefit ratepayers.

In contrast, if a utility recovers income taxes expense that are retained by the parent company in lieu of making payments to taxing authorities, customers will not receive any benefits for having paid the income taxes. That is, the income taxes will not be used for their intended government revenue purpose. Accordingly, there is no cost benefit comparability between customers paying the utility's tax expense that is ultimately paid to government taxing authority and paying income taxes that are retained by the parent company to enhance the parent's after-tax leveraged return.

Q. DOES THIS CONCLUDE YOUR ADDITIONAL DIRECT TESTIMONY?

A. Yes