Exhibit No. ___T (KLE-1T)
Docket No. UE-050684
Witness: Kenneth L. Elgin

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**

SUPPLEMENTAL TESTIMONY OF

Kenneth L. Elgin

STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

January 27, 2006

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1 **I. INTRODUCTION**

2

3 **Q. Please state your name and business address.**

4 A. My name is Kenneth L. Elgin. My business address is Chandler Plaza

5 Building, 1300 South Evergreen Park Drive SW, Olympia, Washington,

6 98504-7250.

7

8 **Q. By whom are you employed and in what capacity?**

9 A. I am employed by the Regulatory Services Division of the Washington

10 Utilities and Transportation Commission as the Case Strategist.

11

12 **Q. Have you prepared an exhibit describing your education and relevant**

13 **employment experience in public utility regulation?**

14 A. Yes, it is Exhibit No. ___ (KLE-2).

15

16 **Q. Have you prepared any other exhibits in support of your testimony?**

17 A. Yes, they are Exhibit Nos. ___ (KLE-3) through ___ (KLE-9).

18

1 **Q. Please describe the scope of your testimony in this docket.**

2 A. My testimony analyzes the cost of capital impacts of MidAmerican Energy
3 Holding Company's ("MEHC") proposed acquisition of PacifiCorp d/b/a
4 Pacific Power & Light Company ("PacifiCorp"). This analysis is a follow-up
5 to Staff's presentation in the Joint Application submitted by MEHC and
6 PacifiCorp in Docket No. UE-051090.

7 In that testimony, Staff recommended that the Commission reopen
8 this general rate case proceeding, if and when the acquisition of PacifiCorp
9 by MEHC closes, in order to examine the impact of the acquisition on
10 PacifiCorp's cost of capital. The Commission's oral ruling on January 11,
11 2006 in this docket and Docket No. UE-051090 requires that examination to
12 take place now.

13

14 **II. SUMMARY**

15

16 **Q. Please summarize your analysis of the cost of capital impact of MEHC's**
17 **acquisition of PacifiCorp.**

18 A. MEHC is a holding company that owns a number of subsidiary utility
19 companies. MEHC currently uses debt in its consolidated capital structure
20 to finance its equity investments in those utility companies. MEHC will

1 continue this same use of debt in its consolidated capital structure if it
2 acquires PacifiCorp.
3 This method of financing is commonly referred to as "double
4 leverage." My analysis shows that, in this case, double leverage provides
5 high returns on book equity to the significant benefit of MEHC shareholders
6 at the expense of PacifiCorp ratepayers.
7 In addition, my analysis shows that MEHC's books currently include
8 an investment of $4.3 billion in Goodwill, an intangible asset, consisting
9 principally of acquisition premiums. If MEHC acquires PacifiCorp, MEHC's
10 investment in Goodwill will increase to $5.5 billion to include the $1.2 billion
11 acquisition premium MEHC must pay to ScottishPower to purchase
12 PacifiCorp. The high returns on book equity generated through double
13 leverage in MEHC's consolidated operations will allow MEHC to recover the
14 PacifiCorp acquisition premium in rates.
15
16 **Q. Please summarize how you recommend the Commission address the**
17 **effects of double leverage in MEHC's consolidated operations.**
18 A. I recommend an adjustment to PacifiCorp's cost of capital to account for the
19 manner in which MEHC will finance its operations. If the adjustment is not
20 made, rates will not meet the "just, fair, reasonable and sufficient" standard

1 of RCW 80.28.010(1) because ratepayers would pay excessive costs of capital
2 for equity and associated federal income taxes, and would provide for
3 recovery of the acquisition premium even though the premium is not
4 instrumental in the provision of utility service by PacifiCorp.
5
6 **Q. What is the impact of your double leverage adjustment on PacifiCorp's**
7 **cost of capital?**
8 A. My double leverage adjustment reduces PacifiCorp's cost of capital for
9 ratemaking purposes to 7.01%. Exhibit No. ___ (KLE-8) provides the
10 calculation.
11
12 **Q. Please summarize why the Commission should adopt a double leverage**
13 **adjustment to PacifiCorp's cost of capital under MEHC's ownership.**
14 A. Once MEHC acquires PacifiCorp, MEHC will control the capital structure of
15 PacifiCorp and will fund part of its equity investment in PacifiCorp with
16 debt. MEHC will profit handsomely from its use of double leverage, similar
17 to the financing arrangement employed by Sam Insull in the 1920's. Exhibit
18 ___ (KLE-3) is an excerpt from The Regulation of Public Utilities by Charles
19 Phillips, Jr. describing the consolidation of the electric industry under the
20 holding company scenario in the 1920's.

1 Rates should support a cost of capital that recognizes the return on
2 debt and the tax benefits associated with MEHC's use of debt to fund a
3 portion of its equity investment in PacifiCorp. Therefore, a double leverage
4 adjustment should be adopted by the Commission to ensure that rates reflect
5 the cost of new ownership so that ratepayers are not harmed by the
6 acquisition of PacifiCorp by MEHC.
7
8 **III. DISCUSSION**
9
10 **A. Nature of the Transaction**
11
12 **Q. Please summarize the proposed acquisition of PacifiCorp in Docket No.**
13 **UE-051090 and MEHC's financing plan for the acquisition.**
14 A. MEHC proposes to acquire ScottishPower's equity investment in PacifiCorp
15 for a purchase price of $5.1 billion. MEHC will also assume all of
16 PacifiCorp's outstanding debt obligations, which at the time of the
17 application was approximately $4.3 billion. The total transaction is valued at
18 approximately $9.4 billion.
19 According to the application filed in Docket No. UE-051090, MEHC
20 plans to obtain the funds for the purchase of PacifiCorp's equity from two

1 sources: 1) $3.4 billion in equity from MEHC's primary owner, Berkshire
2 Hathaway ("Berkshire"); and 2) MEHC's plan to issue new unsecured debt
3 of $1.7 billion. Once the transaction closes, PacifiCorp will be part of the
4 holding company structure of MEHC.
5 After the acquisition closes, MEHC's consolidated balance sheet will
6 recognize all of the assets of PacifiCorp and the $1.2 billion acquisition
7 premium it will pay to acquire the utility. On the liability side of MEHC's
8 consolidated balance sheet, MEHC will show the additional debt issued by
9 MEHC to fund the acquisition and the net book value of PacifiCorp's
10 liabilities at the time of closing.
11
12 **B. Staff's Analysis of Cost of Capital Impacts**
13
14 ***1. Key Terms: "Leverage," "Double Leverage" and "Acquisition Premium"***
15
16 **Q. Three of the terms you use in your testimony are "leverage," "double**
17 **leverage" and "acquisition premium." Before you proceed with your**
18 **analysis of the cost of capital impacts of the acquisition, please explain**
19 **what "leverage" means in terms of financial policy.**

1 A. "Leverage" is the opportunity of any business enterprise to issue debt to
2 finance the long-lived assets that are necessary to deliver a service or
3 product. By financing assets with debt in lieu of equity, financial leverage
4 enables a firm to magnify earned returns for its shareholders. Equity returns
5 are increased because lower cost fixed debt obligations are substituted for
6 higher cost equity capital. In so doing, the business is able to increase net
7 income for shareholders, and lever the returns on the remaining smaller
8 equity investment.
9 The key objective for financial managers is to find the lowest overall
10 cost of capital, which implies the maximum amount of debt, in order to
11 maximize the return to shareholders.
12
13 **Q. Please give an example of a highly leveraged company.**
14 A. Any firm with low business risk is an ideal candidate for being a highly
15 leveraged company. Business risk is determined principally by the
16 variability of the firm's cash flows. Utilities generally fall into the category of
17 low business risk. Indeed, any business that can stabilize its cash flow is able
18 to issue additional debt, lower its overall cost of capital, and maximize the
19 return to shareholders. MEHC is an example of a firm that is able to employ

1 significant leverage due to the stable cash flows from its subsidiary operating
2 companies.
3
4 **Q. Please explain the term "double leverage."**
5 A. Double leverage arises when a business, such as MEHC, is organized as a
6 holding company, and both the holding company and the operating
7 company, here PacifiCorp, can issue debt. Since MEHC controls the amount
8 of equity in PacifiCorp, MEHC can issue debt and record the proceeds on
9 PacifiCorp's books as equity. Therefore, MEHC can enhance its return on
10 equity twice from leverage: once on the equity of the operating company,
11 PacifiCorp, and then again on the equity at the holding company level.
12
13 **Q. Have you prepared an exhibit to illustrate how double leverage appears on**
14 **a balance sheet?**
15 A. Yes. Exhibit No. ___ (KLE-4) is a simple organization chart of a hypothetical
16 Holding Company and two subsidiary operating companies, Utility A and
17 Utility B. The exhibit shows how double leverage is employed in the
18 financial statements of a holding company and the subsidiaries it owns.
19 Chart 1 shows a holding company that does <u>not</u> employ double
20 leverage. Each operating company has a 50% equity ratio represented by $50

1 in debt and $50 in equity. If Holding Company issues $100 in equity to fund
2 its purchase of the two utilities, through the consolidation process Holding
3 Company would have $100 of equity on its books, no additional parent
4 company debt, and the $100 of combined debt of the two subsidiaries. Thus,
5 Holding Company will continue to have a 50% debt ratio.
6 Chart 2 shows the use of double leverage by Holding Company with
7 the same amount of capitalization that is in Chart 1 of the exhibit. At the
8 holding company level, the books show a debt ratio of 70%, or $140 debt and
9 $60 equity. Therefore, the actual equity investment on the books of each
10 utility subsidiary is, in part, funded by the debt issued by Holding
11 Company. In this example, there is a proportional distribution of Holding
12 Company debt to each of the operating utilities. $20 of the equity investment
13 in each utility is actually Holding Company debt, and, therefore, only $30 on
14 the books of the utility is actually equity provided by Holding Company.
15
16 **Q. Does MEHC currently use double leverage to fund its utility subsidiaries?**
17 A. Yes. I reviewed the balance sheet of MEHC's three primary subsidiary
18 companies provided in response to Staff Data Request No. 20 in Docket No.
19 UE-051090. The equity balances for MEHC's three utility subsidiaries as of
20 December 31, 2004 were as follows:

		Total Equity
2	Northern Natural Gas Company	$1,168,433,680
3	Kern River Transmission Company	$ 716,543,803
4	MidAmerican Energy	$1,527,468,000
5	Total	$3,412,455,583

6 The above data shows that the combined total equity for just these
7 three subsidiaries of MEHC was $3,412,445,583. MEHC's stockholder equity
8 was only $2,971,159,000 for the same period. Because the combined total
9 equity of MEHC's utility subsidiaries exceeds MEHC's consolidated equity,
10 it is clear that MEHC uses debt to fund its equity investment in the
11 companies it owns, thus, creating the double leverage effect. A comparison
12 of MEHC's total tangible assets and total debt that appear on its balance
13 sheet also show the effect of double leverage, as I will discuss later.
14
15 **Q. Will MEHC use double leverage after it acquires PacifiCorp?**
16 A. Yes. MEHC's pro forma balance sheet at the time of closing will show
17 MEHC's continued use of double leverage. I discuss this continued use of
18 double leverage in more detail below.
19

1 **Q. Please explain the term "acquisition premium".**

2 A. The term "acquisition premium" describes a sale of any asset for more than
3 its net book value. In this case, it is the difference between the $5.1 billion
4 net purchase price paid by MEHC to ScottishPower to acquire PacifiCorp
5 and PacifiCorp's net book equity at the time of closing, estimated to be $3.9
6 billion. Consequently, the acquisition premium is $1.2 billion.

7

8 **Q. How would any acquisition premium typically be treated for ratemaking**
9 **purposes in a merger or consolidation?**

10 A. Typically, an acquisition premium is not included in the calculation of rate
11 base and, therefore, it is not recognized in the rate setting process. In a
12 typical merger and combination of two companies, *e.g.*, the Pacific Power &
13 Light Company's acquisition of Utah Power & Light Company in 1989, the
14 acquisition premium did not appear directly on the balance sheet after the
15 transaction. Instead, the balance sheet is impacted by the acquisition
16 premium through the dilution of book value that the combined utility will
17 carry following the close of the transaction. It is through expected savings,
18 cost reductions and other benefits of consolidation that shareholders recover
19 the acquisition premium as the book value of the new entity grows over
20 time.

1

2 **Q. Will the $1.2 billion acquisition premium MEHC is paying be recognized**

3 **on MEHC's financial statements?**

4 A. Yes. MEHC's plan to fund the purchase of PacifiCorp in part with additional

5 debt and equity requires MEHC to recognize the acquisition premium on its

6 books. Recording the acquisition premium on MEHC's balance sheet is

7 necessary to reconcile assets and liabilities without diluting existing

8 shareholders' equity investment. The requirement to carry an acquisition

9 premium on the books of MEHC is unique to the structure of a holding

10 company, and, as discussed below, refutes any claim that the acquisition

11 premium will not be recovered from rate payers.

12

13 **2.** *Financial Analysis of PacifiCorp and MEHC*

14

15 **Q. Please describe the financial analysis you performed to evaluate the cost of**

16 **capital impacts of the proposed acquisition of PacifiCorp by MEHC.**

17 A. I began with a review of MEHC's financial statements before the acquisition.

18 This analysis shows that MEHC currently uses significant double leverage to

19 benefit its shareholders.

1 I then did the same analysis of the pro forma financial statements that will result if the transaction closes. This analysis shows that, after the acquisition, MEHC will continue to use double leverage for the benefit of its shareholders.

Finally, I analyzed the intangible assets, *e.g.*, acquisition premiums, on MEHC's balance sheet. That analysis shows that double leverage is the mechanism for MEHC to realize a return on the acquisition premiums that are carried on its balance sheet.

a. Balance Sheet Comparison

Q. Have you prepared an exhibit analyzing MEHC's current, pre-acquisition balance sheet?

A. Yes. Exhibit No. ___ (KLE-5) shows MEHC's consolidated balance sheet and income statement for the twelve months ended March 31, 2005. The balance sheet (page 1) comes from MEHC's regular quarterly filing with the Securities and Exchange Commission (SEC). The income statement (page 2) was produced by MEHC from its annual and quarterly SEC filings in response to a Staff data request in Docket No. UE-051090.

1 **Q. What did your analysis of MEHC's pre-acquisition balance sheet show?**

2 A. MEHC's current debt ratio is approximately 79%. *Exhibit No. ___ (KLE-6),*

3 *page 1, line 13.* The difference between MEHC's consolidated debt ratio and

4 that of its operating subsidiaries shows that MEHC currently uses significant

5 financial leverage in its consolidated operations. The extensive use of debt

6 by the holding company, MEHC, coupled with the more modest use of debt

7 by the operating companies under it, creates the double leverage effect

8 illustrated in Exhibit No. ___ (KLE-4).

9

10 **Q. Please explain how MEHC can benefit from double leverage.**

11 A. As I explained earlier, by employing a more leveraged capital structure,

12 MEHC is able to use debt to finance the equity investment in its operating

13 companies. Regulation sets rates to recover the revenue requirements in its

14 utility operation companies based upon a capital structure that includes a

15 cost component for a reasonable level of equity investment and associated

16 income taxes. However, as I have shown in Exhibit No. ___ (KLE-4), the

17 actual cost of a portion of that equity is actually the net of tax cost of debt to

18 MEHC, not the pre-tax cost of equity. The effect is a mismatch between the

19 assumed cost of ownership provided by regulators and the actual costs of

20 ownership incurred by MEHC. This mismatch benefits MEHC's

1 shareholders. MEHC's consolidated return on book equity increases as it
2 increases in its debt ratio. MEHC is rewarded since it gets both the higher
3 equity return and associated income taxes on funds it provided at the net of
4 tax cost of debt. That benefit then translates to a return on MEHC's equity
5 investment in intangible assets, including acquisition premiums.
6
7 **Q. What was MEHC's return on equity from continuing operations during the**
8 **twelve months ending March 31, 2005?**
9 A. MEHC's return on equity was 17%. *Exhibit No. ___ (KLE-7), page 1, line 6*.
10 This reveals the dramatic effects of double leverage on MEHC's consolidated
11 book equity. From a purely theoretical perspective, this is precisely what
12 one would expect from any firm that uses significant financial leverage on its
13 balance sheet in order to increase earned returns on book equity.
14
15 **Q. Could ratepayers be harmed by the significant leverage MEHC uses in its**
16 **capital structure?**
17 A. Yes. MEHC, as an unregulated holding company, has the financial incentive
18 to issue as much debt as possible, but, in turn, propose significantly greater
19 amounts of equity in utility capitalization ratios for ratemaking purposes.
20 The Commission must reconcile these divergent objectives. The double

1 leverage adjustment is necessary in order to determine the appropriate cost
2 of capital for rate making purposes.
3
4 **Q. You have explained MEHC's current financial statements. Once MEHC**
5 **acquires PacifiCorp, will this issue of divergent capital structures between**
6 **PacifiCorp's regulated utility operations and the parent still remain?**
7 A. Yes. However, under the current financing plan to acquire PacifiCorp,
8 MEHC's balance sheet will show a reduction of double leverage from current
9 levels, assuming, of course, that the financing plan is carried out.
10
11 **Q. Have you prepared an exhibit to show the financial ratios and**
12 **capitalization amounts that will occur under the proposed financing plan**
13 **for MEHC to acquire PacifiCorp?**
14 A. Yes. Exhibit No. ___ (KLE-6), page 2 contains MEHC's pro forma balance
15 sheet amounts of debt and equity once it acquires PacifiCorp. This exhibit
16 shows a similar opportunity, after MEHC purchases PacifiCorp, for MEHC's
17 shareholders to realize high returns due to double leverage. MEHC's equity
18 and debt ratios will improve to 28% and 72%, respectively. However,
19 PacifiCorp will continue to show on its books a higher equity ratio and a
20 lower debt ratio than MEHC. I have included in Exhibit No. ___ (KLE-5),

1 page 5 PacifiCorp's balance sheet for the period ending March 31, 2005. It
2 shows PacifiCorp's equity ratio at 43%, which is significantly different from
3 the pro forma consolidated debt ratio of 72% for MEHC.
4
5 **Q. How did you calculate the pro forma amounts on page 2 of Exhibit No. ___**
6 **(KLE-6)?**
7 A. First, the exhibit is calculated based upon the financing plan presented in the
8 acquisition proceeding. To generate the cash for the purchase, MEHC will
9 receive $3,419,700,000 in new equity from Berkshire (line 19), and MEHC will
10 issue an additional $1,709,800,000 in long-term unsecured debt (line 12). The
11 sum of these two figures equals the estimated purchase price of $5.1 billion
12 for PacifiCorp's estimated book equity at the time of closing. Finally, line 11
13 of the exhibit shows $3,629,000,000 in PacifiCorp's outstanding debt
14 consolidated into MEHC.
15 Accordingly, MEHC's pro forma amount of debt and equity will
16 increase to $16,884,559,000 and $6,513,400,000, respectively. MEHC's *pro*
17 *forma* debt ratio is 72% and the pro forma equity ratio is 28%. As I stated
18 previously, MEHC's investment in intangible assets must then increase by
19 the $1.2 billion acquisition premium in order to maintain equality in the
20 assets and liabilities on its balance sheet.

1

2 **Q. What is your estimate of the pro forma return on equity for MEHC for the**
3 **twelve months ended March 31, 2005?**

4 A. I estimate that the pro forma return on equity for MEHC is about 14%.
5 *Exhibit No. ___ (KLE-7), page 1, line 23*. This calculation includes estimates of
6 both the additional interest expense on the $1.7 billion of new debt MEHC
7 will issue to pay for the acquisition, and an adjustment to normalize
8 PacifiCorp's operations.

9

10 **Q. What causes the decrease in pro forma return on equity for MEHC from**
11 **17% actual to 14%?**

12 A. The reduction in MEHC's pro forma earned return on book equity from 17%
13 to 14% is caused primarily by the magnitude of Berkshire's equity
14 investment in PacifiCorp and the financial assumptions of including
15 PacifiCorp's normalized operations in MEHC's consolidated operations.
16 Nevertheless, the exhibit shows that MEHC will expect to earn about 14% on
17 its consolidated book equity once the transaction is closed; a very attractive
18 return in today's environment.

19

1 **Q. If the transaction is completed, what will be the effect on MEHC's assets**

2 **and its underlying equity investment in those assets?**

3 A. After the transaction is completed, MEHC's pro forma balance sheet will

4 show new book equity investment of $6,513,377,000, compared to

5 $3,093,677,000 before the transaction. *Exhibit No.____ (KLE-6), page 2, line 21*

6 *versus page 1, line 17.* This calculation simply adds the estimate of

7 PacifiCorp's net book equity at closing to MEHC's books.

8

9 **b. Acquisition Premiums on MEHC's Books**

10

11 **Q. What other salient features of MEHC's consolidated financial statements**

12 **should the Commission consider in this docket?**

13 A. Pre-acquisition, MEHC's books show an asset in the amount of

14 $4,285,132,000 for "Goodwill." This is an intangible asset that exceeds

15 MEHC's current book equity of $3,093,677,000 by $1,191,455,000. *Exhibit No.*

16 *___ (KLE-5), lines 9 and 36*. In other words, MEHC currently has negative

17 tangible book equity exceeding $1 billion.

18 Once the transaction closes, MEHC's pro forma balance sheet will

19 show Goodwill of approximately $5,450,332,000. In other words, the

1 financial statements of MEHC today and at the pro forma level show that
2 MEHC's equity investment is primarily in intangible assets.
3 Furthermore, the financial statements, when viewed together, show
4 that consolidated operating income currently provides a return for MEHC's
5 equity investment in intangibles and it will continue to do so after the
6 transaction closes.
7
8 **Q. For purposes of financial reporting, has MEHC provided any notice to**
9 **shareholders about this large amount of Goodwill on its balance sheet?**
10 A. Yes. Exhibit No. ___ (KLE-9), pages 1-3, contain footnotes from MEHC's SEC
11 Form 10-K (pages 53, 54 and 66, respectively). They explain the critical
12 accounting policies surrounding SFAS No. 142, "Goodwill and Other
13 Intangible Assets" and how these assets are recognized on MEHC's balance
14 sheet. They also explain that Goodwill is not amortized, and it is regularly
15 reviewed by MEHC's auditors to determine whether MEHC can continue to
16 carry its investment in Goodwill on its books.
17
18 **Q. What comprises this $4.3 billion in Goodwill currently on MEHC's books?**
19 A. This $4.3 billion is comprised primarily of acquisition premiums associated
20 with MEHC's prior purchases of the operating companies within MEHC's

1 holding company structure. Exhibit No. ___ (KLE-9), at pages 4 and 5,
2 contains footnotes from MEHC's SEC Form 10-K (pages 69 and 70),
3 explaining the recognition of Goodwill due to MEHC's recent acquisitions of
4 two of those companies, Kern River and Northern Natural Gas. The
5 footnotes do not explicitly state the amounts of the premium MEHC paid to
6 acquire those companies.
7
8 **Q. Why is this intangible asset on MEHC's balance sheet an important factor**
9 **for the Commission to consider in this case?**
10 A. As an intangible asset, Goodwill does not produce the underlying value and
11 services of MEHC's operating companies. The $1.2 billion acquisition
12 premium MEHC will pay for PacifiCorp should be similarly considered. It is
13 not used and useful in the provision of utility service to PacifiCorp
14 customers.
15 If an intangible asset is impaired, it would be removed from the
16 balance sheet. Under present circumstances, if these intangible assets were
17 impaired and written off of MEHC's books, the current debt ratio for MEHC
18 would exceed 100%, indicating negative tangible equity. After the
19 transaction closes, and if MEHC's auditors were to determine that the

1 intangibles were no longer of any value, MEHC's debt ratio would be almost
2 93%.
3 This is a significant and ongoing risk for MEHC. MEHC's ability to
4 carry these intangibles is a function of the "earning power" of the net assets
5 on its books, and the degree to which MEHC can continue to efficiently
6 finance both the tangible and intangible assets. In a competitive market,
7 where prices are determined by market forces, these may be reasonable
8 business and financial risks for shareholders to assume. However, in
9 regulated markets where rates are set to provide an opportunity to earn a
10 fair return on used and useful property, MEHC must find a way to earn on
11 this intangible asset. By employing double leverage, MEHC is able to realize
12 a return on its intangible assets, which include the acquisition premiums.
13 The relevant question is whether this financial structure under new
14 ownership is appropriate and fair to ratepayers. It is not. Unless a double
15 leverage adjustment is made for ratemaking purposes to recognize the actual
16 costs of ownership and to prevent the implicit recovery of the acquisition
17 premium that will be carried by MEHC on its books, ratepayers are harmed.
18
19 **Q. What could cause an intangible asset to be impaired and, thus, no longer**
20 **carried on MEHC's balance sheet?**

1 A. Any event that would materially affect the earnings of an operating
2 company might cause MEHC's independent auditors to question the
3 continued recognition of the asset or some portion of it.
4 The significant factor affecting valuation is whether returns regulators
5 provide to the utility operating companies will continue to support equity
6 prices that exceed book value. The auditors implicitly recognize that the
7 values of the operating companies owned by MEHC today could be sold for
8 amounts that exceed of book value. Secondly, MEHC is able to use double
9 leverage to earn a return on is equity investment in Goodwill.
10 Therefore, MEHC's ability to carry Goodwill is a function of two
11 factors: 1) utilities with market-to-book ratios above one; and 2) MEHC's
12 ability to use double leverage without an offsetting ratemaking adjustment
13 to the cost of capital to account for the effects of double leverage.
14
15 **Q. Is there any other significant information in MEHC's financial statements**
16 **with respect to *tangible* assets and how these assets are financed?**
17 A. Yes. Exhibit No. ___ (KLE-5), page 1, line 8, shows a MEHC balance sheet
18 item for a category of assets entitled, "Properties, plants and equipment,
19 net." This entry represents the "real" long-lived assets of MEHC that, for
20 regulatory purposes, are the core components of any rate base calculation

1 under the used and useful principle. MEHC's balance sheet shows a net
2 amount of $11,679,031,000 classified to these accounts at March 31, 2005.
3 MEHC's total debt for the same period is $11,545,759,000. *Exhibit No. ___*
4 *(KLE-5), page 1, line 13*.
5 As you can see, these amounts are virtually identical, which confirms
6 my conclusion that the tangible assets of MEHC are financed with debt.
7
8 **Q. What conclusions are appropriate to draw from this data and the data you**
9 **discussed earlier concerning MEHC's balance sheet, its assets, both**
10 **tangible and intangible, and its liabilities?**
11 A. It is appropriate to conclude the following: 1) MEHC finances its operations
12 with a significant amount of debt; 2) MEHC's current equity investment in
13 its operating companies is also financed with debt; and 3) MEHC's current
14 equity investment is primarily Goodwill, an intangible asset. All finance
15 theories aside, these conclusions are based upon the most fundamental
16 indicator of financial management and performance: the balance sheets and
17 income statements of MEHC today and after the transaction closes.
18
19 **Q. Why is recovery of the acquisition premium an important consideration**
20 **for the Commission in this docket?**

1 A. As I explained earlier, utilities are generally not permitted to recover an
2 acquisition premium. If public service commissions include acquisition
3 premiums in rate base calculations, then there is an incentive to artificially
4 inflate rate base, *i.e.,* "pyramiding," through successive acquisitions of utility
5 operating companies at prices above book value. *Exhibit No. ___ (KLE-3).*
6 On the other hand, commissions may permit recovery of all or part of
7 an acquisition premium in rate base to the extent the utility can show
8 sufficient ratepayer benefits from the transaction that justify paying a specific
9 amount more than book value for the assets. That rationale does not apply
10 to the MEHC acquisition of PacifiCorp. The acquisition is not expected to
11 result in substantial synergies and cost reductions.[1] Thus, there are
12 insufficient benefits to offset MEHC's decision to pay $1.2 billion above book
13 value for PacifiCorp.
14 Consequently, without double leverage, MEHC cannot provide a
15 return to shareholders for their *total* investment in the operating companies,
16 including the acquisition premium. This explains why MEHC stated in the
17 application proceeding, Docket No. UE-051090, that it will propose to
18 directly recover the acquisition premium if any other party proposes a

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[1] *See* Exhibit No. 11T at 23: 23 (Abel) and Exhibit No. 29T at 13: 11-13 (Gale), Docket No. UE-051090.

1 double leverage adjustment in a rate case. As I have explained, MEHC has
2 not shown it is entitled to such recovery.
3
4 **c. Other Issues**
5
6 **Q. Do you have any other comments about the acquisition in the context of**
7 **the *pro forma* capital structure and ratios in your exhibits?**
8 A. Yes. All of the *pro forma* calculations assume that the proposed plan to
9 finance the purchase of PacifiCorp will endure. There is nothing preventing
10 MEHC from varying from its proposed financing plan, such as by issuing
11 additional debt after the acquisition. It is reasonable to expect MEHC to
12 stretch its debt ratio to previous levels particularly as the subsidiaries grow
13 and finance new assets.
14
15 ***3. Regulatory Response to Double Leverage***
16
17 **Q. How should the Commission protect ratepayers from the financial**
18 **leverage problem you have identified?**
19 A. The Commission should adjust PacifiCorp's ratemaking capital structure for
20 the effect of MEHC's decision to finance its equity investment in PacifiCorp

1 partially with debt. While such an adjustment may be called a "double
2 leverage" adjustment, it is also accurate to call the adjustment a
3 "consolidated capital structure adjustment" because it applies the cost of
4 debt incurred by MEHC to acquire PacifiCorp to that portion of equity in
5 PacifiCorp's capital structure that is financed with new debt. The adjustment
6 also takes the tax advantages of the debt for the benefit of ratepayers. In
7 essence, this approach accepts the capital structure of the holding company
8 and sets rates recognizing the capital cost savings that result from the higher
9 leverage employed by MEHC.
10
11 **Q. Have you prepared an exhibit which calculates an adjustment for purposes
12 of this case?**
13 A. Yes. Exhibit No. ___ (KLE-8) shows the adjustment. The first step is to
14 estimate the cost of debt for the additional $1,709,000,000 MEHC will add to
15 its cost structure in order to acquire PacifiCorp's equity. At current rates,
16 MEHC should be able to issue new long-term debt at a cost not to exceed
17 5.25%. This figure is based upon current long term Treasury rates of 4.5%
18 with a 75 basis point adjustment to account for current spreads and other
19 costs. The adjustment then substitutes this incremental cost of debt to the

1 proportion of PacifiCorp's book equity that is financed with MEHC debt.

2 *Exhibit No. ___ (KLE-7), page 1, line 26.*

3 The next step is to account for the potential increase in equity costs

4 due to the higher leverage of MEHC. Due to time constraints and the need

5 for further study regarding whether there is any impact on equity costs, I

6 have relied upon a study of Mr. Rothschild that supported his recommended

7 return on equity for PacifiCorp. *Exhibit No. 151-T, page 54, line 6.* His study

8 evaluated the impact of changing capital structure on investor return

9 requirements. It shows that each 1% increase in the debt ratio requires a

10 corresponding increase in the cost of equity of 3 to 4 basis points. Since I am

11 adjusting PacifiCorp's ratemaking equity ratio from 43.5% to 28%, with a

12 corresponding 15.5% increase in the debt ratio, Mr. Rothschild's analysis

13 indicates an increase in the cost of equity between 45 and 65 basis points.

14 (15.5 X 3= 46.5 and 15.5 X 4 = 62.) Therefore, the revised cost of equity for

15 PacifiCorp with a double leverage adjustment is no more than 9.60%. *Exhibit*

16 *No. ___ (KLE-8), page 1, line 29.*

17 I want to emphasize that this proposal is an attempt to provide the

18 Commission with an adjustment in these unique time constrained

19 circumstances. I propose a solution building on Mr. Rothschild's expert

20 testimony and comprehensive study on the relationship between cost of

1 equity and changes in equity ratio within the capital structure. I believe the
2 theory of a double leverage adjustment is proper in this and future cases, but
3 the precise mechanism of a specific adjustment may be different in a
4 subsequent case involving PacifiCorp under MEHC ownership.
5
6 **Q. Please continue with your discussion of Exhibit No. ___ (KLE-8).**
7 A. The top half of the exhibit contains Staff's recommendation for PacifiCorp's
8 weighted average cost of capital. The bottom half of the page adjusts
9 PacifiCorp's ratemaking equity ratio for MEHC's estimated marginal cost of
10 debt, and uses that cost rate in lieu of common equity costs. The exhibit then
11 adjusts the cost of equity for the additional leverage
12 The result is that the overall rate of return is reduced from 7.40% to
13 7.01%.[2] The calculation also needs to adjust interest expense in the overall
14 results of operations statement so that the new weighted cost of debt is
15 included in the *pro forma* cost of debt calculation. This ensures that the tax
16 effects of the additional leverage are recognized in the calculation of
17 PacifiCorp's revenue requirements. The new weighted cost of debt is 4.24%,
18 as shown on line 34 of Exhibit No. ___ (KLE-8).

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[2] This number is rounded. The precise number is 7.0105% and appears in Exhibit No. ___ (TES-13), page 4, line 7.

1

2 **Q. Is your recommended adjustment a conservative approach?**

3 A. Yes. The adjustment recommended in this docket is a very conservative

4 approach to resolving the issue so that ratepayers pay the true cost of capital.

5 Upon close of the transaction, MEHC's investment in Goodwill will increase

6 to $5.5 billion, and its books will show $6.5 billion of equity. It is arguable

7 that a proper adjustment should remove the equity investment in intangible

8 assets on MEHC's financial statements. The result of such a calculation

9 would assume that MEHC has only $1.0 billion in real equity, with the

10 remainder of its tangible assets financed with debt. For purposes of this case,

11 however, Staff is satisfied with its proposed adjustment and its consistency

12 with the overall rate of return recommendation of Mr. Rothschild.

13

14 **Q. If the Commission adopts a different return on equity or capital structure**

15 **than that proposed by Mr. Rothschild, what adjustment should be made to**

16 **your double leverage proposal?**

17 A. The Commission should use Exhibit No. ___ (KLE-8), page 1, lines 21-34 to

18 calculate the overall cost of capital should it adopt either a different return

19 on equity or capital structure than Mr. Rothschild has recommended. My

20 testimony on page 28, lines 9-10 shows the adjustment to the return on

1 equity for any additional leverage: each 1% increase in the debt ratio
2 requires a corresponding increase in the cost of equity of 3 to 4 basis points.
3 Any change from Mr. Rothschild's capital structure that the Commission
4 may adopt would result in a corresponding adjustment to line 26
5 ("Leverage") and line 29 ("Common") in the first column of Exhibit No. ___
6 (KLE-8).

7 **Q. Is your adjustment to PacifiCorp's capital structure consistent with the**
8 **ratemaking process utilized by this Commission?**

9 A. Yes. The capital structure issue has been part of the rate setting process since
10 the earliest days of economic regulation in this country. The Commission
11 regularly determines an appropriate capital structure for ratemaking
12 purposes. The issue is how much equity is reasonable to balance the
13 competing interests of safety and cost. There is always a tension between
14 utility requests for increases in the equity component of capital and the
15 actual equity financing assets dedicated to serving the public. To the extent
16 utilities are able to achieve favorable regulatory results and finance
17 operations differently, the utility's shareholders and managers benefit.

18 This case is no different even though it involves a holding company
19 scenario. As always, the further the utility ratemaking capital structure
20 diverges from the actual capital structure and the true costs of capital the

1 holding company uses to finance utility assets, the greater the impact the
2 divergent leverage will have upon earned returns from the ownership of
3 utility stock.
4 At today's tax rates, every $1.00 of return necessary to compensate
5 common equity owners for their investment requires $1.54 in revenue
6 requirements. Conversely, every $1.00 of return necessary to compensate
7 bondholders for their investment requires only $0.65 in revenue
8 requirements. The difference is $0.89.
9 This simple calculation explains why rates should <u>not</u> provide equity
10 returns and associated income taxes when the cost to MEHC for its equity
11 investment in PacifiCorp is something else.
12 This is the critical inquiry. The effect of MEHC's proposal is to ignore
13 the real costs of ownership and to turn the notion of historical cost rate base
14 regulation on its head. The double leverage employed by MEHC
15 compensates shareholders for the total investment in PacifiCorp, including
16 the acquisition premium. It asks the Commission to ignore the parent,
17 consider the utility as a "stand-alone" entity, and regulate PacifiCorp
18 accordingly. This proposal is unfair and unreasonable. If rates are to
19 support costs of ownership and associated federal income taxes, then there

1 needs to be equity capital at risk and the taxes collected in rates need to be
2 paid to the United States Treasury.
3
4 ***4. Response to PacifiCorp Supplemental Testimony of Dr. Vander Weide***
5
6 **Q. Please summarize PacifiCorp's supplemental testimony and its**
7 **recommendation to the Commission regarding the cost of capital impacts**
8 **of its acquisition by MEHC.**
9 A. Through the testimony of Dr. Vander Weide, PacifiCorp provides theoretical
10 arguments as to why the Commission should reject any adjustment to
11 PacifiCorp's cost of capital to reflect the effects of double leverage. His
12 testimony ignores the reality of reflecting the acquisition on MEHC's balance
13 sheet through double leverage.
14
15 **Q. What is the primary argument that Dr. Vander Weide offers in support of**
16 **his position that the Commission should ignore double leverage once**
17 **MEHC's acquires PacifiCorp?**
18 A. His primary argument is that witnesses that sponsor a double leverage
19 adjustment do not take into account the impacts of double leverage on their
20 return on equity determination.

1

2 **Q. Does his argument apply to your recommended double leverage**

3 **adjustment?**

4 A. No. The adjustment I propose in Exhibit No. ___ (KLE-8) recognizes the

5 effect of the increased leverage of MEHC on PacifiCorp's return on equity,

6 and it captures the cost of new debt the parent will issue to support its equity

7 investment in PacifiCorp. The adjustment simply reflects the cost of equity

8 to MEHC for its equity investment in PacifiCorp. Therefore, the bulk of Dr.

9 Vander Weide's criticism is rendered moot.

10

11 **Q. Dr. Vander Weide presents a hypothetical in Exhibit No. ___ (JHV-1T),**

12 **pages 8 through 12, and Exhibit No. ___ (JHV-4). Is he correct that a**

13 **double leverage adjustment incorrectly produces a return on equity for a**

14 **subsidiary utility that is lower than the return on equity for a stand-alone**

15 **utility?**

16 A. No. His hypothetical is a tautology because he simply assumes that the cost

17 of equity increases proportionally to the change in debt ratio in order to hold

18 the overall cost of capital constant. However, in reality, the holding

19 company is able to issue debt to fund its equity investment, yet MEHC's cost

20 of equity does not change proportionally. His simple example in Exhibit

1 ____ (JHV-1T) on the top of page 1 is unsupportable. That is precisely why
2 the double leverage adjustment is necessary.
3
4 **Q. Dr. Vander Weide asserts at page 18 of his testimony that the creation of**
5 **PPW Holdings LLC (PPW") between MEHC and PacifiCorp eliminates**
6 **double leverage because PPW, the "parent", will be 100 percent equity**
7 **financed. Do you agree with his conclusion?**
8 A. No. First, PPW is an intermediary, not the parent. The parent is MEHC.
9 Moreover, MEHC will carry on its balance sheet the debt that will appear as
10 equity on PacifiCorp's balance sheet. Therefore, one must go up to the
11 parent, as I have. PPW's capital structure is irrelevant.
12
13 **Q. What other arguments does PacifiCorp offer in support of its position that**
14 **the Commission should ignore double leverage?**
15 A. Dr. Vander Weide asserts at page 7, lines 20-22 of his testimony what he
16 believes to be a fundamental principle of financial theory: that the required
17 rate of return must be the same on all investments of equal risk. He cites the
18 *Hope* decision in support of this principle, and he argues that a double
19 leverage adjustment violates the standards of *Hope*.
20

1 **Q. Is his argument valid?**

2 A. No. Holding companies have challenged commission orders adopting
3 double leverage adjustments on the grounds that such adjustments violate
4 *Hope*. These challenges have failed.[3] A critical element supporting double
5 leverage adjustments has been the actual parent-subsidiary relationship and
6 the fact that the parent will control the subsidiary's capital structure. In
7 essence, the courts recognize that a double leverage adjustment is simply a
8 means to find the true cost of capital to the wholly-owned subsidiary. My
9 double leverage adjustment does nothing more.

10

11 **Q. According to Dr. Vander Weide, at pages 12 through 15 of his testimony,**
12 **double leverage adjustments violate the principle that the required return**
13 **should depend on the specific risks of that investment. Do you agree with**
14 **this testimony?**

15 A. No. The investment decision, *e.g.*, the evaluation of any specific project or
16 investment, is independent of the financing decision. As I stated previously,
17 the financial manager's objective is to minimize the cost of capital, and

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[3]*General Telephone Co. of the Midwest v. Iowa State Commerce Comm'n*, 275 N.W.2d 364 (Iowa 1979); *United Telephone Co. v. Iowa State Commerce Comm'n*, 257 N.W.2d 466 (Iowa 1977); *General Telephone Co. of the Northwest, Inc. v. Idaho Public Service Comm'n*, 712 P.2d 643 (Idaho 1986); *State ex rel. Associated Natural Gas Co. v. Public Service Comm'n of Missouri*, 706 S.W.2d 870 (Mo. 1985); *General Telephone Co. of the Southwest v. Public Utility Comm'n of Texas*, 628 S.W.2d 832 (Texas 1982); *General Telephone Co. of the Southwest v. Corporation Comm'n*, 652 P.2d 1200 (N.M. 1982).

1 potential investments are evaluated in the context of whether they exceed the
2 cost of capital. The double leverage adjustment is necessary because the
3 parent has issued debt to finance an equity investment in a subsidiary. The
4 adjustment merely determines the cost of financing MEHC's investment in
5 utility operations.
6 Moreover, Dr. Vander Weide's argument fails to recognize the effects
7 of diversification. Modern financial theory is explicit in this regard: only
8 non-diversifiable risk receives compensation. There is no compensation for
9 diversifiable risk. Dr. Vander Weide suggests that the total project or
10 investment risk is relevant. That is simply wrong.
11
12 **Q. Dr. Vander Weide, at page 5 lines 14-16 of his testimony, criticizes a**
13 **double leverage adjustment as being overly complex. What is your**
14 **response to this criticism?**
15 A. Dr. Vander Weide simply misses the point. Without a proper regulatory
16 response to the new ownership arrangement, rates will support excessive
17 capital costs. The structure of the holding company/subsidiary relationship
18 is not created by the Commission. It is created by MEHC. If avoiding
19 complexity is the objective, then the acquisition of a public service company
20 by a holding company should also be avoided.

1 In the case of MEHC's acquisition of PacifiCorp, MEHC will finance
2 its total portfolio of assets with only 28% common equity and 70% debt. The
3 adjustment I propose simply reflects the cost to MEHC of owning PacifiCorp
4 within a consolidated holding company structure.
5
6 **Q. Finally, Dr. Vander Weide asserts at pages 5 and 6 of his testimony that a**
7 **double leverage adjustment is unnecessary due to the ring fencing**
8 **provisions that will be in place after the acquisition closes. What is your**
9 **response to this argument?**
10 A. The argument lacks merit. Ring fencing is unique to the effort to create a
11 separate bankruptcy risk for each subsidiary operating company and for the
12 parent. The principle function of ring fencing is to ensure that the operating
13 company is protected from the financial distress of the parent and all of its
14 other business activities. Ring fencing has nothing to do with how a holding
15 company finances its investments and structures its balance sheet.
16 Double leverage, on the other hand, is directly related to a holding
17 company's decision to finance its investments and acquisitions. It is directly
18 related to the specific debt and equity costs of the holding company. This is
19 important because the operating company here, PacifiCorp, no longer

1 controls the financing decision, particularly when it comes to decisions
2 regarding equity ratios.
3 In other words, the decision to ring fence a utility is independent of
4 the decision to employ double leverage. To combine the two concepts is to
5 create an illusion of independence for the utility that isn't there. MEHC still
6 controls how it finances its equity investment within the holding company.
7
8 **IV. CONCLUSION**
9
10 **Q. Do you have any concluding remarks for the Commission regarding your**
11 **proposed double leverage adjustment?**
12 A. Yes. MEHC plans to finance its equity investment in PacifiCorp with debt
13 and the use double leverage. Nevertheless, PacifiCorp asks the Commission
14 to ignore that plan and the ratemaking consequences of those decisions. A
15 double leverage adjustment simply reflects the ability of a holding company
16 to finance its consolidated operations with debt and record that debt on the
17 utility's books as equity.
18 All theoretical discussions aside, I would ask the Commission to look
19 at MEHC's financial statements. They accurately portray MEHC's decisions
20 to finance its acquisitions and the impacts these financing decisions have on

1 earned returns. They clearly show that double leverage will allow
2 shareholders of MEHC to realize a high return on the full amount of their
3 equity investment in the operating companies, which includes the
4 acquisition premiums.[4] Ratepayers should not support these investments by
5 paying phantom equity costs and associated federal income taxes, and by
6 paying for an acquisition premium that is not used and useful in providing
7 utility service.
8
9 **Q. Please summarize Staff's recommendation to reflect the impact of the**
10 **acquisition on PacifiCorp's cost of capital through a double leverage**
11 **adjustment.**
12 A. The Commission should find that MEHC's proposal to acquire PacifiCorp
13 has an immediate and direct impact on the cost of service to ratepayers. It
14 should find that a double leverage adjustment to PacifiCorp's cost of capital
15 is necessary to recognize that the cost of capital is directly impacted by the

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[4] The financial impact of this transaction is clear to others, too. Mr. Tim O'Brien, a portfolio manager for Evergreen Utility and Telecommunications Fund in Boston, summarized the transaction as follows:

> (Berkshire) has $25 billion in cash assets earning a 3% return, which is depressing Berkshire's return on equity. A regulated public utility, even a weak one like PacifiCorp, can earn 8% to 9%, return on income. Put a little parent leverage on that and you can get returns up in the low teens. It's unexciting, but certainly a big improvement.

Yahooo! Finance., TheDeal.com, "MidAmerican grabs PacifiCorp," Wednesday May 25, 6:00 am ET, Claire Poole in Houston. Berkshire's current cash position is approximately $47 billion.

1 amount of debt MEHC will carry to finance PacifiCorp once MEHC acquires
2 the utility. The rate of return should be reduced to 7.01% and the
3 Commission should adjust the weighted cost of debt to ensure that the tax
4 effects of the increased interest expense are reflected in rates. Mr. Thomas
5 Schooley provides supplemental testimony which calculates the impact of
6 Staff's cost of capital adjustment to PacifiCorp's revenue requirements.
7
8 **Q. Does that complete your direct testimony?**
9 A. Yes.