BEFORE THE WASHINGTON STATE

UTILITIES AND TRANSPORTATION COMMISSION

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| WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, vs. PACIFICORP d/b/a PACIFIC POWER & LIGHT COMPANY, Respondent. | DOCKET NO. UE-050684<br>Volume XII<br>Pages 1440 to 1612 |
| In the Matter of the Petition of PACIFICORP d/b/a PACIFIC POWER & LIGHT COMPANY For an Order Approving Deferral of Costs Related to Declining Hydro Generation. | DOCKET NO. UE-050412<br>(Consolidated) |

A hearing in the above matter was held on February 2, 2006, from 9:45 a.m to 4:15 p.m., at 1300 South Evergreen Park Drive Southwest, Room 206, Olympia, Washington, before Administrative Law Judge ANN E. RENDAHL and CHAIRMAN MARK H. SIDRAN and COMMISSIONER PATRICK J. OSHIE and COMMISSIONER PHILIP B. JONES.

Joan E. Kinn, CCR, RPR

Court Reporter

The parties were present as follows:

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THOMAS E. SCHOOLEY

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P R O C E E D I N G S

JUDGE RENDAHL: We're back in hearing in Docket Numbers UE-050684 and UE-050412, that's PacifiCorp's general rate case and a petition for deferral of hydroelectric costs.

We had a prehearing this morning to mark exhibits and had argument on the company's proposal for oral rebuttal through Mr. Williams. The upshot of that is Mr Williams will appear after Mr. Wrigley this morning and make some oral rebuttal testimony. Mr. Elgin and Mr. Hill may present oral surrebuttal if necessary based upon that testimony.

The company has circulated its prepared oral rebuttal testimony for Mr. Wrigley and Mr. Williams, and copies of those are on the Bench in front of you, and the company is also proposing and may have oral rebuttal for Mr. Vander Weide tomorrow, and that's still subject to discussion between the parties. At this point I understand the company will let the parties know as soon as possible this afternoon if it knows whether it will have oral rebuttal for Mr. Vander Weide and what the scope of that will be, and we may have argument on that tomorrow morning depending on the scope.

So I think that's a recap of the prehearing conference this morning.

MR. WOOD: Your Honor, mention one thing, for the benefit of other counsel, we did distribute copies of the intended oral, additional oral testimony, and in deference to some of the concerns that were expressed, the last Q&A on Mr. Williams' testimony has been marked through so to avoid a claim that will engage in an argument in there, so I just wanted to let the other parties know that in advance.

JUDGE RENDAHL: So the company won't be offering the last Q&A?

MR. WOOD: That's correct. We marked it through in the version we sent to the Bench.

JUDGE RENDAHL: And this won't be an exhibit, this is just for our purposes on the Bench?

MR. WOOD: Precisely, Your Honor.

JUDGE RENDAHL: I noted there are some workpapers attached, are those likely to be included as exhibits, or should we address that as the time comes?

MR. WOOD: It was not our intention to do so. We provided those so that the other parties could review the actual calculations to confirm that they were done correctly.

JUDGE RENDAHL: All right.

MR. WOOD: We didn't intend to offer them.

JUDGE RENDAHL: All right, thank you.

So it seems to me the first matter we need to take up are the additional exhibits for Mr. Wrigley, and also we need to take up, because we have the temperature normalization stipulation which has been marked as Exhibit 593 following Dr. Mariam's testimony, we have not admitted or addressed Dr. Mariam's testimony to this point. So is there any objection to admitting what's been marked as Exhibits 581-T through 587, which were the original prepared testimony and exhibits?

MR. WOOD: No objection, Your Honor.

JUDGE RENDAHL: Hearing no objection, those will be admitted.

And then are there any objections to admitting what are marked as Exhibits 588 through 592, which were PacifiCorp's cross-exhibits?

Hearing no objection, those will be admitted.

And is there any objection to admitting what's been marked as Exhibit 593, which is the temperature normalization stipulation between the company and Staff?

Hearing nothing, that will be admitted, so those are Exhibits 581-T through 593.

Then we have Mr. Wrigley's supplemental, Mr. Wood, do you want to ask any preliminary questions for Mr. Wrigley?

MR. WOOD: Yes, Your Honor.

Whereupon,

PAUL M. WRIGLEY,

having been previously duly sworn, was called as a witness herein and was examined and testified as follows:

D I R E C T   E X A M I N A T I O N

BY MR. WOOD:

Q. Mr. Wrigley, I want to identify exhibits I'm asking you about, they are marked as Exhibits 225, which is your prefiled supplemental testimony PMW-10T, and in addition Exhibit Number 226 and 227, which are respectively your Exhibits PMW-11 and PMW-12; do you have any corrections to make to these exhibits?

A. I have two minor corrections. On Exhibit 225, page 2, line 20, where it says adjustment 4.18 it should say adjustment 4.17.

JUDGE RENDAHL: This is line 20?

THE WITNESS: Yes.

JUDGE RENDAHL: So 4.18 is 4.17?

THE WITNESS: Correct.

JUDGE RENDAHL: Thank you.

A. And on page 3, line 8, where it says 4.xx should read 4.23.

BY MR. WOOD:

Q. As corrected, are these -- first, were these exhibits prepared by you or under your supervision and direction?

A. Yes, they were.

Q. Are they true and correct to the best of your knowledge?

A. Yes.

MR. WOOD: Your Honor, I would propose to handle the additional oral testimony at this time; would that be your desire?

JUDGE RENDAHL: Do you want to offer the exhibits you have just discussed?

MR. WOOD: I would offer Exhibits 225, 226, and 227.

JUDGE RENDAHL: Are there any objections to admitting those exhibits?

Hearing no objection, they will be admitted.

Before you go ahead, Mr. Wood, Mr. Wrigley, you were sworn previously on a prior hearing date in this matter, you're still remaining under oath; is that correct?

THE WITNESS: Yes.

JUDGE RENDAHL: All right, go ahead.

BY MR. WOOD:

Q. Mr. Wrigley, have you reviewed the testimony of the other witnesses in this phase of the proceeding?

A. Yes, and I wish to respond to various statements in the testimonies of Mr. Schooley, Mr. Falkenberg, and Mr. Selecky.

Q. Mr. Schooley describes adjustment 4.21, West Valley non-fuel costs, as reducing certain O&M costs associated with the West Valley lease; is this correct?

A. No, the commitment specifically reduces the cost of the West Valley lease.

Q. Why is this important?

A. As described in both Mr. Falkenberg's Exhibit Number RJF-19T, page 2, lines 4 through 7, and my testimony and under either of the Staff's or ICNU's allocation methodology, the cost of the West Valley lease is excluded from the Washington revenue requirement. Should the Commission accept either of these methodologies or any other methodology which assigns West Valley lease costs away from Washington, the company should return Washington portions of the West Valley savings proposed in the MEHC stipulation.

Q. Mr. Selecky says on page 2 of his testimony, lines 15 through 17, that:

> It is not evident from the materials supplied that PacifiCorp's total revenue

requirement reflects $1.155 Million of costs assigned to affiliates.

Is this correct?

A. No. The company supplied a response to ICNU Data Request 18.1 on January 25th, 2006, that described how the payment of the management fee from the affiliate to PacifiCorp reduces the revenue requirement in this case. In addition, Exhibit Number PMW-11, page 5 of 9, provides the details of the calculation of the $1,155,000.

Q. Mr. Selecky says on page 3 of his testimony, lines 4 and 5 when discussing the captive insurance company that:

The difference between the $7.37 Million and the $16.75 Million needs to be reconciled.

Has the company provided this reconciliation prior to today?

A. Yes. As stated in response to ICNU Data Request 18.3 provided on January the 25th, 2006, the commitment is that the cost of insurance, both property and liability, from the captive insurance costs are less than $7.4 Million. In that response, ICNU was directed to the company's response to WUTC Staff Data Request 381. In that response the company provided an attachment that showed that of the total amount of $37,250,000 of property and liability insurance shown on page 4.17.1 of Exhibit PMW-3, $7.37 Million was related to payments to the captive insurance company.

Q. Mr. Selecky says on page 3 of his testimony, lines 4 and 5 when discussing the hold harmless clause for corporate cost amounts that:

> The Commission should require PacifiCorp to clearly identify this amount in its filings.

Has the company provided information regarding this to parties prior to the filing of his testimony?

A. Yes. In response to ICNU Data Request 18.4, the company explained that the affiliate billings are a credit to energy expense and thus reduce revenue requirement in this case. In addition, the response directed ICNU to the company's response to WUTC Staff Data Request 382 which provided complete details of the $8.5 Million billed to affiliates.

Q. Does this conclude your additional oral testimony?

A. Yes.

MR. WOOD: Mr. Wrigley is available for cross-examination, Your Honor.

JUDGE RENDAHL: Thank you, Mr. Wood.
Mr. Trotter.
MR. TROTTER: Thank you.

C R O S S - E X A M I N A T I O N
BY MR. TROTTER:
Q. Welcome back, Mr. Wrigley.
A. Thank you.
Q. Would you turn to your supplemental testimony, Exhibit 225-T, page 2, I would like to talk about the West Valley non-fuel cost commitment.
A. Yes.
Q. Do you see that testimony?
A. I do.
JUDGE RENDAHL: Could you repeat that reference, Mr. Trotter.
MR. TROTTER: Exhibit 225, page 2, lines 2 through 8.
JUDGE RENDAHL: Thank you.
BY MR. TROTTER:
Q. And you discuss that the adjustment addresses non-fuel costs related to the West Valley lease; is that right?
A. Yes.
Q. And if we look to your Exhibit 226, page 3,

you provide the text of the commitment itself; is that right?

A. This is the Oregon commitment, yes.

Q. Right, and that's the one you're implementing in your testimony that we discussed?

A. Yes, I am.

JUDGE RENDAHL: Mr. Trotter, can you identify what page you're referring to?

MR. TROTTER: It's page 3 of 9.

JUDGE RENDAHL: Thank you.

BY MR. TROTTER:

Q. And according to that, PacifiCorp commits, excuse me, MEHC and PacifiCorp commit to reduce the annual non-fuel cost to PacifiCorp customers of the West Valley lease by $417,000 a month total company, correct?

A. Yes.

Q. Now am I correct that the West Valley lease requires the company to pay a fixed lease payment each month as well as the O&M costs of the facility?

A. It requires them to pay fixed lease payments and O&M costs, yes.

Q. And am I correct that the lease payment is a fixed cost?

A. Yes.

Q. And the other costs would be variable costs, right?

A. They would be variable fuel costs and variable non-fuel costs.

Q. Okay. Now you said fuel and non-fuel O&M?

A. Yeah, correct.

Q. Okay. And the language of this commitment talks about non-fuel costs, and so therefore is it your contention that it includes O&M costs other than fuel as well as the monthly lease payment?

A. It includes all non-fuel costs. I read this commitment to say that MEHC and PacifiCorp commit to reduce the annual costs to PacifiCorp's West Valley lease which are non-fuel costs. Basically I think non-fuel is just describing the lease cost as not being a fuel cost.

Q. Okay.

A. Which is extremely important under the Revised Protocol methodology.

Q. Right, but I guess we talked about three categories of costs associated with the West Valley lease, the fixed cost, which is the lease payment?

A. Right.

Q. Monthly, however many monthly dollars that is.

A. Right.

Q. The second category is fuel, and the third category is non-fuel O&M.

A. Correct.

Q. Okay. And the language that we're focusing on in Exhibit 226, page 3, non-fuel means the fixed lease payment and non-fuel O&M; is that right?

A. Right.

Q. Okay. Now did you read the supplemental testimony of Mr. Schooley?

A. Yes, and I read Mr. Buckley's testimony also.

Q. Okay. And you're then aware that the Staff's transitional allocation method for use in this case maintains the allocation of the West Valley O&M costs to Washington but removes the fixed lease payment?

A. Yeah, basically Staff removes $1.4 Million of the lease payment. So if we look to Section B of the commitment, this commitment is offsetable to the effect that non-fuel cost savings are reflected in PacifiCorp's rates. So by Staff removing $1.4 Million associated with the lease, this dwarfs my adjustment of $413,000, so no future -- no further adjustment needs to be made.

Q. You used a verb there, this loss or what word did you use, dwarfs?

A. Dwarfs.

Q. Dwarfs, thank you, I just didn't hear that, thank you.

A. Sorry.

Q. So it's your contention that under the commitment paragraph B that the Staff's interim or transitional allocation method would qualify for taking these benefits away?

A. Yes.

Q. And that's what you meant to convey when you said in your supplemental testimony, oral testimony today, that "the commitment specifically reduces the cost of the West Valley lease"?

A. Yeah, and the reduction I believe is just they were just addressing the lease. It's appropriate that they're addressing -- that the lease plus fixed O&M cost, but even if it's not specific there, 08-B(i) obviously says it's offsetable if any part of the non-fuel cost savings are reflected in rates, and Staff's adjustment to remove the lease costs satisfies this condition.

Q. Okay, thank you.

Do you know the magnitude of the West Valley O&M costs that are non-fuel and non-lease payment related?

A. Not off the top of my head I do not.

Q. Please turn to Exhibit 227, page 13, and this is your results of operations exhibit, right, based on as of today with implementing the company's supplemental testimony?

A. This implements the supplemental testimony, but it doesn't implement the weather normalization stipulation.

Q. Okay. And you have two other exhibits in the record that are in the same format, in your direct case which is Exhibit 193 and your rebuttal case which is Exhibit 198; is that right?

A. Yes.

Q. And we're on page 13, and this is top of the page it refers to unadjusted results; do you see that?

A. Yes.

Q. And under the Washington column starting on line 515, this is the impact of the embedded cost differentials under the Revised Protocol; is that right?

A. Yes, it is.

Q. And you show on line 523 for these unadjusted results Washington receives a power cost reduction of $8,095,992; is that right?

A. Yes.

Q. Would you accept subject to your check that in your Exhibit 193, your direct testimony results of operations exhibit, on this same page and same line

Washington received a power cost reduction of $8,672,000?

A. Yes, I would.

Q. And can you explain why Washington gets a smaller benefit from the embedded cost differential in your current case, Exhibit 227, than in your direct case, Exhibit 193?

A. I don't believe it's anything I have done in the supplemental testimony this time, so it must have been in my rebuttal, some of the adjustments I made in my rebuttal case.

Q. I think it may be due to both, but if you can just -- if you can answer the question, I would appreciate it.

JUDGE RENDAHL: Can you repeat the question.

MR. TROTTER: Yes, I'm asking him to explain why the embedded cost differential power cost reduction went from $8,672,000 in Exhibit 193 to $8.1 Million in Exhibit 227.

JUDGE RENDAHL: Mr. Trotter, just for the record, you say it's the same page in Exhibit 193.

MR. TROTTER: Yes.

JUDGE RENDAHL: Can you identify which tab it's in.

MR. TROTTER: Tab 2, page 2.10.

JUDGE RENDAHL: Page 2.10?

MR. TROTTER: Yes.

JUDGE RENDAHL: Thank you.

MR. TROTTER: Same line number.

A. I think the biggest change would have been the -- if you go to my rebuttal testimony where we accepted changes in power costs with ICNU and made a $2,500,000 change in power costs, that would have changed the embedded cost differential. But Mr. Taylor would have been a better person to ask questions about the ECD than me.

BY MR. TROTTER:

Q. Fair enough. But the settlement on power supply, that reduced test year power supply expenses, did it not?

A. Yes, it did.

Q. And would there also be a modest change, a small portion of the difference would be due to the West Valley lease adjustment in the merger analysis because that adjusts power supply downward?

That might be represented by the fact that your rebuttal figure for this line is different than your supplemental figure for this line.

A. It would be -- it would have to be the result of the change of the West Valley lease.

Q. So is it fair to say then that when power supply adjustments are made that reduce expenses, the effect on the embedded cost differential is to make the benefit to Washington go down?

A. Right, it is.

Q. And when the benefit to Washington goes down, all else equal, the revenue requirement goes up?

A. Yes.

Q. And another way to say that is, at least as it applies to merger benefits, if a merger benefit relates to power costs and it reduces power costs, that benefit is offset in part by the impact on the embedded cost differential under Revised Protocol in the unadjusted results; is that right?

A. Assuming the adjustment wasn't to a hydro cost. If it was a reduction in a hydroelectric cost, I think that would increase the benefit to Washington.

Q. So --

A. The embedded cost differential is comparing the hydro cost and the non-hydro cost, and so as we reduce the differential, there's less of a benefit to Washington.

Q. So your answer is yes in the non-hydro expense category?

A. Yes, it is.

MR. TROTTER: That's all I have, thank you, Mr. Wrigley.

JUDGE RENDAHL: All right, I don't have any other -- neither Public Counsel nor ICNU has indicated any cross for this witness; is that correct?

MR. FFITCH: That is correct.

JUDGE RENDAHL: All right, are there questions from the Bench for Mr. Wrigley?

Chairman Sidran.

CHAIRMAN SIDRAN: Thank you.

E X A M I N A T I O N

BY CHAIRMAN SIDRAN:

Q. Good morning.

A. Good morning.

Q. I'm going to ask you some questions that basically go in a completely different direction than what we have just been listening to, and I want to take you back to your direct testimony, because I just want to clarify an issue for my own benefit. This is 191 I believe is your direct, and at the bottom you're talking on page 2 about making some adjustments, at the bottom of page 2, and I'm particularly interested in the last sentence and the first sentence that carries over to page 3 where you're talking about adjustments related to wages and benefits. And I want to be sure I understand at the top of the page where you say that you have included wages and benefits that the company will experience in the 12 months ended March 31st, 2006, as an adjustment to the historic test period. I take it then that would that include all of the salaries including the executive salaries, wages, and benefits up to March 31, 2006?

A. The methodology basically takes labor costs in the historic period and then escalates it based on, you know, known, it escalates it with known and measurable changes through that amount. So any salaries of executives which were embedded in the 2004 data are escalated going forward.

Q. So the 2005 executive salaries would be reflected in this adjustment?

A. No, what would be reflected would be the September 2004 salaries escalated forward 18 months, with basically inflation it's about 3%, so it wouldn't reflect the actual salaries paid in the 12 months ending March 2006.

Q. Okay, so if, just help me understand this, so if you have, for example, an executive salary that steps up in addition to inflation, there's a salary increase for a senior executive in 2005, would that be in this

adjustment or not?
A. No, it would not.
Q. So it would only be the inflation adjustment for example?
A. Yes.
Q. Not the actual salary increase?
A. Right, it would be the inflation adjustment.
Q. Okay.
And the second question is, where do you, and you may not know the answer to this, were there any severance compensation as a result of the proposed acquisition by MidAmerican in this adjustment?
A. No, there would not be. This case was prepared and finished before the acquisition by MEHC was announced.
Q. That's helpful, I understand that, but I did not understand what an adjustment that ends March 31st, 2006, encompassed. So as I understand your testimony, doesn't encompass any salaries increased beyond inflation adjustments and does not encompass any severance or other compensation that's a result of the pending acquisition?
A. That's correct.
CHAIRMAN SIDRAN: Okay, great, thank you.
All right, I think that's the only question I

had.

E X A M I N A T I O N

BY JUDGE RENDAHL:

Q. Okay, I have a few questions for you, Mr. Wrigley. The first has to do with the temperature normalization stipulation, which is now Exhibit 593; do you have that?

A. I do.

Q. Okay. If you will look at Paragraph 6 of the stipulation, which is on the second page of the stipulation, can you explain in more plain language what the effect of the settlement is on revenue requirement, specifically where it refers to an increase in the company's revenue requirement deficiency?

A. Yes, I can.

Q. Thank you.

A. In the company's original case we filed for a reduction in revenues because of temperature normalization of approximately $2.7 Million. Dr. Mariam recommended that number be replaced and increased. Instead of a negative $2.8 Million, he recommended an increase of $2.2 Million, and we're compromising and replacing that number by minus $1 Million.

Q. So the minus $1 Million that's referenced in that paragraph is the compromise figure?

A. Right.

Q. Between the company and the Staff?

A. It will reduce approximately the revenue requirement we're requesting in our case by $1.7 Million. Originally we had a reduction of minus $2.5 Million, sorry, minus $2.7 Million.

Q. All right, and it will -- this is where I, again not being an accountant, the wording that's used in terms of an increase in the deficiency, my negatives and positives get a little mixed up in my head, so.

A. So it reduces the increase we are requesting.

Q. Thank you. So the effect is, total effect is a $1.7 Million reduction in the revenue requirement for the company?

A. In the company's case, yes.

Q. And looking at the paragraphs A and B which refer to Mr. Schooley's Exhibit 633, is the effect of those calculations, those refer to essentially a $4 Million reduction in expenses or costs, the effects of A and B, and that translates into the $1 Million reduction in revenue requirement; am I reading that correctly?

A. No, what we're doing here is we're -- the $2.2 Million that Staff has in their original case is a number allocated to the state of Washington. We're replacing that by $1 Million.  And then we agreed that -- normally what would happen when we change temperatures, we change loads.  And as you can see on the next page, we agreed basically that irrespective of this, we're not going to make any related adjustments to power cost allocation factors.

Q.    All right.  So the deletion in line 11 referred to on paragraph B has to do with the change in load, but you're not reflecting it elsewhere?

A.    Right, we're taking that out of it now.  So all we're doing is replacing, just putting the $1 Million number in and taking out any adjustments for loads.

Q.    Okay, thank you.

And in terms of paragraph 7, which is what appears to be the refinement of the methodology, is the intent of the stipulation to further refine the company's proposal in this case for a multiple based temperature methodology; is that the intent?

A.    No, I think the intent is in future cases for the Staff and the company to work together to build a model that we all agree upon so that this issue will not be brought up in future rate cases.

Q.    Okay.

A.    Probably Dr. Mariam or Mr. Klein would be more knowledgeable about that part of the stipulation.

Q. All right. Do you know whether the company intends to use this new methodology in the next rate case? Because there was some language, let's see if I can find it, in paragraph 7.A:

> The company anticipates filing its next general rate case in mid 2006 and will incorporate these refinements in the filing.

So it's the intent to use this refinement in the next filing?

A. It is, and then go on to make future enhancements in the future working to get more load data so we can develop better models, models which satisfy Dr. Mariam's concerns. So we have a settlement in this case, a commitment to work together to refine the models before the next case, and then a long-term commitment to develop more data to get even better models going forward.

Q. Okay, thank you, and we appreciate the parties working together to resolve that issue.

JUDGE RENDAHL: Turning to another issue, and that has to do with the acquisition credits, the acquisition stipulation credits. And as a question for counsel, we have the Oregon stipulation in the record, and at the time Mr. Wrigley's testimony was filed the Washington stipulation had not yet been filed. We can take administrative notice of the stipulation that's been filed, or we can include it in the record for reference.

MR. TROTTER: It's fine to include it from Staff's perspective, Your Honor.

JUDGE RENDAHL: To include it in the record?

MR. TROTTER: Sure.

JUDGE RENDAHL: So what we would do is include the stipulation in Docket UE-051090 that includes the, which is the stipulation for the acquisition proceeding. Any preference on where to include that in the record in terms of the number? Should we include it with Mr. Wrigley's exhibits?

MR. TROTTER: That's fine, Your Honor, Exhibit 228.

MR. WOOD: Certainly.

JUDGE RENDAHL: All right, so the stipulation in Washington in Docket UE-051090 will be included as Exhibit 228.

Is there any objection to admitting it?

MR. WOOD: No objection.

JUDGE RENDAHL: Okay, then it will be admitted.

I'm not going to be referring to that per se, but I just wanted to make sure we get it into the record appropriately.

BY JUDGE RENDAHL:

Q. So, Mr. Wrigley, if the Commission doesn't include the rate credits from the acquisition settlement in this rate case, how would or how does the company propose to track or account for these rate credits?

A. I'm referring to the Washington stipulation, I think the commitment number 3, which is the West Valley lease.

Q. And what page would it appear on?

A. Appendix A, page 13.

Q. And that's Washington 3?

A. Washington 3 and Washington 7 both have deferred accounting associated with them, so they're not included in this rate case. And say the Commission issues an order in this case in April which does not include those, commitment number 2 basically says they go into a, sorry, commitments 3 and 7 basically start deferred accounting.

Q. Okay.

A. So if they're not -- if you don't implement them in this case and issue an order in April, starting May the 1st we would defer those and accrue interest, and they would become part of rates in the next general rate case.

Q. All right. And as to the other adjustments?

A. I think those are the only -- there's no commitments on deferred accounting on those, I think they're basically hold harmless clauses, and so those are basically only to be implemented in a general rate case.

Q. So there's no need to have accounting, but they would be brought up again in another rate case for treatment?

A. Right. Like with number 5, which is the insurance, the captive insurance, we would look at the cost for captive insurance in the next rate case and see whether it's above or below the $7.4 Million and then make an adjustment if needed.

Similarly, we would look at number 4 and number 7, which are billings to affiliates, we would look at the amount billed to affiliates in a general rate case and see whether an adjustment needed to be made.

Q. Okay, thank you.

I have a few other questions, but they're somewhat similar to Mr. Trotter's trying to clarify differences between your three exhibits, your results of operation exhibits.

A. Okay.

Q. So if you can pull out your exhibits or at least have them at near hand, Exhibits 193, 198, and I guess it's 226 is the next one. If you look specifically at page 2.2 of those exhibits, which for Exhibit 226 is page 5 of 42, maybe if you start there.

A. Okay, I have that.

Q. Okay. So page 5 of 42 of Exhibit 226, if you would look at the column labeled Washington and look down at line 33, that shows the operating revenue for return as $39,061,554; do you see that?

A. Yes, I do.

Q. And similar to Mr. Trotter's question, would you accept subject to check that the Exhibit 193 includes a $39,417,272 number?

A. I would, I can see that number.

Q. Okay. And 198 included a $39,077,272 number?

A. Yes.

Q. Can you explain what causes this change in your results of operations for the test year?

A. I can, it's the embedded cost differential. The embedded cost differential instead of using actual net power costs uses the forecast of net power costs. So as we make changes like the settlement with ICNU on power costs, the changes to the West Valley lease, the allocation factors change, and so the actual amounts for Washington change.

Q. So it's in some respect due to the forecasted nature of the power costs in this case forecasted to 2007?

A. Yes.

Q. Okay. And for the same exhibits, if you look at line 62 where it lists total rate base, again there's a difference in those numbers; is the difference for the same reason?

A. Yes, it is.

Q. Okay. And I'm going to ask you a Bench Request to do some recalculation of these, if you could. So as Bench Request 35, can you prepare a revised Exhibit 226 with the column Washington reporting the amounts shown on your original direct case and then making any additional adjustments necessary in the columns adjustments and adjustment totals. Do you understand what I'm asking?

A. Yes. Yes, I can.

Q. Okay. If you could prepare that, that would be helpful.

A. No problem.

JUDGE RENDAHL: Okay, and that's all I have.

DIRECT BY WOOD)

Are there any other questions for Mr. Wrigley?

Thank you, Mr. Wrigley, you may step down.

All right, let's be off the record for a moment while we bring Mr. Williams on the stand.

(Discussion off the record.)

JUDGE RENDAHL: While we were off the record, counsel for the company clarified that the Bench Request refers to Exhibit 227, not 226, and that's correct, so Bench Request 35 would reflect Exhibit 227.

Mr. Williams, you remain under oath from your appearance previously in this case, so I will turn you over to Mr. Wood.

MR. WOOD: Thank you.

Whereupon,

BRUCE N. WILLIAMS,

having been previously duly sworn, was called as a witness herein and was examined and testified as follows:

D I R E C T   E X A M I N A T I O N

BY MR. WOOD:

Q. Mr. Williams, did you previously file testimony in this proceeding?

A. Yes, I submitted direct testimony in this proceeding.

Q. What is the purpose of your rebuttal testimony?

A. First I will address Mr. Gorman's contention that acquisition by MidAmerican Energy Holding Company or MEHC will likely reduce PacifiCorp's amount of off-balance sheet debt equivalence. Second, I will comment on the potential adverse credit rating effects of the double leverage adjustments proposed by Mr. Hill and Mr. Elgin.

Q. Do you agree with Mr. Gorman's contention that the proposed acquisition by MEHC will likely reduce PacifiCorp's off-balance sheet debt equivalence?

A. No. Mr. Gorman testifies that credit rating agencies likely will reduce PacifiCorp's off-balance sheet debt equivalence after an MEHC acquisition because (1) the West Valley lease costs will be reduced in response to Washington specific commitment WA-3, and (2) the 30-year Blundell steam purchase agreement with an MEHC subsidiary may be assigned a lower risk factor for debt equivalence purposes once a contract is converted from a contract with a non-affiliated third party to an affiliated company.

The changes with respect to these two contracts, however, can not reduce the $570 Million in debt equivalence currently assigned to PacifiCorp's contractual payment obligations for the simple reason that the contracts referred to by Mr. Gorman were not included in the list of contractual obligations provided to Standard & Poor's for its debt equivalence evaluation. Thus the currently assigned debt equivalence is entirely related to contractual obligations other than the ones cited by Mr. Gorman. The acquisition by MEHC therefore will have no impact on PacifiCorp's off-balance sheet debt equivalence of $570 Million.

Q. What is the impact of the double leverage adjustment recommended by Mr. Elgin on PacifiCorp's credit rating matrices?

A. Standard & Poor's ranks the utilities business profile score on a range from 1 to 10, where a score of 1 denotes the strongest business position and a score of 10 corresponds to the weakest business position. Currently Standard & Poor's ranks PacifiCorp's business profile score at 5 and its senior secured debt at A minus. Even if PacifiCorp avoided a further reduction in business risk rating as a result of the proposed double leveraging treatment, the impacts of such treatment if applied generally by PacifiCorp's regulators would be very damaging. All three of the resulting key credit ratios would be the triple B range as summarized below.

For instance, the ratio FFO to interest coverage would be 3.8. That would be on the borderline pass/fail for the A benchmark as published by Standard & Poor's for a business profile of 5 and would indicate a rating of strong triple B. The total debt ratio would be 58.5%, which would fail the A benchmark. And the indicative rating would be weak triple B. FFO to total debt would be 18.8%, again failing the single A benchmark and indicating a rating of triple B.

Q. How would Mr. Hill's proposals regarding the double leverage adjustments to the capital structure and cost of capital affect PacifiCorp's credit ratings?

A. Mr. Hill's recommended capital structure and cost of capital also would be inconsistent with a current A minus credit rating for PacifiCorp. Let me summarize those. The FFO interest coverage ratio under Mr. Hill's proposal would be 3.9%. That would barely pass the single A benchmark test and indicate a rating of weak A. Total debt ratio would be 58.2%, failing the single A benchmark test, indicating a rating of triple B, weak triple B, I'm sorry. FFO to total debt would be

19.6%, again failing the single A benchmark test, indicate a rating of triple B.

Now even these substandard ratios may be conservative and understate the impact of the application of the proposed double leverage capital structure. In the first place, such an adverse decision may cause a further erosion of PacifiCorp's business profile, which would raise the required credit rating metrics for maintenance of an investment grade rating.

Second, I am assuming that the credit agencies would continue to apply a debt ratio based on PacifiCorp's actual debt ratio even if regulators by adoption of a double leveraging rationale announce they would recognize a substantially higher debt ratio for rate making purposes. If the credit agencies assign to PacifiCorp the debt leveraging produced by such double leverage calculations, the ratings metrics would be much worse yet.

Finally, the ratios shown I discussed earlier assume that PacifiCorp was deemed to have a reasonable opportunity to earn the allowed return on its overall electric business, which would seem unlikely if some of the Staff adjustments such as the Staff's interstate cost allocation proposal were adopted.

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.

MR. WOOD: Mr. Williams is available for cross-examination, Your Honor.

JUDGE RENDAHL: Mr. Cedarbaum.

MR. CEDARBAUM: Your Honor, with the understanding that Mr. Elgin will be able to respond to this testimony, we have no questions.

JUDGE RENDAHL: Mr. ffitch.

MR. FFITCH: Your Honor, I just have a couple of questions. We also have the understanding that Mr. Hill will be able to respond to Mr. Williams' testimony.

C R O S S - E X A M I N A T I O N

BY MR. FFITCH:

Q. Good morning again, Mr. Williams.

A. Good morning.

Q. What portion of PacifiCorp's total operations does Washington state represent?

A. I believe it's around 8%.

Q. And in your analysis here, have you assumed that Public Counsel and Staff recommendations are applied to the entire operations of PacifiCorp?

A. This is a look at just the Washington results of operations. And if they were I guess broadened to the entire company, this is how the results would impact.

Q. All right, so in that sense the results depicted here are hypothetical, are they not?

A. No, I don't think they're hypothetical. They are what would result upon the recommendations on the double leverage adjustments proposed by Mr. Hill and Mr. Elgin.

Q. If they were applied throughout the entire PacifiCorp system, to the entire PacifiCorp operation?

A. Well, again, it's a look at the Washington results of operations, and I guess if you expanded that throughout the system, yes, these would be the results that would follow.

MR. FFITCH: All right, I don't have any further questions, thank you, Your Honor.

Thank you, Mr. Williams.

JUDGE RENDAHL: Okay, thank you.

Ms. Davison, are you still on the bridge?

MS. DAVISON: Yes, I am, Your Honor.

JUDGE RENDAHL: And do you have any cross for Mr. Williams?

MS. DAVISON: No, Your Honor.

JUDGE RENDAHL: Okay, thank you.

Are there any questions for Mr. Williams from the Bench?

I'm sorry, before we go, is there any redirect for Mr. Williams?

MR. WOOD: One question.

R E D I R E C T   E X A M I N A T I O N

BY MR. WOOD:

Q. You were asked by Mr. ffitch if you are assuming the Washington results apply to the entire company, he noted that Washington is a relatively small percentage of the company's revenue requirement. In your view, would it be reasonable to take the position that an unreasonable result in Washington is okay because other states might bail the company out?

A. No, I think it's inappropriate for any state to set rates at a low level and with the expectation that other states that regulate PacifiCorp would offset the impacts of those results.

MR. WOOD: Thank you.

That's all I have, Your Honor.

JUDGE RENDAHL: All right.

Any questions from the Bench?

COMMISSIONER JONES: Just one short question factual in nature.

E X A M I N A T I O N

BY COMMISSIONER JONES:

Q. Could you just give me a little ratings agency 101 here, and explain how Standard & Poor's, what are the major factors in calculating a business profile, the scale from 1 to 10, as opposed to the financial metrics, 3 of which you quote in page 2 of your testimony, and what has the business profile of PacifiCorp been since 2000, 2001, has it changed, and what were the reasons that the business profile went up and down, if it did?

A. Okay, let me respond to your last question first. The business profile I believe in 2000 was 3 and was changed to a 4, oh, I believe in 2002 following the Western Power Crisis. And the company's results at that time I think indicated to Standard & Poor's that there was more risk in the business than what they had believed earlier. And again, 3 is a relatively low risk profile or business profile, again on a scale of 1 to 10 with 1 being the highest grade you could have to a 10 being the weakest.

Again then we were changed in 2004 from a 4 business profile to a 5 when S&P redid some of their methodologies and some of their scoring at that time.

That was a change not based on the company itself, but was more a change that affected a number of companies based on their methodologies.

Okay, I think your first question about how do they determine the business profile, it's a bit of an art, but there are a number of factors that go into it. Things such as your competitive position or your rates versus other utilities, their perception of how much risk you have in the business and management's willingness to mitigate those risks, other things such as some of the financial risk that you might or might not employ in your financing of the business. I would say also regulation is a key criteria as well, their perception of how they view the regulatory climate in the states that the utility serves. I think those are among the factors they consider in setting that business profile.

Q. So they, just to confirm that latter point, so it's a comprehensive list of factors including the regulatory climate of the six states in which PacifiCorp operates as well as the competitive position in each of the states, operational risk, financial risk?

A. Yes, they're --

Q. And which would be both systemwide as well I guess for each of the states in which they operate in?

A. Yes, that is correct.

COMMISSIONER JONES: Thank you.

E X A M I N A T I O N

BY CHAIRMAN SIDRAN:

Q. Good morning, Mr. Williams.

A. Good morning.

Q. I just want to follow up on Commissioner Jones' question, these criteria that he was asking about, would you characterize those as an effort to rate the performance of the company, if you will, from an investor perspective?

A. I'm not sure I would say it's an effort to rate the company. I think it's -- or the company's performance. I think what they're trying to do is to establish like categories or categories for like utilities that have the same type of risk in their business. And then within that category, they have published benchmarks or targets for the various financial metrics that need to be met for various ratings levels. And the way they differentiate then for a company with a business position say of 7 or 8 will have to have -- have to meet more stringent financial requirements than a company with a business position say of 3 or 4 or 5. So as their perception of your risk increases, they will require you to have greater coverages, less leverage, those types of things.

Q. So from an investor point of view, would it be fair to say that a company with in this case I guess a lower number is a better or at least safer investment than a company with a higher number?

A. Yeah, I think that's true. They might say it is a lower risk business, but yeah, I generally believe you are correct.

Q. And just looking at the 2003-2005 time frame, has the company's rating changed? I believe you said, I can't remember precisely your testimony, but it changed from a 4 to a 5 in what year?

A. That was in 2004. Yes, our ratings did change I believe in -- I believe it was also in I'm not sure if it was 2004 or early 2005, but Standard & Poor's downgraded us from a single A to an A minus where we are today.

CHAIRMAN SIDRAN: Thank you.

THE WITNESS: You're welcome.

JUDGE RENDAHL: Okay, are there any other questions for Mr. Williams?

Okay, with that, Mr. Williams, thank you very much for coming back this morning, you can step down.

Let's be off the record for a moment.

(Recess taken.)

JUDGE RENDAHL: All right let's be back on the record after our mid-morning break.

Good morning, Mr. Elgin.

MR. ELGIN: Good morning.

(Witness KENNETH L. ELGIN was sworn.)

JUDGE RENDAHL: Please be seated.

Mr. Cedarbaum.

MR. CEDARBAUM: Thank you, Your Honor.

Whereupon,

KENNETH L. ELGIN,

having been first duly sworn, was called as a witness herein and was examined and testified as follows:

D I R E C T  E X A M I N A T I O N

BY MR. CEDARBAUM:

Q. Mr. Elgin, if you could please state your name, your position with the Commission, and your business address.

A. Yes, my name is Kenneth Elgin, E-L-G-I-N. I'm the case strategist with the regulatory service division. My address is Chandler Plaza Building, 1300 South Evergreen Park Drive Southwest, Olympia, Washington 98504.

Q. And have you prepared supplemental testimony

on the subject of double leverage in this proceeding?
A. Yes, I have.
Q. Referring you to what's been marked for identification as Exhibit 791-T, is that your prefiled testimony on double leverage?
A. Yes.
Q. And was that exhibit prepared by you or under your supervision and direction?
A. Yes.
Q. Do you have any corrections to make to that exhibit?
A. Yes, I have on two pages.
The first would be on page 28, line 2, the reference to Exhibit KLE-7, the 7 should be stricken and it should reference KLE-8.
And then on that same page, line 7, the reference to Exhibit Number 151-T, page 154, line 6, just insert 6-9, so it should read lines 6 through 9.
Q. And you're referring to page 54, not 154; is that right?
A. Yes, excuse me, page 54.
Q. So just for the record, the complete citation, internal citation that you have on page 28, is Exhibit Number 151-T, page 54, lines 6 through 9?
A. Correct.

And the other minor correction is on page 34, line 7, the last two words should be stricken so the sentence would read:

The adjustment simply reflects the cost to MEHC for its equity investment in PacifiCorp.

Q. Are those all of your corrections?

A. Yes.

Q. So that if I were to ask you the questions in Exhibit 971-T, your answers would be as reflected in that exhibit?

A. Yes, they would.

Q. During the course of your testimony, you refer to a number of exhibits, are the exhibits that have been marked for identification as Exhibits 792 through 799 the exhibits referenced in your testimony?

A. Yes.

Q. And have all of those exhibits been prepared by you or under your supervision and direction?

A. Yes.

Q. Are they true and correct to the best of your knowledge and belief?

A. Yes.

MR. CEDARBAUM: Your Honor, at this time I would offer Exhibits 791-T through 799.

MR. WOOD: Your Honor, I will object to -- I would move to strike a portion of Exhibit 791-T and also to strike Exhibit 793. What I'm referring to is the language that begins on page 4 of KLE-1T starts with, MEHC will profit handsomely from its use of double leverage, and the material I would move to strike is the language that begins at the word similar and goes through line 20.

JUDGE RENDAHL: And the basis?

MR. WOOD: And the basis is as follows. In what we view as the feeding frenzy that is on the company's return, this goes over the line. What this witness is saying here is comparing MEHC and Warren Buffet to the notorious Sam Insull claiming that the financing arrangement is similar. He then puts in an exhibit which contains a description of the notorious Holding Company Act abuses including stock watering, inflation of capital asset prices, intercorporate abuses, and luring stockholders into a situation where a $300,000 investment controlled assets of $1 Billion. There is no probative relationship of this material to the issues at hand. We see them as nothing but an attempt to replace reason with an appeal to emotion. Nobody believes and the Staff is not contending that the MEHC arrangement is similar to the Insull empire or that the abuses of that empire are relevant. I'm sure Staff wouldn't have entered a stipulation to approve the acquisition under those circumstances. So I move to strike because it lacks probative value, and it's prejudicial.

JUDGE RENDAHL: Mr. Cedarbaum.

MR. CEDARBAUM: Two points, Your Honor. First of all, Exhibit 793 is also an exhibit in the acquisition docket. It was admitted into evidence without objection. It's simply the same document, so I don't see that -- if it was not prejudicial in that docket, I don't see how it can be prejudicial in this docket.

And secondly, none of Mr. Wood's comments really form the basis for an objection to the admission of this evidence. If he wants to cross-examine Mr. Elgin on this testimony, fine, but in terms of its admission, I didn't hear anything that would warrant striking of this material.

JUDGE RENDAHL: Mr. Wood, any response?

MR. WOOD: I believe the fact that there's no shown probative value and relevance to these issues in this proceeding, unless there is a claim that there's some comparison with the abuses of Samuel Insull and of MEHC, and it's plainly an appeal to prejudice.

(Discussion on the Bench.)

JUDGE RENDAHL: Your motion to strike is denied, the exhibits will be admitted. The issue as to the prejudicial aspect of it I think the Commission is able to evaluate the information, it really goes to the weight, and I think the Commission is capable of evaluating the weight of the information.

So what's been marked as Exhibit 791-T including the portion, Mr. Wood, that you moved to strike, 791-T through 799 will be admitted. And I will note that Exhibit 800, which is identified as KLE-10, the Staff withdrew that soon after filing, so Exhibits 791-T through 799 will be admitted.

MR. CEDARBAUM: Your Honor, at this time with your permission I would like to ask Mr. Elgin a few questions to follow up on Mr. Williams' testimony this morning.

JUDGE RENDAHL: Based on our discussion this morning, please go ahead.

MR. CEDARBAUM: Thank you.

BY MR. CEDARBAUM:

Q. Mr. Elgin, were you in the hearing room when Mr. Williams testified with respect to his opinion of the impact of your double leverage adjustment on PacifiCorp's credit rating matrix?

A. Yes.
Q. And have you reviewed a workpaper provided to you by the company in which he calculated his opinion of the impact of the adjustment on the company's credit rating matrix?
A. Yes.
Q. Can you just briefly explain just the mechanics of that calculation as you understand it?
A. Yes. The mechanics of the calculation simply take the company's position with respect to interstate cost allocations and apply them to various rate base and depreciation and cash flow metrics. And so I would say that the first thing that it does is it accepts something in terms of a factual foundation that -- this allocation methodology has never been accepted by the Commission, and so it seems to me that all the metrics that they used to establish these where the company would be assumes something that the Commission has never adopted. And so I would say that it overstates the effect. While the effect is there, the extent to which it's overstated is clear in my mind.
Q. So you would disagree with the underlying principle or methodology with which these calculations were made?
A. Yes, not only the methodology, but also the

notion that somehow this is of relevance with respect to how the company would finance its operations. It does not finance its operations as a Washington stand-alone company.

Q. The calculation as you understand it assumes that the company does finance as a stand-alone company?

A. Correct.

Q. In the course of his testimony this morning, Mr. Williams stated that the impacts of a double leverage adjustment such as yours, if applied generally by PacifiCorp's regulators, would be very damaging. What is your response to that testimony?

A. I disagree with the characterization that it's very damaging. I agree with the assessment that it would have a downward pressure on the ratings, but to ascribe it and raise it to a level that would be construed very damaging is an overstatement.

Q. He I believe provided some indicative ratings using a -- assuming proposed double leverage adjustments that were in the strong to weak triple B category; do you recall that?

A. Yes, I do.

Q. What does that tell you in terms of the company's ability to finance?

A. It tells me that the company is still investment grade, that it would have reasonable access to capital, and that -- it gets back to the testimony that I heard earlier in this proceeding with respect to this notion of what's fair and what's the company's burden, that the Staff recommendation is that the investment grade would provide reasonable access to capital, and that there's been no showing by the company with respect to the A minus rating, and it is at the lowest ever overall average cost of capital, and does that adequately represent the best balance between economy and safety with respect to the issue of capital structure and financing and access to capital.

Q. Finally, Mr. Williams also testified with respect to the ratios that he presented that the ratios that he presented assume that PacifiCorp was deemed to have a reasonable opportunity to earn the allowed return on its overall electric business, which would seem unlikely if some of the Staff adjustments such as the Staff's interstate cost allocation proposal were adopted; do you recall that testimony?

A. Yes.

Q. And what is your response to his testimony on that point?

A. Again, this gets to the issue of the impact of this case and the substantive issue regarding interstate cost allocations. I would say that clearly the overriding impact of this would be driven by more of the impact on the major jurisdictions where it would serve, and that would be Utah and Oregon, and I would say that the question of a reasonable opportunity is really what this Commission determines is the proper rate base, the proper level of investments, and the proper level of expenses, and to really say that somehow this is denying them an opportunity to allow a fair rate of return is again an overstatement. The Commission decides what's used and useful, what's proper rate base, and makes its decisions on the record and provides an opportunity to earn a fair return.

MR. CEDARBAUM: Thank you.

Your Honor, those are all my questions prompted by Mr. Williams' testimony, and so that Mr. Elgin is now available for cross-examination or questions from the Bench.

JUDGE RENDAHL: Thank you, Mr. Cedarbaum.

Mr. Wood.

MR. WOOD: Yes.

C R O S S - E X A M I N A T I O N

BY MR. WOOD:

Q. Mr. Elgin, let me just start with the first response you made in your oral testimony.

JUDGE RENDAHL: Mr. Wood, I'm sorry, is your microphone on?

MR. WOOD: Can you hear me, is this better?

JUDGE RENDAHL: Better, thank you.

BY MR. WOOD:

Q. I believe you stated that you noted that Mr. Williams had employed the company's allocation methodology in applying the Washington results to the total company; is that correct?

A. I believe that's what I testified to.

Q. And by using that methodology, what Mr. Williams was assuming, am I correct, is that the return would in fact be applied to the company's entire rate base; is that correct?

A. Yes.

Q. And if, in fact, the Commission were to adopt a revenue requirement that did not apply the rate of return, that combined with the revenue requirements of other states did not apply the revenue requirement to the entire rate base, the ratings metrics would be worse, not better, correct?

A. No, I don't understand your question.

Q. If I have a coverage ratio based on the assumption that a given return is earned on my entire rate base, will that coverage ratio be better than an assumption of the same earnings but not allowed to be earned on the entire rate base; which will produce the higher ratio?

A. Well, that's the trouble I have with -- and again that's why I can't answer your question, because it's mixing apples and oranges. What Mr. Williams has assumed is that Washington results of operations and the Revised Protocol would not be accepted in the state of Washington, so that's my understanding of what his analysis is at least in terms of the context of your question.

Q. Let me just make sure we're clear on the record here.

A. All right.

Q. Mr. Williams assumed, did he not, that the Washington return because of the allocation methodology could be earned on the company's entire rate base, correct?

A. Yes.

Q. And if there are inconsistent allocation methodologies, the same return would not be earned on the entire rate base, correct?

A. I agree with your -- I'm having trouble understanding your question, because it's the way I hear you asking it, you're talking about what -- there would not -- could you repeat your question again, I think that's the best thing.

Q. Yes. Isn't an assumption that the Staff proposed return will be earned on the entire rate base the most optimistic of potential assumptions concerning the earnings of the company for purposes of establishing the metrics?

A. No, I don't agree with that.

Q. Okay, we'll move on.

On your testimony I want to talk a little bit about theory and a fair amount about arithmetic, Mr. Elgin. Let's start with theory. Could you turn to your Exhibit 791-T, page 34.

A. I have that.

Q. I take it you take issue with Dr. Vander Weide concerning the effect of setting up a holding company to finance a utility's equity, correct? You take issue with his effect on whether that can -- whether by such a mechanism one can change the inherit cost of the equity?

A. I agree that there's a change. What I take an exception to in my testimony on page 34, beginning on line 11 and continuing on, is the proportional increase. This is why the double leverage adjustment is necessary is that the holding company can increase its leverage, and the proportional change in returns on equity are not there, so it's a form of arbitrage.

Q. I see.

A. And so what's really happening is the holding company is enabling to issue additional equity and then lever that return through the regulatory process of assuming the equity is -- in the operating company is actually there, which is it's not.

Q. And so it's your testimony that a company -- that a utility by setting up a holding company and to hold its equity and financing itself partially with debt can actually reduce the overall rate of return, correct, without harm to shareholders?

A. Well, again, let's parse your question.

Q. Let me restate it if it's difficult.

A. Yes.

Q. It is your position that if a stand-alone utility has a given appropriate capital structure and rate of return that by setting up a -- by that utility setting up a holding company that is partially debt financed, the utility can effectively reduce its required rate of return?

A. No, that's not what my testimony is. What my testimony is saying is that because a holding company is able to issue additional debt and finance that equity investment in the operating company, it is able to enhance its earned returns on book equity so that the overall cost of capital for PacifiCorp is reduced.

Q. Maybe we're saying the same thing.

A. Okay.

Q. You're saying that under the circumstance you have described, setting up the holding company, that the utility's stockholders or the holding company's stockholders can receive a reasonable return on their investment, and the rate of return to the utility can be lower than for the stand-alone utility, correct?

A. No, you're mixing what I'm saying. I'm saying that PacifiCorp's -- the cost to rate payers for the equity investment in PacifiCorp is changed by the holding company structure. That's what I'm saying.

Q. Let me restate it.

A. Okay.

Q. If we have a stand-alone utility and the Commission determines that that utility stand-alone should have a certain equity percentage and a certain cost of equity.

A. That's correct.

Q. Okay. Is it your testimony that by setting up a holding company for that utility and partially debt financing that holding company, the utility's required equity return can be reduced?

A. No. In fact, my testimony -- the equity return is changed. I calculated a change in the return on equity from the additional leverage by the holding company.

Q. Because this is important, let me try again.

A. Okay.

Q. If the utility has a rate of return based on, stand-alone utility, based upon a given debt-equity ratio that's found reasonable and a given equity return is found reasonable; got that so far?

A. Yes.

Q. And that utility sets up a holding company --

A. Well, that's where we have to stop, the utility does not set up the holding company. The utility doesn't do that.

Q. Why couldn't it?

A. Because the utility is a publicly traded company, and if it did set up a holding company, then we would have to look at how it chose to finance the equity investment that's on the books now of the operating company in the subsidiary. That's why I'm having trouble with your question. You keep saying that the utility sets up the holding company and sets that up, that's not what we have here. It's MEHC's decision to buy it, and it's MEHC's decision to bring it and subsume it under its holding company, so the utility is not making that decision.

Q. I'm asking you a hypothetical question about your own theory. By your own theory, a utility could set up a holding company and reduce its rate of return, correct, its required rate of return?

A. Yes, it could.

Q. And on page 7 of your testimony, you note that I take it that utilities are particularly able to do this because you characterize them as having low business risk, correct?

A. Yes.

Q. So my theory question is pretty simple. If your economic theory is correct, that you can reduce the rate of return to a properly leveraged stand-alone utility simply by that utility creating a holding company, why wouldn't you require all Washington utilities to do it, why wouldn't you require Puget to set up a holding company or Avista to set up a holding company if it's a way to simply reduce the cost of capital?

MR. CEDARBAUM: I just want to clarify, the question still assumes the hypothetical that Mr. Wood has been asking about for the last five minutes.

MR. WOOD: It assumes that the -- I understood the witness to have told me that his economic theory, financial theory, is that a utility simply by setting up a holding company and partially debt financing can reduce its rate of return, and so my question is, if that theory were economically sound, why wouldn't you require it for all Washington utilities?

MR. CEDARBAUM: I just want to make sure we're on -- Mr. Elgin disputed the factual basis of that question in this case. He answered it in terms of a hypothetical. I just want to make sure we're still on that page.

MR. WOOD: I guess the record speaks for itself. I thought the witness told me that, and I think it's inevitable from his theory, that you could reduce the rate of return by setting up a parent; is that correct?

THE WITNESS: I don't know which question to answer, Your Honor.

JUDGE RENDAHL: I don't see a problem in the witness answering the question. I think it's clear from the record that there's a hypothetical posed by Mr. Wood based on the theory.

So with that assumption, Mr. Wood, can you repeat your question for the witness.

MR. WOOD: Certainly.

BY MR. WOOD:

Q. If your financial theory is correct that by setting up a holding company to hold a utility's stock and partially debt financing that company, you can actually reduce the utility's rate of return, if that theory is true, why wouldn't you require it for the stand-alone utilities in Washington, that they create such holding company?

A. You could, but in your limited hypothetical what would happen is that it would be a question of what Puget Energy could do and how much additional leverage and then whether or not the rating agencies would look through the holding company and look to the operating company, which would give rise to what's really going on. So in your limited hypothetical, you could argue that there would be benefits, and then the question would become how much of a benefit is there, and how much additional leverage under that hypothetical could Puget Energy own in Puget Sound Power -- Puget Sound Energy could issue and finance itself.

Q. So you're basically saying that there are risks that might be unacceptable to that holding company in the example I gave you --

A. That's not my --

Q. -- to its investors?

A. No, I'm just saying -- I'm just saying it would depend on the circumstances and how much leverage the parent additionally could issue and finance that.

Q. Have you any thoughts on why such a requirement has never been imposed on a utility?

A. Well, again, it's that this Commission doesn't impose those requirements. This Commission takes what's presented to it and evaluates those factual circumstances in front of it and makes judgments. I don't think it would be appropriate for this Commission to tell the owners of any company how it ought to structure itself and how it ought to operate its business.

So I think what you have here is you're trying to take a hypothetical and then saying, well, and trying to force it into the facts and circumstances that are presented by the potential of MEHC acquiring PacifiCorp. And so what we have is we have clearly MEHC issuing additional debt and financing the equity investment in PacifiCorp, and under those circumstances I think the Commission looks at that and makes a judgment about whether or not a double leverage is appropriate, and Staff thinks it is.

Q. And you reject the concept that perhaps this great device for reducing costs has not been required because perhaps the professor from Duke is right and you're not right about the ability to reduce capital costs this way?

A. Well, the professor from Duke, are you referring to Dr. Vander Weide?

Q. Yes.

A. Well, again the companies make their judgments about how they want to finance their businesses and how they want to operate, and the Commission evaluates those and makes its judgments and makes determinations for rate making.

Q. Let's turn to arithmetic. I'm going to ask you questions about Exhibit KLE-7.

A. I have that.

JUDGE RENDAHL: And is that Exhibit 797?

MR. WOOD: Yes, it is, Your Honor, I'm sorry.

JUDGE RENDAHL: And what page are we looking at?

MR. WOOD: I'm going to be turning to a page in the --

JUDGE RENDAHL: There will be one.

MR. WOOD: There will be one. I was looking for a page in the testimony I wanted to refer to, I apologize, I apologize for taking time.

BY MR. WOOD:

Q. On Exhibit 797, page 1.

A. Yes.

Q. To summarize what this exhibit purports to show, if I see page 15 of your testimony, which is Exhibit 791-T, first you say, I take it, that you point to the return of MEHC on equity of 17.04% and say that indicates the dramatic impact of financial leverage on its balance sheet, correct?

A. Yes.

Q. You then you say on page 18 of your testimony that MEHC can earn 14% on book equity after the transaction with PacifiCorp, correct?

A. I did a estimate of what I thought a ProForma return for the consolidated operations would be.

Q. Are you suggesting then, are you implying that the MEHC under these, your assumptions, could make a 14% return on its investment in PacifiCorp?

A. Yes. What this exhibit purports to show is I put myself in the position of being a financial analyst for MEHC, and what I said to myself was, given our plan to finance MEHC and given normal results from PacifiCorp and we put it all together, what would the like -- what would be the impact on our return on book equity once we acquired PacifiCorp. And so that's what lines 11 through 23 is attempting to show.

Q. So you're saying that, without regard to a lower allowance by this or other Commissions, that MEHC could make roughly 14% on its investment in PacifiCorp under your assumptions?

A. Well, I thought I just answered your question, I explained what this exhibit purported to show, so I guess the answer is yes.

Q. Okay, good. I'm going to ask you some mathematics questions, and because they can be crushingly dull and so we aren't talking past each other, I thought I would just hand out an outline of what I'm going to ask you so you can follow.

JUDGE RENDAHL: Okay, let's be off the record.

(Discussion off the record.)

JUDGE RENDAHL: Mr. Wood.

BY MR. WOOD:

Q. Mr. Elgin, my questions are going to focus on your Exhibit KLE-7. Let me start with a basic math question. If I have an investment that is currently returning 17%, and I make a second investment, and the 2 combined return 14%, is the second investment returning 14%?

A. No.

Q. So if I have a 17% return before acquiring PacifiCorp and I have a 14% return afterwards, one thing we know is that the actual MEHC return in your hypothetical for PacifiCorp is less than 14%, correct?

A. Yes.

Q. Okay. And I want to walk through, so I think it's important since this has become an issue to clarify how much less and what the relationship is, what MEHC is earning. Let's walk through your numbers. We're starting with the normalized -- well, first let me ask you about the 17.04%, you describe it as the result of leverage. Now does MEHC own a variety of companies?

A. Yes.

Q. For example, it has the country's second largest real estate brokerage company as one of its subsidiaries, correct?

A. Yes.

Q. And it owned California Energy, which owns Geothermal Resources as an independent power producer?

A. Yes.

Q. And it owns companies abroad?

A. Yes.

Q. So is it fair to say that you have not really broken down what the causes of and sources of the

earnings are for MEHC to determine where they came from?
A. Yes, I have, they're in MEHC's 10-K, and they do report the various earnings of the business segments.
Q. And --
A. So the preponderance of the revenues to MEHC which support the return on equity in the principal businesses are, as I defined in my testimony, the two pipeline companies they own and MidAmerican Energy. So the preponderance of the revenues and the NOI for MEHC are from the utility, regulated utility operations, both on the assets, revenues, it's the bulk of their investment, and it provides the bulk of their return.
Q. Is the utility earnings on retail or coming from wholesale sales?
A. I mean retail would mean -- they come under the tariffed rates, they're regulated operations, so if that's what you mean by retail, I would say yes.
Q. But what I'm asking is, do the earnings you're talking about, do you know what the impact of wholesale sales as opposed to regulated retail operations are for those utilities?
A. I didn't parse it that finely. I looked at the various business segments and looked at what the pipeline companies and the regulated MEHC operations were producing to MEHC, the holding company's bottom

line.

Q. Okay.

A. So I did not parse them between retail and wholesale.

Q. Okay, well, let's go through the hypothetical. You assumed that the normalized PacifiCorp operating income is $438,280,000 in your example, correct?

A. Yes.

Q. Now I take it from your response to Staff Data Request 5.1, which we included as an exhibit, that that is an assumption that's based on an assumption that the company will earn an 11% return on equity, correct?

A. Yes, that's the -- in the response to the data request, that was -- again this is ProForma.

Q. Right.

A. So it's we're looking out, and so what I did was look at the -- both Mr. Hadaway's indication of what he thought the long-term return on book equity, now again this is book equity, and what Mr. Rothschild both used in terms of calculating a DCF cost of equity, and so that's where -- that's the primary foundation for my use of the 11% return on book equity. That's not an investor return requirement, that's the projected looking at what investors are expecting PacifiCorp to earn and the comparable group that provided the foundation for the DCF.

Q. And you applied that number to what you presumed to be the company's book equity as of March 31, 2006, correct?

A. Yes. So in other words, that $3.9 Billion times 11% is $438 Million and change.

Q. Okay. The first point --

JUDGE RENDAHL: Mr. Wood, before you go on, I just want to clarify the record, that response to Data Request 5.1 has been marked as Exhibit 801.

MR. WOOD: 801, thank you, Your Honor.

BY MR. WOOD:

Q. So our starting point is an 11% stand-alone equity return, correct?

A. Yes.

Q. And the --

A. Return on book equity.

Q. Book equity.

And by simply dividing that number by .11, I came up with -- would you accept subject to check that that assumes a stand-alone book equity at 3-31-06 of $3,984,364,000? And you're welcome to do the calculation if you would like.

A. I have the calculation if it's Exhibit --

well, to speed this up I will accept that that looks similar to the number that I calculated for the estimated book value of PacifiCorp at the time of closing.

Q. And is it fair to say that on a systemwide basis that's about $1/2 Billion more than Staff recommends be recognized as PacifiCorp's equity on a systemwide basis in this case?

A. I don't know.

Q. Okay.

A. I know that -- what I do know is that this is again a projection of what we expect it to be at the time of closing, so.

Q. Just as a comparison, if we turn to Exhibit 795, which is KLE-5, page 5.

MR. FFITCH: Which page?

MR. WOOD: Page 5.

A. I have that.

BY MR. WOOD:

Q. For the most recent reported year, the actual earnings of PacifiCorp instead of being $438.3 Million were about $249.6 Million, correct?

A. Correct.

Q. Okay. I assume that implies that the company is earning a whole lot less than this 11% currently?

MR. CEDARBAUM: Your Honor, I will object to the form of the question, I don't know what a whole lot less means.

Q. Let me ask it in a different way.

This operating income is slightly over one half of the operating income you put into the 11% case, correct?

A. Yes, I would agree with that calculation.

Q. Okay. And then to go on to see what of the numbers in KLE-7, go back to that calculation, which I believe again is 797, you have identified a net of tax incremental cost of the debt that you assume will be used to acquire PacifiCorp stock, correct, and that's on line 13?

A. Yes.

Q. Okay.

A. And this is where -- this is where the hypothetical that you've got falls apart. You've got Pacific -- normalized Pacific operating income of $438 Million, and then now you're mixing MEHC's costs, which these aren't Pacific costs, this is MEHC's costs.

Q. I want you to walk through with me, because what I'm going to be asking you is what MEHC after all we have heard, if they invest $1.709 Million in debt and have the equity investment that you've got, what they're

going to earn on their investment.
A. Okay.
Q. So I'm simply asking you the question, if you deduct the after tax interest of the debt used to acquire PacifiCorp from the normalized operating income, would you accept subject to check that the remaining operating income available for equity is as shown, $379,933,000?
A. I will accept that arithmetic.
Q. Okay. And you have shown that the equity investment that MEHC would be making as $3,419,700,000, correct?
A. Yes.
Q. And would you accept subject to check that if we divided the operating income of $379,933,000 by the equity investment of $3,419,700,000 that the resulting return on the MEHC acquisition equity would be 11.1%?
A. I agree with the arithmetic.
Q. Okay. And just walking through the same calculation, you understand you have assumed a 5.25% cost of acquisition of debt, correct?
A. Yes.
Q. You understand that Mr. Hill testified that triple -- that a company with MEHC's credit rating would have -- was currently having about a 5.95% debt cost, of

incremental debt?

A. Mr. Hill and I used a different analysis to come up with what we thought would be a reasonable surrogate for what this incremental debt would cost. He used S&P's weighted average, and I looked more at current rates and spreads for triple B credits and financing costs. So we approached it differently, but we -- we both used different numbers.

Q. Well, we could walk through the same, but would you accept subject to check that if the cost of the acquisition debt was 5.95% instead of 5.25%, the starting stand-alone number of 11% converts to 10.88% at the MEHC level?

A. I agree with what -- I agree with these calculations, yes.

Q. Okay. And finally on page 2, same result, I wanted to flag a couple of matters in the Staff case and the effect and what benefit or non-benefit the structure has. Again, this example uses Mr. Hill's cost of debt and then uses -- the Staff is recommending a return on common equity of 8.95%, correct?

A. No.

Q. What are they recommending? I'm sorry, let me restate that.

The Staff is claiming that a fair return for the stand-alone utility absent MEHC transaction would be 8.95%?

A. Yes.

Q. Okay. And I'm a little confused, I think perhaps -- I hope I've got your -- correctly got your -- the Staff's restated amount of equity, and for that I would direct you to your testimony, which is again 791-T, at, here's where you state the equity before and after the PacifiCorp acquisition, oh, yes, page 19.

A. Yes.

Q. On that page you state that the post acquisition book equity would be $6,513,377,000; is that correct?

A. Yeah, that number sounds familiar.

Q. And the pre-acquisition book equity would be $3,093,677,000?

Again, this is just from page 19 of your testimony.

A. Yes.

Q. Okay. And if I wanted to know what the PacifiCorp book equity being added to this transaction, I would simply subtract the second number from the first, correct?

A. Yes.

Q. Would you accept subject to check that would be book equity of $3,419,700,000?

A. Yes.

Q. Okay. And would you accept subject to check that the operating income if you multiplied the number I have just identified as book equity times .895 would be $306,063,000?

A. Yes, I will accept those calculations.

Q. Okay. And that doing the same arithmetic we have on the previous page, the leveraged equity return if the stand-alone company was allowed an 8.95% return on this proposed rate base, that the MEHC return on its equity investment would be 7.07%?

A. No, that doesn't follow, because that's not rate base.

Q. I have asked the question -- I didn't ask that, I asked was that -- does it follow, is that the return that MEHC makes on its equity investment?

A. No, sir, you asked rate base and --

Q. I will restate the question.

Is 7.07% the return, the comparable return that MEHC would earn on its equity investment?

A. No.

Q. Is there any difference between this calculation and the previous two other than changing the numbers?

A. Well, having just seen this for the first time this morning and responding to it on the stand, I would have to try to reconcile this with my exhibit, and I haven't had an opportunity to do that, so. But the problem I'm having is it would appear to me that what you have done up above is forgot to add in MEHC's investment in the acquisition premium, so I don't -- I think what's happening here in your calculation in your hypothetical, but I haven't had a chance to really reconcile the two exhibits, but I think what's happening is that this 707 figure is being diluted by the fact that we're not considering the acquisition premium in the calculation. So what I think this exhibit is doing is saying that the acquisition premium is earning nothing, and so it's diluting the return on book equity down to 7%. But I need to -- I need some time to check that. But that's what -- that's what I think is this hypothetical that you have walked me through. Again, I agree with all the arithmetic, but they haven't accounted for the acquisition premium, and that's $1.2 Billion, so I think there's a problem with what we have done here.

Q. Does the actual cost for the stock in your assumption consist of two elements, that is what it costs MEHC, slightly over $1.7 Billion in new debt, correct?

A. Yes.

Q. And $3,419,700,000 in new equity?

A. Yes, it's 5. -- we -- it's the $5.1 Billion to acquire a $3 1/2 Billion equity in investment, which then gives rise to the acquisition premium.

Q. And is it fair to say that if we know what the operating income is and deduct the net of tax interest expense on the loan, the remaining moneys would be what's available for MEHC's $3 Billion plus in equity investment?

A. Yes, sir, but what you have done is that you forgot to consider the impact of the acquisition adjustment and the acquisition premium on returns on book equity. You have taken a return figure and applied it to an equity investment, but you forgot to factor into the fact that PacifiCorp now for valuation purposes and earning purposes from MEHC's books is really $5.1 Billion.

And so that's why -- that's why you have to -- that's why my testimony is what it's saying is that in order to get this return on book equity up, the double leverage is the mechanism that enables the holding company to lever its investment and take this acquisition premium and recover it so that they earn on their total investment of $5.1 Billion, that's what's going on.

And like I said, I have to reconcile the two exhibits, but I think that that's the problem with this hypothetical we walked through here is that they're not recognizing the full investment that MEHC is making in PacifiCorp, and so the double leverage is the means to have investors in this very last line that we're walking through here get a full return. That's how they do it, that's how the transaction makes sense. And so like I said, if you give me some time over the lunch hour I can reconcile these, but I think that that's what the problem with your mathematical exhibit here, Mr. Wood.

Q. It doesn't seem to you, I take it, obvious that if a company pays $5.1 Billion for stock that has a book value of $3.9 Billion that the result may be, in fact, diluting the return rather than improving the return for the purchaser?

A. Well, it would if it were financed with equity. If it was full equity investment, the full dilutive effects would materialize, which is exactly what my testimony describes earlier when Pacific acquired Utah. They paid in excess of book, and they swapped stock for it, so it was a full equity investment. And so once that transaction closed, the dilution took place, and yes, I agree. But again, the return is achieved by the double leverage, that the fact that the holding company now has the opportunity to finance that investment with debt, but the cost regulatory purposes don't recognize that, and so I think this is what's going on.

Q. Would you agree that your argument would be severely undermined if it turned out that the arithmetic showed that MEHC's expected return would be lower than the stand-alone utility's return, not higher; would that undermine your argument?

A. Well, I think that's what you're trying to show here.

Q. That's right.

A. Yes.

Q. And would you --

A. But again, I think there's a problem with this analysis. If Pacific were to be acquired and you account for the $1.2 Billion acquisition premium and it was equity financed, there would be these dilutive effects, absolutely, I would agree with that.

Q. And is it fair to say that if the company either through this cross-examination or on brief can demonstrate that the MEHC returns, expected returns, would be not higher but lower than the stand-alone

utility's, would you agree that such demonstration would undermine your testimony?
A. No, it would not, because I stand by the calculations on KLE-7 that show ProForma what's likely to occur on the closing, what MEHC would reasonably expect and anticipate on the closing. So again, I don't think -- I think there's a real problem with this hypothetical, and I don't believe that you're going to be able to show that. I think KLE-7 shows clearly what's going to happen or likely to happen under normalized operations for the combination company. But you may argue that on brief, and that's your prerogative, I'm not suggesting otherwise.
Q. I'm going to repeat my hypothetical to you, which is, if we can demonstrate that in fact MEHC's expected return without double leveraging adjustments will be lower than the company's, than the stand-alone company's, you don't have to agree with that assumption, if it is demonstrated, would you agree that that demonstration would undermine your double leverages testimony?
A. I just -- I just don't understand what you're asking me to agree to. I'm having difficulty with the question, sir.
MR. WOOD: This would be a good time for a

break, if you would like.

JUDGE RENDAHL: Why don't we take our lunch break, and we will be back at 1:30, and we will continue with Mr. Elgin's cross-examination.

We will be off the record.

(Luncheon recess taken at 12:00 p.m.)

A F T E R N O O N   S E S S I O N

(1:45 p.m.)

JUDGE RENDAHL: Mr. Wood, I think we're back to you.

MR. WOOD: All right, thank you.

BY MR. WOOD:

Q. Mr. Elgin, I want to turn to the subject of precisely how -- what it is you are proposing, and for that I wanted to set up a hypothetical. And again because hypotheticals can be crushingly confusing, I tried both to simplify it and to put it on a piece of paper so it can be seen what I'm actually asking you about. I will go ahead and distribute it.

JUDGE RENDAHL: Let's be off the record for a moment.

(Discussion off the record.)

JUDGE RENDAHL: Mr. Wood.

MR. WOOD: Thank you.

BY MR. WOOD:

Q. I'm going to describe the first slide, the simplified example, because I'm going to be asking you some questions. In this example, we have Washington Electric Company, a utility that's 50% capitalized with debt at 5% and 50% with equity, $1 Million of each, it has a rate base of $2 Million, and it's been allowed a 10% equity return. Do you understand what I'm saying here?

A. Yes, I do.

Q. Great. And its sole owner is we call it HoldCo, could be Scottish Power in the current situation but we call it HoldCo. HoldCo has put the $1 Million in equity into Washington Electric Company and has equity with book value of $1 Million; do you understand that piece?

A. Yes.

Q. And this is what you would describe as an unlevered capital structure, correct?

A. Yes, it's similar to what I have prepared in Exhibit KLE-4, which would be Exhibit Number 794.

Q. And under this structure -- and we're assuming the parent and sub are consolidated.

A. Correct.

Q. And so if Washington Electric Company earns

10%, HoldCo will earn 10% on its equity.

A. That's right. And I should point out to you that this unlevered capital structure has no acquisition premium on its books.

Q. That is correct.

A. Okay.

Q. Turn to the second page. AcquireCo decides to buy the stock of HoldCo.

A. I see that.

Q. Pays $1 Million, gets the stock. Again there's no acquisition premium, correct?

A. Right.

Q. And the $1 Million that AcquireCo paid went to HoldCo, correct, for the stock?

A. Yes.

Q. It was not capital contributed to Washington Electric Company, correct?

A. That's correct, it's a stock transaction.

Q. Right.

A. Although I did want to mention too that HoldCo, this exhibit is a little bit misleading, because on page 1 HoldCo would also on its consolidated books have the $1 Million of debt on its books as well.

Q. Yes.

A. Okay.

Q. And I should qualify that we are talking about the unconsolidated position for simplification, the unconsolidated AcquireCo, the unconsolidated utility.

A. I see that.

Q. In this case, once again this is not a situation you would describe as levered, correct?

A. Yes.

Q. And AcquireCo has the same position as HoldCo had, that is if the utility earns a 10% return, AcquireCo will also earn a 10% return, correct?

A. Yes, for all intents and purposes what would happen is Washington Electric Company now would go underneath AcquireCo.

Q. Right.

A. As a result of the transaction on page 2 of this illustrative exhibit.

Q. Right. And to the extent AcquireCo's -- and AcquireCo's equity would have been spent buying the stock of HoldCo?

A. That's correct.

Q. Okay. Then turn to --

A. And there would be no acquisition premium.

Q. Correct.

Turn to page 3, the levered structure. In this example, AcquireCo pays an acquisition premium, AcquireCo buys the stock but pays $2 Million for it and finances that acquisition 50% with debt and 50% with equity; so you see the example?

A. Yes.

Q. Okay. Now that is what you would call a levered structure, correct?

A. Well, you would have a problem with this. Right now, number -- once you go to number 3, you have a problem, this balance sheet doesn't balance.

Q. I'm not giving you --

A. Your hypothetical falls apart now, because you can't go any further, because the balance sheet doesn't balance, it stops. Because in this example you have not considered the acquisition premium, because now what you have is a $1 Billion or $1 Million acquisition premium, and the balance sheets do not balance.

Q. I don't believe I put a balance sheet here, have I? I have just talked about the --

A. Well, you're --

Q. Remember we're talking company only debt and equity, there's not a balance sheet here, I'm just asking AcquireCo has issued $1 Million in debt and $1 Million in equity, correct?

A. That's correct, but when you -- what you're doing here and what you have done when you say here's the Acquire Company equity return, you're assuming that there's a return on the book equity in the HoldCo, and AcquireCo in this example, but you have not considered the fact that the balance sheet is not reconciled. You haven't accounted for the acquisition premium by the fact that you're paying twice book for the investment in HoldCo.

Q. Can we turn back to Exhibit 795 I think it is, KLE-7.

JUDGE RENDAHL: That would be 797.

Q. I'm sorry, 797.

A. I have that.

Q. Let's look at your calculation for a minute.

A. Okay.

Q. Now do you see that lines 11 and 12 show income from continuing operations?

A. That's correct.

Q. And you subtracted from that the net of tax incremental interest expense, correct?

A. Correct.

Q. And that gave you the -- and the result of that was the $907,011,000, correct?

A. That's correct.

Q. You divide, to determine the ProForma return on equity, you divided that $907 Million by the ProForma book equity, correct?

A. Correct, and that includes the acquisition premiums. I had to do that to make the balance sheet balance.

Q. That is correct.

And the book equity of AcquireCo also includes the acquisition premium. It is identical, is it not, to what you have on lines 18 and 19 of KLE-7?

A. In this page 3 of your illustrative?

Q. Yes.

A. No, it's not identical, because you have not accounted for the acquisition premium.

Q. Are lines 18 and 19 of KLE-7 the actual book equity of MEHC?

A. It's lines 18 and 19 are -- is the per books equity of MEHC and the cash contribution of Berkshire that goes into additional paid in capital on their financial statements.

Q. That's correct. If we look at the MEHC book equity, it is the actual equity that was put in, which included the amount of equity needed to pay for the acquisition adjustment, correct?

A. Correct.

Q. Okay. And the amount of equity on page 3 for

AcquireCo is the amount of equity put in including the amount of equity needed to pay the acquisition adjustment on the HoldCo stock purchase.

A. That's what was used to acquire it, but what you would have on page 3 is the additional $1 Million of debt that came from Washington Electric Company. That's what's the problem with this, you have not accounted for the fact that once you pay more than book, you either issue equity and dilute your prior equity investment, or you carry the acquisition premium.

Q. Show me the acquisition premium on Exhibit KLE-7.

A. Show it to you?

Q. Yes.

A. It's the -- it's -- I don't have it here because it's the sum of -- I'm only showing return on equity, I'm not showing the whole liability section, which you are attempting to do here, sir. You're trying to show the whole balance sheet here in this example because you're having the debt and the equity. The acquisition premium would appear if I did it -- this exhibit, the way you have done it here, I would have to also account for the additional $1.7 Million of debt that you would issue to acquire -- that MEHC would issue to acquire PacifiCorp.

Q. Let me just ask my questions carefully and see if we can get a direct answer. I think this is taking longer than it should.

Do not assume that I am asking you about a balance sheet. In the box for AcquireCo, in order to buy the $1 Million in stock, am I correct in saying that if it was 50/50 financed by debt and equity, the box shows that there would be $1 Million in debt that AcquireCo would have to issue and $1 Million in equity? It's not a balance sheet question.

MR. CEDARBAUM: I will object, the question has been asked and answered a few times, and it's argumentative.

MR. WOOD: The question has been asked and evaded several times, Your Honor. The --

MR. CEDARBAUM: You're just not getting the answer you want.

JUDGE RENDAHL: Mr. Cedarbaum, if you can direct your response to the Bench as opposed to counsel, that would be appreciated.

Mr. Wood, please finish your statement.

MR. WOOD: I was simply observing that I have asked several times the simple question about whether if he understands in this assumption that all we're showing in the box he is questioning is if there is $2 Million for the stock, and the assumption is AcquireCo issued $1 Million in debt and $1 Million in equity to acquire it. I keep getting an answer about balance sheet. There's nothing in the balance sheet, no balance sheet numbers on KLE-7, the numbers are identical. I'm not asking about balance sheet, and I keep getting an answer about balance sheet. I'm asking does he understand in the hypothetical that the box shows the debt and equity that was issued by AcquireCo to acquire the $2 Million in stock.

JUDGE RENDAHL: Okay, the objection is overruled at this point, can you ask your question again.

MR. WOOD: Sure.

JUDGE RENDAHL: And, Mr. Elgin, can you provide an answer, please.

THE WITNESS: Yes, Your Honor.

BY MR. WOOD:

Q. Mr. Elgin, do you understand that for purposes of my question what is in the box labeled AcquireCo represents for purposes of my hypothetical the assumption that $1 Million in debt and $1 Million in equity was issued by AcquireCo to buy the HoldCo stock?

A. Yes, you have accurately portrayed your box.

Q. Okay. Is it also correct that there's no levered acquisition adjustment, that AcquireCo must pay the interest on its newly issued debt with its operating income before it can earn, can apply any funds to its equity?

A. Well, again, it would have to pay both the debt at the holding company -- at the operating company, so on its consolidated balance sheet, the interest expense to fund the existing debt, and the debt in the second box of AcquireCo before you could calculate a return on book equity for AcquireCo.

Q. Okay, let me ask you then from KLE-7, would you point to me the deduction for book equity that appears in your calculation of the MEHC ProForma return on equity other than the acquisition debt that was issued; where is in your calculation a deduction for interest on the debt of the utility?

A. It's implicit when you look at line 3, Mr. Wood, and also line 11 is exactly line 3 and line 12. We're dealing with return on equity, and so once you have income available for common with which you calculate a return on book equity, it's presumed that the interest expense is paid for both MEHC and PacifiCorp in this ProForma calculation.

Q. If you will turn to Washington Electric Company, in the example of the 10% equity return, the debt if Washington Electric Company stand-alone produces a 10% equity return, that's $100,000, correct?

A. That's correct.

Q. And if it does that, in order to produce that it will already have paid the interest on the Washington Electric Utility debt, that is an after interest payment number, the $100,000, correct?

A. That's correct.

Q. Okay. So what goes to AcquireCo is $100,000 with the interest from Washington Electric Company's debt already paid?

A. Correct.

Q. Okay. AcquireCo before it can pay anything to its equity holders must pay the interest after tax on its debt in addition, correct?

A. Correct.

Q. And if that debt is at 6% and there's 35% tax assumed, would you accept subject to check that that would require, the net of tax debt cost would be $39,000?

A. I will accept that.

Q. Okay. Which would leave $61,000 remaining for AcquireCo's equity?

A. That's correct.

Q. Which would equate to a 6.1% return on equity?

A. I agree with that math.

Q. Okay. Then if we turn to the next page -- this is a situation where you believe that we need to make a double leverage adjustment, the one I have just described, correct?

A. I'm not sure I understand. I'm saying I agreed with your math, I'm not saying that there is by necessity a double leverage adjustment, but is that what your assumption is?

Q. I'm asking you, is the situation shown on -- according to your theory about double leverages, is the situation described on page 3 where there is an acquisition premium and AcquireCo issues debt as well as equity to acquire the stock a double leverage situation that requires a downward adjustment?

A. And again, this gets back to the problem I had before is that you have in this hypothetical not accounted for the acquisition premium, but I can go to your next page and answer any questions that you may have about this or what you're trying to show here, but.

Q. Okay.

A. Again --

Q. Well, let's look at your KLE-8.

JUDGE RENDAHL: And that's Exhibit 798.

MR. WOOD: I'm sorry.

BY MR. WOOD:

Q. I tried to replicate how you make the double leverage adjustment. Am I correct that you would go back to the utility, if the utility was 50% debt, you would take that long-term debt at its cost for 50% of the capital?

A. Yes.

Q. And if the parent financed -- if the parent was 50% debt, 50% equity, you would treat half of the utility's equity as being AcquireCo double leverage and the other half as being AcquireCo leverage, I mean equity?

A. No.

Q. What would you treat it as?

A. Again, go back to number 3.

JUDGE RENDAHL: You mean page 3 on the illustrative?

THE WITNESS: Yes.

A. Because essentially what you have at AcquireCo consolidated is you have a 33% equity ratio and a 67% debt ratio on the consolidated operations under this scenario.

BY MR. WOOD:

Q. Okay. Tell me in going to KLE-8, you have shown 15.5% for MEHC double leverage and 28% for common; where did that ratio come from?

A. It came from -- the 28% common came from MEHC's consolidated balance sheet, which turning again to the illustrative exhibit is you have $1 Million of debt at Washington Electric Company, $1 Million debt of AcquireCo, plus $1 Million equity, so you would have 67% or two thirds debt consolidated and one third consolidated capital of equity.

Q. Would you turn back to KLE-6 at page 1.

JUDGE RENDAHL: I'm sorry, that's Exhibit 796.

MR. WOOD: Sorry.

JUDGE RENDAHL: Just trying to keep the record straight.

MR. WOOD: I'm sorry.

BY MR. WOOD:

Q. I'm confused at your answer. You show the debt of MEHC as being 79% of the total capitalization, yet the double leverage is smaller than the common percent; are you sure that you used the consolidated debt, or did you use the debt and equity component of the $5.1 Billion purchase price?

A. Well, if you look at Exhibit 786, page 1, that's MEHC's capitalization before the acquisition, and that's showing roughly 80% debt, 20% equity. And if you go to the second page where I calculated the ProForma capitalization of March 31st, 2006, you will see the anticipated consolidated capital structure of MEHC once it acquires PacifiCorp and under the presumption that the financing plan that's in the merger or the acquisition docket is carried out, and that's why I highlighted the figures on the lines 11, 12, and 19.

JUDGE RENDAHL: Mr. Elgin, I just want to clarify, I think you said 786, do you mean 796?

THE WITNESS: 796.

JUDGE RENDAHL: This Exhibit KLE-6, 796?

THE WITNESS: Yes, thank you, Your Honor.

A. So the 28% that's on my Exhibit 798 is the 28% that appears on line 21 of 796.

BY MR. WOOD:

Q. Okay, thank you for the clarification.

In that case, what you're telling me is in your calculation the AcquireCo double leverage number would have been 33 2/3% of the capital, and the equity would be 16 1/3%, correct?

A. No.

Q. Correct it if you --

A. What I'm saying is that on 798 what I'm saying is that for purposes of the double leverage calculation, 15 1/2% of the equity investment on PacifiCorp's books is actually MEHC's -- is debt on MEHC's balance sheet. That's why I called it in my testimony -- some people call it a double leverage adjustment, some call it a consolidated capital structure adjustment. So the number on line 25 is the proportion of the book equity in Pacific that's actually debt on MEHC's balance sheet.

Q. Then would you enlighten us on page 4 by the method you're applying, what would be the ratios of the three capital items?

JUDGE RENDAHL: And when you refer to page 4, you refer to page 4 of your illustrative exhibit.

Q. I'm sorry, of the illustrative exhibit so we understand what you're doing.

A. Well, if I were to be doing this illustrative exhibit, I would say that the equity figure would be 33%.

Q. Okay.

A. Or 33 1/3%.

Q. Okay.

A. And the 17% would be the AcquireCo double leverage amount.

Q. Say again?

A. 17%.

Q. Okay, 16 2/3?

A. Yes.

Q. Okay. And 50% long-term debt?

A. Yes.

Q. Okay.

A. Which is again consistent then with how I would recast number 3 to account for the fact that you've got debt and equity, but that's an incomplete balance sheet for AcquireCo because there would be an additional $1 Million of debt on AcquireCo's books.

JUDGE RENDAHL: And when you say page 3, I think it's time to make this illustrative exhibit an exhibit in the record.

MR. WOOD: Let's do. In fact, for purposes of clarity I would like to offer the exhibit we discussed earlier, because there's a lot of reference to that as an exhibit and then this exhibit; does that make sense?

JUDGE RENDAHL: Yes. So the prior illustrative exhibit that we were talking about before lunch, I'm going to add it to the end of the cross-exhibits, well, let's make that 810-A and this will be 810-B.

Do you have any further of these?

MR. WOOD: No further, this is it.

JUDGE RENDAHL: All right, so 810-A will be the PacifiCorp stand-alone versus MEHC returns on equity per Exhibit KLE-7, and Exhibit 810-B will be what looks like a power point presentation of slides, the first page identified as unlevered capital structure.

MR. WOOD: Thank you.

MR. CEDARBAUM: Excuse me, have those been offered?

JUDGE RENDAHL: They have been offered.

MR. CEDARBAUM: I don't think -- we don't have an objection to them because there has been extensive discussion, but it seems to me that these were exhibits that were prepared ahead of time, they should have been predistributed as cross-examination so that the witness could have had them and to be able to prepare for them. So I think that while we won't object, I think that this procedure is really abused in this case on these two exhibits. And if the company has additional exhibits like this, we ought to have them now rather than on the go, which has been the case with these two.

MR. WOOD: We have no others, Your Honor, and we have been trying to deal ourselves with short timelines here, we have no other exhibits besides these two that we're going to be suggesting.

JUDGE RENDAHL: Okay, and if there are any other exhibits for other witnesses in the proceeding, if you can provide them in advance, that will be very useful for counsel.

MR. WOOD: I will be happy to do that, but we do not anticipate any others.

JUDGE RENDAHL: And I do understand the time pressure that all of you have been under.

With that, any other party have an objection to admitting 810-A and B?

They will be admitted.

MR. WOOD: Thank you.

BY MR. WOOD:

Q. Mr. Elgin, I appreciate your clarification, and so you're doing the calculation now, but is it fair to assume that the revised rate of return is 7.16%?

A. Well, let's just go through it. The weighted cost percentage would decrease from 1.50 to 1.02, and the equity return piece would increase to 3.33, so that's 6.85, you're correct, sir.

Q. 6.85. And if you turn to the next page, you would recommend that that 6.85% be applied to the rate base of $2 Million, correct, in the underlying utility?

A. Yes.

Q. And that would produce $137,000 minus the utility debt, that would be $93,000, I'm sorry, that would be $87,000 for equity?

A. Yes.

Q. And that means that your reduction in the situation we have described would be that the return because of the situation we described earlier would drop to 8.7% for the utility?

A. That math works.

Q. Right. And likewise, last line.

A. Last line?

JUDGE RENDAHL: Page 6?

MR. WOOD: Yes.

BY MR. WOOD:

Q. If the amount of net operating income was $87,000 for AcquireCo, we would still have to subtract its after tax cost of debt before paying any equity return, correct?

A. Correct.

Q. And that would leave a 4.8% equity return at the AcquireCo level?

A. Right. And that reduction in return and the mathematics work that way because the acquisition premium earned nothing. That's what's causing the dilution is the fact that it has no earning power, it's an intangible.

Q. I just wanted to --
A. So what this hypothetical --
Q. Go ahead, sir.
A. What this hypothetical is showing is clearly the impact of acquiring assets above their book value that for whatever reason don't -- are intangible. And so this is exactly what happens to the returns, and this is exactly why there's the need for either the inclusion of the acquisition premium so that the company would earn on that, or in the circumstance that we have here is the use of double leverage so that this return goes up.
Q. I have a couple of questions about your KLE-6, which is Exhibit 796.
A. One moment.
Yes, I have that.
Q. Because we have heard a lot about this 21% stockholder equity, I wanted to ask you a couple of detailed questions. If we look at line 11, subsidiary and project debt, that is not debt of MEHC itself, is it, it's a debt of MEHC's subsidiaries?
A. Yes, but it does appear as debt on MEHC's consolidated, yes, capital structure.
Q. For example Northern Natural Gas would be a subsidiary, correct?

A. Yes.

Q. And this would have -- and its debt would show up under this line 11?

A. Yes. And, for example, assuming that the acquisition would go forward, that's where PacifiCorp's debt would appear, in that category of MEHC's consolidated balance sheet. So once they acquire it, that will grow by the amount of outstanding debt on PacifiCorp's balance sheet, I mean from Pacific to MEHC.

Q. And is it fair to say that none of the debt -- that because the debt on line 11 is not debt of MEHC itself, it is not debt that could be used for MEHC to buy stock of other entities?

A. That's correct.

Q. And if we turn to Exhibit, this is a cross-examination exhibit, 808.

A. One moment, please.

Okay.

Q. And if you turn to page 4 of 6.

A. I have that.

Q. Do you recognize page 4 of 6 as being the capital structure stand alone of MidAmerican Energy Holdings Company itself March 31, 2005?

A. Yes.

Q. And that's the same date that you use for your consolidated numbers in KLE-6?

A. Yes.

Q. And first you note that for the stand alone the common equity is 39.15% equity?

A. That's what this exhibit portrays, that's the way the company calculated it.

Q. Okay. And if you look at subordinated debt, subordinated debt which shows up on Exhibit 808 also shows up on your lines 8 and 10 as debt in your KLE-6, correct?

A. Correct.

Q. And do you agree with the footnote which points out that most of the subordinated debt is, in fact, issued to Berkshire Hathaway and is treated as equity for all rating purposes?

A. Yes, I see that.

Q. And would you accept subject to check that if we treated the MidAmerican capital trust 11% subordinated as equity, that the equity of the parent would be in excess of 57% equity ratio?

A. Yes.

Q. Okay.

A. I will accept those numbers.

Q. Okay.

A. They sound reasonable.

Q. Thank you.

And finally, the last thing I wanted to ask you about had to do with your testimony in Exhibit 791, your testimony.

A. Yes, sir.

Q. Page 38.

A. I have that.

Q. And you respond to Dr. Vander Weide's statement, and I will just read you the material I wanted to ask you about, it says:

Finally, Dr. Vander Weide asserts at pages 5 and 6 of his testimony that a double leverage adjustment is unnecessary due to the ringfencing provisions that will be in place after the acquisition closes. What is your response to this argument?

And do you recall your answer is:

The argument lacks merit. Ringfencing is unique to the effort to create a separate bankruptcy risk for each subsidiary operating company and to the parent. The principal function of ring fencing is to ensure that the operating company is protected from the financial

distress of the parent and all of its
other business activities. Ringfencing
has nothing to do with how a holding
company finances its investments and
structures its balance sheet.
That's your testimony?

A. Yes, it is.

Q. Did you also submit testimony in the MEHC merger proceeding?

A. Yes.

Q. And do you recall, if you would turn to it on page 38 of that testimony, the following --

MR. CEDARBAUM: Excuse me, Your Honor, this is his direct testimony in the acquisition docket?

MR. WOOD: That is correct.

MR. CEDARBAUM: If you would give me a chance to grab it.

MR. WOOD: Certainly.

JUDGE RENDAHL: I don't believe we have it up at the Bench, but I think for the purpose you're going to use it for I'm not sure we need it.

MR. WOOD: I don't believe so, I'm simply going to ask him certain things about his testimony in the other docket.

MR. CEDARBAUM: That was page 38?

MR. WOOD: 38.

Q. Do you recall first the following from that testimony.

Question: Are there ways to protect rate payers from the financial leverage problem you have identified if the Commission authorizes the transaction?

Answer: Yes, there are two different ways to protect rate payers from double leverage. The first method is to adjust the rate making capital structure for the effect of MEHC's leverage.

Do you recall that?

A. Yes.

Q. And do you recall going over to page 39 being asked:

What is the other way to protect rate payers from additional financial leverage used by MEHC?

And the answer:

The other approach is for regulators to ignore the leverage at the holding company and consider PacifiCorp as a truly stand-alone entity. This is the ringfencing theory advocated by the

joint applicants in this proceeding.
The ringfencing provisions proposed by the joint applicants are intended to separate PacifiCorp from the other operating companies within the MEHC holding company structure and from the parent itself.
Exhibit numbers and you identify them.
The joint application contains similar ringfencing provisions to shield MEHC's other operating companies from the parent and one another.
Do you recall that question and answer?

A. Yes.

Q. And you --

A. You read it accurately.

Q. Thank you.
And finally, not finally, almost finally, it says:
Has this ringfencing theory been discussed in the regulatory arena as a way to protect rate payers from the effects of double leverage?
Yes.
And then you go on to quote a Public Utility

Fortnightly article, correct?

A. Correct.

Q. Which you did not include in your testimony in this case?

A. No.

Q. And then finally if you turn to page 40, you were asked:

Will ringfencing in fact protect rate payers from harm if MEHC's purchase of PacifiCorp is consummated.

And you answered, it's unclear, correct?

A. Correct.

MR. WOOD: Thank you.

I have no other questions, Your Honor.

JUDGE RENDAHL: Okay, is there any redirect for this witness, Mr. Cedarbaum?

MR. CEDARBAUM: Yes, Your Honor.

R E D I R E C T E X A M I N A T I O N

BY MR. CEDARBAUM:

Q. Mr. Elgin, my questions are in two areas, and the first has to do with your KLE-7, which is Exhibit 797.

A. One moment, please.

Okay.

Q. And also if you could have with you Exhibit 810-A.
A. Yes, I have that.
Q. That was the first hypothetical that Mr. Wood questioned you about this morning I believe and some this afternoon.
First of all, with respect to Exhibit 797, the face of the exhibit itself, can you first describe what the purpose of this exhibit is?
A. Yes, I attempted to be a financial analyst for MEHC, and I attempted to replicate what might have been done by MEHC in its acquisition of PacifiCorp. So in other words, if the two utilities come together, what would be the likelihood of the outcome given the way we -- MEHC has indicated they plan to finance the transaction, and what would happen to MEHC's consolidated earned returns on equity. And so that's what I have attempted to accomplish here is to replicate an analysis that I believe that somebody from MEHC would have done to show those kinds of returns and what would happen to MEHC once it acquired PacifiCorp.
Q. And now looking at Exhibit 810-A, can you explain whether or not this exhibit is consistent with your Exhibit 797, and if not, why not?
A. There are parts that are consistent, and then

there are other parts that are inconsistent, but I think even the inconsistencies lead one to the same conclusion. The first two calculations pretty much replicate what I have done, and they show -- and the reason why they do is because they presume an earned return on book equity for PacifiCorp at 11%.

When you go to the second page, the problem I'm having with the exhibit and what I was able to ascertain over the lunch break is this notion that this is the same calculation and is somehow connected to my exhibit, and it's not. If that's what the intent was, really what needed to happen was to simply adjust the lines 12 and 13 for 2 figures, and that's what do you presume would be the earned return for PacifiCorp going forward, so that's a sensitive number, has a big impact on this bottom line number that you see on line 23.

JUDGE RENDAHL: And when you refer to line 23, you're referring to 797?

THE WITNESS: Yes, ma'am.

JUDGE RENDAHL: Okay.

A. So that -- I agree with the question from Mr. Wood about once you put Pacific in, because Pacific's earning less, it brings down the consolidated return on equity to MEHC because two factors. Pacific is big, compared to relative size it's earned returns are less than MEHC's consolidated returns, but the biggest factor is the fact that Berkshire is planning to infuse equity through MEHC to acquire it.

So but in terms of sensitivity, that number has, on line 12, so if you -- if you somehow say that it's only 9% or 10% or whatever, that does bring down line 23. So if you're going to say trying to compare apples to apples, that would be the critical number to look at, so that's what -- I object to what Mr. Wood has proffered here on page 2.

But the second point, and this gets down to the concern I have about consolidated holding companies and acquisitions of utilities and this issue of double leverage is even if you assume that this calculation on here is correct, if you look at the figures on there for MEHC post closing book equity, of that $6.5 Billion on its books, $5.5 Billion is intangible assets, it's good will, and that's my concern. Even if you drive this analysis down, as Mr. Wood has, the company still through the way it finances the operations of its consolidated entities is still earning a return on an intangible asset, which is represented by book value.

And, in fact, that's what's so troubling to me is that this analysis still supports my concern about the implicit return of the acquisition premium. And it's just the way the transaction is structured, the way the company finances it, and then the way MEHC's consolidated books carry both the debt and equity going forward. So I would say that that would be my response to what this would be. If you want to make it the same calculation, make that number sensitive, I agree, it does drive down this number. But the effect is still the same, and that is the acquisition premium, the intangibles on the consolidated balance sheet, and the ability to earn a return on those.

BY MR. CEDARBAUM:

Q. The next question I have for you on the second page of Exhibit 810, Mr. Wood asked you some questions about the 7.07% figure that shows up on the last line of that page, and I think his question was, if MEHC's equity return is 7.07 and it's less than PacifiCorp's equity return, does that eliminate your recommendation for a double leverage adjustment. And my question to you is, would that be the case?

A. No, because this is still showing that if you do not consider double leverage and you do not consider the impact of the debt financing, the company's still earning on its acquisition premiums, albeit a lower level, but that's still the analysis, that's still what's driving this transaction in my opinion is how the company finances it and the fact that regulation for its operating companies does not -- is not -- does not explicitly take into account the impact of double leverage on utility revenue requirements.

Q. And also with respect to the 7.07%, assuming for the sake of argument that that number is accurate, does MEHC have control over the financial parameters that drive that number?

A. Yes, they do. These numbers are all driven by their plan to finance the transaction, and MEHC controls that, and they also then control the equity ratio and the capitalization ratios of PacifiCorp once they acquire that utility. There is no more market determined capital structure in that sense, and it's driven by MEHC and how they want to control their financing and the equity infusions that they make to PacifiCorp.

Q. And so if MEHC wished to change that number, it could change its financing plan for acquiring PacifiCorp or change its financing of the utility itself?

A. Yes, it would -- in my mind it could change its financing plan both for the acquisition but also for the other consolidated businesses that it owns.

Q. I have a few questions for you aside from

Exhibits 810 and 797, and it has to do with the questions you were asked this morning about the other business activities of MEHC besides its regulated utility businesses. Do you recall that general line?

A. Yes, was the questions about whether they were wholesale or retail sales?

Q. Well, the questions were generally about MEHC's diversified operations.

A. Oh, yes.

Q. Do you know, has the Commission addressed the issue of the rate making consequences of diversification by the company?

A. Yes, it has.

Q. Can you please explain your answer?

A. In a PacifiCorp rate case in U-84-65, the issue at the time that -- was the diversification activities of PacifiCorp, and the company at that time was engaging in significant diversified activities. And the Staff witness for cost of capital took the position that diversification should be looked at as a benefit to rate payers and that there are benefits from diversification in terms of lowering cost of capital, that those benefits should be reflected in rates. But conversely, if the company did choose to diversify and there were adverse consequences, that rate payers should be held harmless. And the Commission in its order accepted that as a principle for companies that choose to diversify.

I would add in this circumstance one of the concerns ultimately is MEHC as a diversified holding company, what is its cost of capital, and are there any other benefits for rate payers as a result of its diversification and its ability to stabilize its cash flows and produce lower cost of capital for not only PacifiCorp rate payers but all its rate payers in its operating companies.

Q. Just to be clear, that case from the '80's involving PacifiCorp, that was not a holding company situation, that was diversification of the regulated company?

A. Yes, in '84 the company chose not to become a holding company because it did not want to be subject to the onerous provisions of the Public Utility Holding Company Act, and so it organized itself so that it had diversified companies, but it was all subsumed through inter Pacific and owned by the utility Pacific Power & Light and subsequently PacifiCorp.

MR. CEDARBAUM: Thank you, those are all my questions.

MR. WOOD: Your Honor, very brief.

JUDGE RENDAHL: Go ahead, Mr. Wood.

MR. FFITCH: Excuse me, Your Honor.

JUDGE RENDAHL: Oh, I'm sorry, Mr. ffitch.

MR. FFITCH: I realize I don't have any right to redirect or cross, I did have a clarification question if I could ask leave. There's a point of confusion that we have with regard to Exhibit 810-B.

JUDGE RENDAHL: All right, please go ahead.

C R O S S - E X A M I N A T I O N

BY MR. FFITCH:

Q. Mr. Elgin, could you look at please 810-B, that's the illustrative exhibit in the sort of power point format, page 3 of that, and it says leveraged structure at the top.

A. Yes, sir, I have that.

Q. And here it shows I guess AcquireCo company has purchased $1 Million of Washington Electric Company equity with 50% equity and 50% debt; is that correct?

A. Yes, it purchased -- it paid $2 Million for a $1 Million book equity investment, and the source of funds was $1 Billion new debt and $1 Billion equity.

Q. $1 Million?

A. $1 Million, excuse me.

Q. Does that mean that the amount of equity at the parent level that supports the equity investment in Washington Electric is $500,000?

A. I'm thinking of it in percentages, and you're thinking dollar, so I'm having trouble right now twisting so -- flipping in my head.

Q. Let me ask it another way and see if it helps. I'm looking at the $1 Million equity in Washington Electric, and my understanding of this is that that's financed 50% debt, 50% equity by the AcquireCo, right?

MR. WOOD: Your Honor, I will object, I don't think this is clarification at all, it's attempting to make whatever points Mr. ffitch wants to make through this witness, and this isn't a right he has.

JUDGE RENDAHL: Mr. ffitch, I'm not seeing a clarification at this point.

MR. FFITCH: Well, we were asked whether we had any objection to this exhibit, and there's been no company sponsor for the witness, the only way we can find out if the numbers are correct or to get clarification on this is to ask the witness on the stand, and I'm trying to lead up to a number that we think is incorrect on this exhibit.

JUDGE RENDAHL: I guess what might be more useful is at a break if you can clarify with the company what the number is, and if the parties agree that there is a problem, then we will bring it on the record, and if there's not, we can bring it on the record. That's I think the most useful way since Mr. Elgin didn't prepare the exhibit.

MR. FFITCH: That's perfectly acceptable, thank you, Your Honor.

JUDGE RENDAHL: Mr. Wood.

R E C R O S S - E X A M I N A T I O N

BY MR. WOOD:

Q. Mr. Elgin, I think you described on KLE-7 that as a financial analyst for MEHC looking to buy the stock of PacifiCorp, you would make an examination of the effect on MEHC's overall return on equity; is that correct?

A. Yes, sir.

Q. As an analyst, do you think Warren Buffet might be more interested in having you tell him what the return on his actual investment in PacifiCorp was going to be as opposed to what his new overall return for his company would be?

A. No, I would think that as an analyst what Mr. Buffet would look at would be to some extent the return on Pacific. He knows embedded in this is what

Pacific's return on equity would be, but Mr. Buffet also has a cost of capital, and then he would also look at that in terms of a hurdle rate and how he would -- how -- what his cost of capital is and how he would finance his operations. And it seems to me that what Mr. Buffet is doing is using MEHC, as I testified to in the acquisition docket, he is using MEHC as a conduit to take cash that is earning a very low return on his balance sheet and funneling it through MEHC to earn high returns on book equity, and we will see more of this.

Q. And so it's your testimony that you believe that the proper analysis is to ask what the post closing average return of MEHC would be rather than asking what the incremental return on the proposed investment would be?

A. No, that wasn't what I testified to. I testified that this is what I attempted to do to show two things, what would MEHC look like once I acquired it, and that's independent of the decision to make the investment decision. The investment decision has already been made, now the question is what happens, and what does PacifiCorp have to do, and how do I finance it, and what happens to MEHC once everything is all said and done. But I agree with you, the investment decision is made, and that's the critical thing, and that's look

-- and that analysis is done with respect to what is the investors' cost of capital and how they -- and that's -- and implicit in that is how much debt, what's my return on equity, and those sorts of questions.

Q. You were asked questions concerning Exhibit 810-A I believe as to assuming that the 7.07% return was correct if MEHC could perhaps change that return by financing different ways; do you recall that?

A. I don't think that was what the question was, I think the question was, is MEHC -- the question was, would this change if MEHC financed this thing differently.

Q. Fine.

A. And yes, indeed it would.

Q. And is it fair to say that if the Commission decides that -- and is it fair to say that as long as the Commission sets the return on PacifiCorp based on the stand-alone ringfenced utility, if MEHC makes a decision which produces a lower return for it than for the utility, that's not the Commission's problem, correct, they shouldn't be concerned about that?

A. That's the company's theory, yes, of this case.

Q. Okay. And you wouldn't suggest that the investor be compensated if it paid a price that didn't

recovery the utility return, would you?
A. No, but what I'm suggesting is that the double leverage adjustment is an explicit acknowledgment of how MEHC does plan to finance its equity investment in the company and what are the consequences.
MR. WOOD: No other questions.
JUDGE RENDAHL: Are there any questions from the Bench for Mr. Elgin?
Commissioner Jones.
COMMISSIONER JONES: Are we going to take a break, do you want to ask questions now or wait?
JUDGE RENDAHL: Why don't we go ahead and finish.

E X A M I N A T I O N

BY COMMISSIONER JONES:
Q. Mr. Elgin, have you in your -- both in your direct and in your rebuttal, it appears that you have a great deal of knowledge on holding companies and their structure, and you insert some historical materials, et cetera, but I wondered if you had a chance either in your direct or in your testimony, well, in your supplemental testimony, excuse me, to look at other holding company structures in other states and if they have applied double leverage adjustments?

A. I have had limited review and not the kind of review that I would have liked to have done given more time. If you -- in my testimony I have a footnote, let me find that here. What did I do with it, oh, this is --

Q. I see your footnote on page 36.

A. Yeah, my testimony there was to review some cases regarding double leverage and the different jurisdictions that have adopted.

Q. Okay.

A. And then one of -- and then also we asked in discovery from Dr. Vander Weide regarding, you know, his experience where he has been and the Iowa Commission, which is the principal jurisdiction for the MidAmerican Energy Company's utility operations, they have adopted a double leverage adjustment.

So I have not done an exhaustive research, but the purpose of my testimony was really to look at this notion of is it somehow unfair and does it violate the traditional kind of standards, and is this something that regulatory commissions have done. And I have come to the conclusion that it's an appropriate adjustment and that the commissions have accepted the notion that there should be some acknowledgment of how a holding company finances utility operations, and the courts have upheld those.

I also am familiar with the FERC, and in fairness the FERC does not adopt double leverage, so take that as you will. But it's not as exhaustive as I would like, but there has been some research in that regard.

Q. In terms of this state and this jurisdiction, has this Commission ever imposed a double leverage adjustment on any of the acquisitions to come before this Commission?

A. No, because none have been structured and financed in this way, so this is a case of first impression in my mind. Although the telephone companies during the AT&T and the restructuring, I did notice that there were some holding company issues, but in my review of them, I didn't find them dispositive about energy companies because of -- it was generally what was going on is the holding company had more equity than -- and that's what they were proposing to be used in the operating company. And also in more recent cases with holding companies that owned telephone business and land lines and those kinds of assets, that the operating company because of its business risk has more equity, and then the question becomes, should the operating company have a similar capital structure. So I didn't find those very useful in guidance for this particular case.

Q. What about the Scottish Power acquisition of PacifiCorp in 1998-1999, weren't you involved in that case as a Staff witness or in some analysis of that case, and was any thorough analysis done of leveraging for the holding company for that case, and if not, why, is it simply because Staff concluded that leverage at the holding company was not sufficiently high to justify this sort of detailed analysis?

A. Well, there were two things. The equity ratio, at least when I looked at it in 1999, and to be honest with you I did not spend a lot of time with that, it wasn't something that jumped off the page, and so I personally did not look at it. I have looked at Scottish Power over the time, and in my mind it's not an issue because of the way Scottish Power finances its consolidated operations, and it doesn't appear to me to be a double leverage issue. This transaction, the financial statements, it just jumps right out at you, and I guess that's why it became important. I mean it was so clear to me when doing the review of the acquisition that this was what was going on, it was compelling.

Q. In your supplemental testimony you included an article from Public Utilities Fortnightly, I think it's KLE-10, and I would just like to --

MR. CEDARBAUM: Commissioner, I'm sorry, that was not an exhibit that we offered, it was withdrawn.

COMMISSIONER JONES: Was it withdrawn?

JUDGE RENDAHL: It was withdrawn, yes.

BY COMMISSIONER JONES:

Q. So let me pose the question this way. You would agree that there are a lot of mergers, consolidations, or acquisitions going on in the utility industry in this country today; do you agree with that or not?

A. I agree there's some, I suspect I would agree with the statement that there's going to be more.

Q. And as a financial characteristic of those deals, isn't it fairly common for a company to pay above book value for an acquisition?

A. Yes.

Q. So isn't it true that many of the holding companies, however these deals are structured, the holding company or the actual utility will be carrying amount -- will be carrying a fair amount of intangible, goodwill if you will, intangible assets on their books, correct?

A. Yes.

Q. Have you had a chance to analyze any of those cases? And the issue that you raise on page 21 I think of your testimony and in that part where you talk about the acquisition premium and your concerns on the premium, you spend a great deal of time on the issue of impairment.

A. Yes.

Q. And did you have a chance to do an analysis to see if impairment has actually occurred in these acquisitions that have taken place over the past let's say three to five years?

A. No, sir.

Q. And did you have a chance to examine in detail SFAS Number 42, this goodwill and other intangible assets issue, as it applies to PacifiCorp? My understanding is that every year the auditor has to do a detailed examination based on discounted cash flow of the intangible assets, and as you say, most of it is goodwill, correct?

A. Correct.

Q. So did you have a chance to look at any of that analysis done by the auditor in accordance with SFAS Number 42, 142?

A. No, I have not, and as my testimony indicates, I think that the primary reason why that's still carried and -- is the fact that MEHC if it ran into financial trouble could sell those assets. And so as long as we're in an environment where utility market prices exceed book values, I think the auditors are pretty comfortable with those assets being continued to be carried on the books, so that's one thing. And then the question becomes, as an equity investment on the books, is it earning a return, and so -- but no, I have not done a detailed analysis.

It was, again, this is a case of first impression, the limited opportunity to do the analysis, but mindful that holding companies carry these and assets become impaired, especially intangibles. Puget Energy just took a charge this year for some of its unregulated operations and intangibles that it was carrying on its books, and it's not unusual. And if we were to go I would say into an environment where cost of capital would increase and might go into inflation and there would be pressure on utility market prices, the ability to carry those intangibles would be a significant issue.

Q. So is it fair to say if you had to rate your concerns in your supplemental testimony as I read them, one concern you have is as you stated would be higher interest rate environment which would be difficult to carry intangible assets, goodwill. Another would be I think toward the end of your testimony you talk about rate case pyramiding, and this deals with one of the stipulations in the acquisition case where, you know, holding companies are structured and somehow it's put into rate base where the acquisition premium is actually put into rate base, that's another concern you have, correct?

A. That's not such a big concern. I don't think we're going to go back to an environment because of the ability for knowledge and information to be shared that we have like the Insull type of pyramiding. But the notion that utilities will be acquired and they will be financed this way and there are no operating synergies, so it's purely what I called it in the acquisition docket a financial transaction, this is how the return on that asset gets carried forward.

The other concern would be at some point when do, at least in my estimation, the regulations start recognizing that the return to shareholders are supporting market prices that are above book and ROE's begin to come down and, at least in my mind, reflect investors' required rates of return, and that's another pressure. And then if these things start to happen, will the owners of the holding company pony up the cash once those investments are impaired to supply the equity investment for financing the utility in the ongoing operations of the operating companies underneath it. So those are my major concerns, and the fact that rates, the corollary to that is do rates support the acquisition adjustment implicitly through double leverage.

Q. If goodwill or any asset is impaired, did you consider in your testimony or in your analysis the ability of Berkshire Hathaway, the great grandfather in this case, the ability of Berkshire Hathaway through its balance sheet to instead of selling off assets to inject more equity into MEHC?

A. Yes.

Q. You did consider that?

A. I did consider that, but I also considered the fact that things change over time. That's why we have the MEHC acquisition. We have the Scottish Power people say we want this utility, we're in this for the long run, and it's been six years. Things change, circumstances change, and who knows what kind of investment decisions, and when push comes to shove, will they write that $6 Billion to $7 Billion check.

Q. My last question concerns ringfencing. Another concern that you may have or may not have, I would like to get it on the record, is the ringfencing contained in the stipulation agreed to by the parties. Is one of your concerns that the ringfencing in the stipulations are not adequate, both in their treatment of dividends and in all other stipulations, that ringfencing is not sufficient to deal with these sorts of issues of either financial distress or some of the tax issues that you mention in your supplemental testimony?

A. I wouldn't characterize it quite that way, sir. What I would characterize -- I think the ringfencing provisions are adequate, and they're the state of the art in that regard. The question really becomes is that if there is financial pressure on Berkshire, and they own the equity, they control it, if you have a -- if we're really going to have a stand-alone utility and we're going to make utility return on equities and have, you know, good equity ratios and good coverages and all that kind of stuff, there's a lot more flexibility in that scenario when bad times happen.

I mean, yeah, granted capital is going to be more expensive, but the utility can go to the market, and it gets the market price of credit. Once it goes into the holding company, you know, we're at -- you're kind of at the hands of what will the owner do, will the owner have the wherewithal to issue additional debt to fund the necessary infrastructure, or will it walk away. I'm not saying that it will, but I'm just saying there is that additional risk.

And the only thing that ringfencing does is it protects the utility from being all the innards sucked out in financial emergency, which could happen. And that's, you know, I think the ringfencing is good, there's some protection, but truly if you -- if we're going to go down this road, my belief is that there are, you know, these other tangible benefits from publicly traded companies, and things change, we do our best, but -- if anybody would have said in the Enron acquisition of PG&E that Enron is going to be one of the biggest bankruptcy risks, do you see what I'm saying, it's just like --

Q. I understand what you're saying.

I was going to ask you about that, finally, this is my last question, so thanks for bringing it up, would you agree that the ringfencing provisions, especially relating to capital structure and dividends and other issues relating to those financial issues that you address in your supplemental testimony, that the ringfencing provisions in the Enron-PG&E case were similar, were they basically structured in the same way, and did they work?

A. Yes.

Q. Okay.

A. They worked. There's one caveat though that's a little bit different in PG&E and Enron that I think deserves some consideration too. You had one jurisdiction and there was -- it's a little bit different statutory construction with respect to the implementation of ringfencing provisions, and I'm not fully aware of all those. But in this circumstance you have six different jurisdictions, and so it's a little bit different. But in general they're mirrored after I think it's called, I forget the exact company's ringfencing, but they're the state of the art, they're the best that we have under today's circumstances trying to consider all the variables that are reasonably considered to say how do we protect PacifiCorp.

COMMISSIONER JONES: Thank you, that's all I have.

JUDGE RENDAHL: Are there any other questions from the Bench?

Commissioner Oshie.

COMMISSIONER OSHIE: Thank you.

E X A M I N A T I O N

BY COMMISSIONER OSHIE:

Q. Mr. Elgin, I want to go back to a question that was asked by counsel for the company, and I think he asked you why Staff isn't recommending this same double leverage adjustment or something like that is being applied or recommended to be applied to let's say Avista or Puget Sound Energy or other electric companies, and I'm very, you know, I'm interested in your answer, and I would like maybe for you to repeat it, and let's just stop there, go ahead.

A. Well, so the way I understood the question and if we're talking -- so if I can clarify, it's I thought the question was why don't -- why doesn't the Commission require like Avista and Puget Energy to become holding companies and do this extra leverage to reduce the cost of capital, is that the --

Q. Well, that's one aspect of it. I mean if it's a -- if that results in rate payers paying less money, why wouldn't we have done that at some point, or why hasn't Staff recommended that, and wouldn't that -- that certainly could have been imputed much like we're being asked in this case by Staff to impute a level of equity?

A. Well, we have to some extent, and later on in my testimony I do have this discussion about how this is really similar to the capital structure question that's been -- that's endemic to the rate setting process. In the Puget case we have had -- we had differences regarding what ought to be the appropriate equity ratio, and we have had those in Pacific over time, we have had that in -- so it's always there, and so in my mind the question is really, is this a reasonable capital structure to finance utility operations.

I'm a little concerned about this transaction, because in the holding company, I mean the acquisition case I'm really at a disconnect between why can Berkshire Hathaway through MEHC finance negative tangible equity and carry a 20% equity ratio and get a triple B minus credit rating. Now there is this notion about halo effect, but my concern just generally over the past ten years has been the rating agencies have put a lot of pressure on commissions to push up equity ratios when capital costs are declining.

And I would say that Avista and PSE, and PSE as a holding company really is Puget Sound Energy, it's not Puget Energy, there's no difference between the utility and the holding company, and if you really peel away Avista's unregulated operations, you sort of have the same kind of issue, it's the utility that's financing everything. So to the extent that you can arbitrage this and do it, I think that's what I understood Mr. Hill from Public Counsel talk about, they're taking advantage of the situation that's in front of them, and then the question becomes, what should regulation do about it.

And I would argue that if they could issue more leverage, they should, because I do think that there's benefits both to rate payers and shareholders for levering properly, reducing overall cost of capital, keeping the cost low, and then to the extent that they can find efficiencies, they're able to lever their return on book equity for the benefit of their shareholders. It goes both ways, it's a two-edged street. So I would say that, you know, your traditional kind of capital structure question is asking the question, does this capital structure sufficiently balance safety and economy. In this circumstance you have a utility that no longer controls its capital structure, and so now the issue becomes, do you recognize how the new owner intends to fund the equity investment in utility operations.

Q. I guess my question was really more, and of course I understand your answer, I appreciate the detail that you provided, but if this provides a mechanism again that rates would be lower, are we going to be asked in the future to impute this same kind of structure for companies that, for example, like Avista that do not -- that are not structured as a holding company with subsidiaries below to take advantage of leveraging that could be achieved and then pass that savings on to rate payers?

A. Well, sir, if I were being prescriptive about what we would be directing our utilities to do, I would say that there are public interest benefits of publicly traded companies that have regularly traded stock which we can observe the stock prices and have best evidence regarding both the cost of capital and what is a market driven reasonable capital structure for utility rate making purposes. And for the -- so that would be the first. And then the second thing is that I would as a utility regulator be very prescriptive about the kinds of diversification that utilities could do. So that would be my first emphasis.

And then the second emphasis would be that if through consolidation and combinations that there are real benefits in synergies, both in reduced cost of capital, benefits to consumers and the company with respect to lower costs, then those are the kinds of acquisitions and transactions that we should be evaluating, not a transaction that is simply, I don't want to mean this in a pejorative sense, but a way to structure a financial transaction so that the total return, the total investment including the acquisition premium gets recovery and is allowed to be carried on the holding company's books. Because in a traditional merger, you would not have that, it would be a non-issue whatsoever, unless like again, as my testimony said, there would be some benefits, so --

Q. Well --

A. Again, to your question about prescriptive capital structures, I'm leaning more towards sufficient equity and capital at risk that is fair to shareholders and fair to rate payers and the direct observable evidence about those costs and those equities in the market.

Q. Now perhaps you answered this question, let me ask it in a different way. What you're asking, Staff's asking us to do in this situation, and I think because it's apparent, to look behind the financial dealings of the investor and to use that information to set a rate of return on equity. And if, you know, that's my simple view of it, because we know how this transaction is going to be structured. And if we do it in this case, why wouldn't we do it as well let's say just to use as a hypothetical with Puget? And, you know, would we be required then if we were to do it to examine how, let's say make it easier, institutional investors pay for their acquisition of common equity, whether they do it through their own resources or they have to borrow money to go ahead and finance that or maybe in simpler terms investors who buy stocks on the margins, are we to take that into consideration as well? Because that would certainly change perhaps how we would view the setting of rate of return in these cases and require us to, you know, dig behind each transaction or at least the major transactions to determine what individual investors are expecting for their return on the dollar invested.

A. Well, first off, let me try to deal with each one of those pieces there, but the sum and substance of your question is, should you go behind and look at what the owner's doing.

Q. I think that's exactly right, that is, that's what we're being asked to do in this situation.

A. And I think you should, because two fundamental reasons is that if you and I were to choose to buy stock on margin, that's a risk that you and I take. We don't own the company, we don't bring all those debts of the company onto our balance sheet, nor do we bring in the acquisition premium on our books. And furthermore, when we make that margin decision, we're putting our equity capital at risk, so we are not controlling the capital structure, we are not controlling the source of capital to the company, so I think that's a big difference.

And the second point again is, and in my research on this, is it's really getting to the holding company subsidiary relationship, and that's in my mind clearly distinguishable is that when you buy on margin, you have no influence, you don't have that, you're not engaging in the decision making about how that utility ought to be financed, how it carries things on its books. And then furthermore in bad circumstances, you have limited your exposure as a holding company to what little equity you have invested. For all intents and purposes, when it goes away, that's it, you have no other obligation. Whereas as an equity investor, you have a choice now, and it affects or it has no effect on the utility and the company that we choose to invest on margin on their ability to attract capital and access capital markets.

And so in my mind, I think it's reasonable, and my review of the court decisions and what commissions have done have said that's an important distinction, and that's why we're making the adjustment, and that's why. And I think you implicitly do it even if it wasn't a holding company, because in the Puget case and in the Avista case you make judgments about the amount of equity and is it fair and does it balance those interests.

Q. But we don't look behind let's say the -- how an individual, and let's just use as an example for hypothetically an institutional investor finances its decision to acquire common equity.

A. But that institutional investor's decision to acquire common equity has no impact whatsoever on the company's decision with respect to capitalization.

Q. Right, but it makes a decision on whether they are going to invest or not?

A. They make the decision on whether they are going to invest first off, and then if they choose to do margin, the returns are based on the market.

Q. Well, let's move off the margin, let's just move into a situation where they have used -- they have borrowed money to invest in the company, so maybe similar to this, their cost of capital has been reduced because they are borrowing money as opposed to using their own equity, and so I see it as very similar in that circumstance to this situation. And if we're to look behind this transaction, perhaps your testimony is we should look behind other, you know, transactions of other investors to determine what their expected rate of return may be and to set the cost of equity accordingly?

A. Well, let's take this to the logical extreme is that if everybody were buying on margin and assuming that risk in a publicly traded company, that would be reflected in the stock price for one thing, okay. So if it's that good a deal and everybody is doing it, then that's reflected in the stock price. We don't have that. We had no arm's length transaction. We don't have no independent review, review is the wrong word, there's no independence between the investor's decision and the returns that he realizes from that decision to exercise margin or not.

In this circumstance what you have is the investor being able to control the capital structure of the utility and then come to the regulators and say, my equity ratio is 49% or 50%, but yet it doesn't reflect the reality of how they finance that equity investment. And they're controlling it, and I think that is the critical distinction. And it has an impact because of the leverage on their balance sheet and what they're carrying on their balance sheet, and it imposes a risk to rate payers. And if an institutional investor chooses to buy margin and it's a bad decision, it has no impact on rate payers, it has impact only on his return, and to me that's a critical distinction.

Q. Now maybe you can repeat why you believe that this deal is structured so that the -- so that MEHC can earn a return on the acquisition premium. That's what I understood from your testimony.

A. That's correct.

Q. That that was the reason why they structured this deal in the way that they did.

A. If you look at the balance sheet of MEHC, the consolidated balance sheet, the assets, the core properties that give rise to provision of utility service. Let's say we're going to make a rate base calculation, those core properties are about equal to the amount of total debt that the company is carrying. Conversely, the other way to look at it is what's on its balance sheet and what's its equity investment, and surprisingly you're finding that the investment currently before acquisition, the investment in intangibles exceeds the book equity by $1 Billion.

Q. Well, I'm trying to make the connection between what's on paper and the intent behind it.

A. That --

Q. You have testified that the intent of the company was to cover its acquisition premium, but so I don't know what -- how you have come to that conclusion as its sole reason for doing so or at least a primary compelling reason to do so.

A. Because the financial statements tell you exactly what's going on. They're telling you exactly what the company is recognizing as its assets and liabilities. The income statement tells you exactly what the costs are, what's the return to shareholders, and you can look at those and they tell you exactly what's happening. They are the documents. That's what I said in my testimony, all theory aside, if you look at the balance sheet and income statements, they tell you what the company is doing and what is the effect of what they have done in the past and at least in my mind what they expect to continue to do in the future. And this is -- this is what I'm saying and I'm seeing from those financial statements, they tell you in black and white what the company is doing. There's no other conclusion that you can reach, it's just basic finance as described by the balance sheet and the income statement. I can put it no simpler than that, they tell you. It jumps off the page.

COMMISSIONER OSHIE: No further questions.

JUDGE RENDAHL: Chairman Sidran, did you have any questions for Mr. Elgin?

E X A M I N A T I O N

BY CHAIRMAN SIDRAN:

Q. Well, first I will concede the irony that we asked for it by bringing this issue into this case, so with that concession, we have pending this acquisition docket, and we now have a stipulated settlement agreement that specifically states, and I'm doing this from memory so you can correct me if I'm wrong, that the acquisition premium shall not be recovered in rates, and, although I don't recall any of the details, that there will be extensive ringfencing. So the issues that you raise, could we adequately address those concerns, assuming now for the sake of argument that this acquisition goes forward, that that settlement agreement is approved, that we look not to the future and try to guess just what will be in terms of how the acquisition will in the end be financed and those yet to be determined factors, and instead simply look at PacifiCorp as it exists today in the record we have before us with respect to the test year and all the issues that are being litigated in this case, we determine the rates based on PacifiCorp, disregarding this pending acquisition, bearing in mind the company's representative will be back soon with another rate case presumably post acquisition, and we can then if appropriate delve into the issues that you and others have been addressing with respect to what might be the ultimate details of the acquisition and whether and how those might be reflected in rates?

A. Yes, you have the discretion to do that. I think that that's something you could do, although in the application my concern is that when you set rates in this docket, the transaction will close, and from that date forward do rates meet the standard regarding the cost of capital. And so if you choose to put it off for the next rate case, I think that's something you could do, but that's not the Staff recommendation, I think as I understand your question, or is it --

Q. I think so. So you're saying the rates could be fair, just, reasonable, and sufficient at the time we issue the order, but at the time the acquisition closes, they would not be fair, just, reasonable, and sufficient?

A. That's correct.

Q. Okay. You testified earlier in response to some of the questions my colleagues asked to the effect that things change. Why wouldn't it be prudent for us to wait in effect to see exactly how this acquisition is financed, and rather than using for example the hypothetical that you have put forward in your testimony, deal with this issue in the next rate case using real numbers, and we can determine in that context whether or not to go down this road of your double leverage adjustment?

A. Well, there's two reasons why. First off, I don't think better numbers, you might get a little bit more accuracy, but the degree of accuracy, I don't know that it would be worth the effort. I think this financing plan and even though these are estimated numbers, I think my perception is the way this is structured and how the street is perceiving it and how things are going forward, I think that it's pretty likely that this is what you're going to see, so it's not going to be that much different.

And if it were that much different, again we have the next rate case, so my preference would be to err on the side of protecting rate payers and adopting the adjustment, and then do the fine tuning in the next rate case. That would be my recommendation to you, because there is an impact to rate payers, and I think this is good evidence. I think my number and Mr. Hill's number are pretty consistent, I think you find a good record if you so choose to adopt a double leverage adjustment as to how to implement that. Mr. Hill offers two other options, but I think it's important that you adopt a double leverage adjustment now, and then the next rate case is to fine tune it would be the way I would approach it.

CHAIRMAN SIDRAN: Thank you, that's all I have.

JUDGE RENDAHL: All right, is there anything else for Mr. Elgin this afternoon?

MR. CEDARBAUM: Your Honor, I just, I know he's been up there for a while, I just have half a dozen questions.

JUDGE RENDAHL: Okay, I think we ought to take a break before we do that. I'm also concerned that we're going to get to Mr. Schooley today. So let's take our afternoon break, and we'll come back at 3:45.

MR. CEDARBAUM: Your Honor, I'm sorry to interrupt, just in the interest of timing, I think anything I was going to ask I could cover on brief another way, so I wouldn't have any more questions.

JUDGE RENDAHL: All right, well, with that, is there anything more for Mr. Elgin this afternoon?

All right, Mr. Elgin, thank you very much, you may step down.

We'll take our afternoon break and come back at 3:45 and begin with Mr. Schooley.

(Recess taken.)

JUDGE RENDAHL: All right, let's be back on the record after we have taken our break. The Commissioners advised me there's one more question for Mr. Elgin, so thank you very much for coming back, I thought you were done, but you're not.

So Chairman Sidran.

BY CHAIRMAN SIDRAN:

Q. Well, I don't want to make too much of the fact that you came back, because, after all, you do work here, you get a limited amount of credit for that.

I did want to follow up with just one additional question that occurred after we left the Bench, and it's really the corollary of the question that I asked you at the end. If you will recall, I asked you if we were to basically make the determination of rates based on the record that we have in this case and set aside the acquisition issue, and I asked you if then the acquisition closed, if the rates were fair, just, and reasonable at the time we entered our order, would those rates be unfair and unjust and unreasonable at the time the acquisition closed, and I believe if you recall the question I think your answer was yes.

A. Yes.

Q. So as my late mother-in-law would put it, does that door swing both ways, if we were to make your adjustment in this case, base the rates in part on that adjustment, and then for some reason the acquisition does not close, are those rates unfair, unjust, and unreasonable?

A. Yes, it would work both ways.

CHAIRMAN SIDRAN: My mother-in-law would be pleased to hear it. Thank you, that's all I have.

JUDGE RENDAHL: All right, Mr. Cedarbaum, did you have anything you wanted to ask Mr. Elgin?

MR. CEDARBAUM: Just a couple questions.

JUDGE RENDAHL: Okay.

R E D I R E C T E X A M I N A T I O N

BY MR. CEDARBAUM:

Q. Mr. Elgin, in your discussion with Commissioner Jones about ringfencing, the context of that discussion was the purpose of ringfencing with respect to protecting the ringfenced company from the financial distress or bankruptcy risk of the other companies within the holding company structure; is that right?

A. Yes, it was limited to that specific context.

Q. Okay. And in your testimony for example at page 38, the context of your discussion with respect to ring fencing there has to do with the financing decision of MEHC; is that correct?

A. That is correct, the ringfencing decision has nothing to do with how a holding company would choose to finance the operating companies underneath it, they're independent decisions.

JUDGE RENDAHL: And, Mr. Cedarbaum, just to clarify, were you referring to page 38 of his testimony here or page 38 of the acquisition testimony which we also had some discussion on?

MR. CEDARBAUM: I'm referring to Exhibit 791-T in this docket.

JUDGE RENDAHL: Thank you.

BY MR. CEDARBAUM:

Q. The other area I had for you, again in your discussion with Commissioner Jones, he asked you questions about Scottish Power cases in the late '90's, is it correct that that was the time frame in which the Commission approved a rate plan for PacifiCorp under Scottish Power ownership?

A. Yes.

Q. And so is it correct that cost of capital was not litigated in that case as part of establishing a rate plan?

A. No, it was not.

MR. CEDARBAUM: Thank you, those are all my questions.

JUDGE RENDAHL: Okay, thank you.

Now, Mr. Elgin, you may step down.

All right, let's be off the record for a moment while we bring Mr. Schooley back.

(Discussion off the record.)

JUDGE RENDAHL: Good afternoon, Mr. Schooley.

THE WITNESS: Good afternoon.

JUDGE RENDAHL: You remain under oath from your testimony previous days.

THE WITNESS: Yes.

JUDGE RENDAHL: Mr. Trotter, did you have any preliminary questions you wanted to ask?

MR. TROTTER: Yes, Your Honor, is the witness still under oath then?

JUDGE RENDAHL: Yes.

MR. TROTTER: Thank you.

Whereupon,

THOMAS E. SCHOOLEY,

having been previously duly sworn, was called as a witness herein and was examined and testified as follows:

D I R E C T   E X A M I N A T I O N

BY MR. TROTTER:

Q. Mr. Schooley, you're the same Thomas E. Schooley that testified earlier in this docket; is that right?

A. Yes.

Q. And referring you to Exhibit 642-T, is that your supplemental testimony on MEHC related issues?

A. Yes.

Q. If I ask you the questions that appear in that exhibit, would you give the answers that appear there?

A. Yes.

Q. In the course of that testimony, you refer to various Exhibits 643 through 645.

A. Yes.

Q. Were those prepared by you, and are they true and correct?

A. Yes.

MR. TROTTER: Your Honor, I move for the admission of Exhibits 642-T, 643 through 645.

JUDGE RENDAHL: Is there any objection to admitting what's been marked as Exhibits 642-T through 645?

MR. WOOD: No objection, Your Honor.

JUDGE RENDAHL: All right, and no objection, those exhibits will be admitted.

MR. TROTTER: And, Your Honor, the company has identified Exhibit 646 as a cross-exhibit for Mr. Schooley, and technically it's beyond the scope, but Mr. Wood has told me the area of his questioning, I'm not going to object on that basis if that's the scope.

JUDGE RENDAHL: All right, so should we wait until after the questioning to address the exhibit?

MR. TROTTER: Sure.

MR. WOOD: Oh, could I also at this time offer the cross-examination exhibits for Mr. Elgin.

JUDGE RENDAHL: That would be a good idea, and those were Exhibits 801 through 809.

MR. WOOD: I believe that's correct, Your Honor.

JUDGE RENDAHL: All right, are there any objections to admitting those exhibits?

Hearing no objection, what's been marked as Exhibits 801 through 809 will be admitted.

MR. TROTTER: The witness is available for cross.

MR. WOOD: Thank you.

JUDGE RENDAHL: Mr. Wood.

CROSS BY WOOD)

C R O S S - E X A M I N A T I O N

BY MR. WOOD:

Q. Mr. Schooley, I just wanted to clarify something on Bench Request 25, you prepared that, didn't you?

A. Yes.

Q. And if we turn to page 3.

MR. TROTTER: This is Exhibit 646?

Q. 646, sorry.

A. Page 3 of 4, or are you --

Q. It's labeled 3 of 3 on my version.

A. Somebody probably reprinted them. What's on the exhibit?

JUDGE RENDAHL: 646 is Bench Request Number 25.

MR. WOOD: That is correct, Your Honor.

THE WITNESS: Is it table 1 up in the upper left-hand corner?

MR. WOOD: It is table 1.

BY MR. WOOD:

Q. I simply wanted to clarify which columns compared with which. The column 1, or sorry, there's a column labeled Pacific-WA without BPA followed by a column that says Pacific-WA with BPA. Am I correct that the difference is that the first column I named is the PacifiCorp rate without the Bonneville rate credit and the second column is the rate with the Bonneville rate credit?

A. Correct.

Q. And if we compare with Avista-Wa and PSE, which are the last two columns, are both of those the columns for the respective utilities with the BPA rate credit?

A. It's not that simple. With PSE, yes, it is with the BPA rate credit I believe, because their rates today are in the, without the credit, are about 7 plus cents, and here they're at 6 or just over so -- and PSE has had the residential exchange throughout this period of time. Avista opted out of the residential exchange until approximately the year 2000, and at present the residential exchange for Avista is about 4/10 of 1 cent, so it's a small number.

Q. So both these columns contain whatever BPA credit is available to those utilities?

A. Yes.

Q. And of course Pacific-Utah is Utah is not entitled to the credit, correct?

A. Correct.

MR. WOOD: That's all I have.

JUDGE RENDAHL: On that exhibit or for Mr. Schooley?

MR. WOOD: That's all I have period.

JUDGE RENDAHL: Oh, okay.

Mr. Trotter, is there any redirect for the witness?

MR. TROTTER: Just one quick one.

R E D I R E C T   E X A M I N A T I O N

BY MR. TROTTER:

Q. Counsel asked you whether the Avista and PSE columns reflected whatever BPA credit was available, am I correct that with respect to Avista that when Avista opted out, the BPA credit was not available; is that right?

A. Right, their customers did not receive the residential customer credit exchange for most of this period of time.

MR. TROTTER: I think that's all I have, thank you.

JUDGE RENDAHL: All right, are there any questions from the Bench for Mr. Schooley?

All right, well, Mr. Schooley, I do have a few, so sorry.

THE WITNESS: Okay.

E X A M I N A T I O N

BY JUDGE RENDAHL:

Q. Were you in the room when Mr. Wrigley was testifying this morning?

A. Yes.

Q. And I asked Mr. Wrigley several questions, the first few were addressing the temperature normalization stipulation; did you hear those?

A. Yes.

JUDGE RENDAHL: Off the record I noted that I had misnumbered that exhibit, it should be Exhibit Number 592, the stipulation of temperature normalization adjustments, so I'm making that clarification on the record. There is an Exhibit 592 already.

MR. WOOD: Your Honor, did you mean to say that the stipulation should be 593?

JUDGE RENDAHL: Yes, should be 593. Did I just say 592?

MR. WOOD: Yes.

JUDGE RENDAHL: It's late, it should be 593.

BY JUDGE RENDAHL:

Q. Do you concur with Mr. Wrigley's explanation of the effect of the compromise on revenue requirement?

A. I believe so, the effect should be that the total revenue requirements from this stipulation should be $1 Million for the company.

Q. Okay. I understood Mr. Wrigley to say that the revenue requirement, it was a $1 Million reduction meaning that they had proposed $2.7 Million reduction, it would increase the deficiency is the way the stipulation phrases it, and I understood Mr. Wrigley to say the company had proposed a $2.7 Million reduction to revenue requirement and that the effect of this stipulation would be the company proposes a $1.7 Million reduction.

A. Not true.

Q. All right, so how would you describe the effect of the stipulation on revenue requirement and what the Commission should factor in as revenue requirement for this adjustment?

A. To me, the correct beginning point is zero or per books or the unadjusted results, and from that point you would put negative $1 Million in revenues, no changes to power costs, but that does have an effect on customer accounts and other taxes, both of which are parts of the conversion factor. Once you get to the net operating income or as the company calls it the operating revenue for return, then the conversion factor brings that back up to $1 Million. So there's $1 Million of additional revenues the company would receive from this adjustment.

Q. All right.

And did you also hear Mr. Wrigley explain the refinement in the methodology portion of the stipulation?

A. Yes.

Q. And I think what I asked Mr. Wrigley was whether the intent of the stipulation is to further refine the company's proposal for this rate case for a multiple base temperature?

A. No, there will be no further changes in this docket.

Q. Okay.

A. In the next rate case, whenever that may be, we hope to have an agreement between Staff and the company as to what's to be done in that case, and there will be from that point on continuing discussions as to how to come up with better data for Washington and for the system for that case.

Q. So the hope is to have a refinement to present in the next rate case?

A. Yes, and there's a meeting set up for February 10th to begin those discussions.

Q. Okay, well, thank you for that.
And did you also hear -- are you at all involved in the acquisition case?
A. I tried to stay out of it, I think I have been dragged into it though.
Q. All right. Were you a party, were you familiar, are you familiar with the settlement?
A. A little bit, I'm familiar with the adjustments that impact revenue requirements.
Q. All right, well, that's what I want to ask about.
A. Yes.
Q. And do you concur with what Mr. Wrigley testified about the accounting treatment of those revenue requirement adjustments, the rate credits if the Commission, I think the question I asked Mr. Wrigley was what would the company do in terms of tracking or including the rate credits in a future filing if the Commission did not include the rate credits in this general rate case?
A. I guess by saying that the company or the Commission has not included those credits in this rate case would also imply that the subject of the credits have been included in the rate case. For instance, if Staff has proposed removing the West Valley lease from

operating expenses, there's -- I'm still uncertain as to how that is to be treated in the West Valley adjustment from the MEHC acquisition adjustment. But if that cost is included in rates here but the adjustment from the MEHC acquisition is not included, then it would follow what the stipulation says as to how to capture that from day one of the approval of the acquisition until there is a rate case to capture that so that there would be a credit posted each month which would be a regulatory liability. That regulatory liability at the time of the next rate case would be captured and dealt with in that case.

Q. Okay, and that would be similar to I think what was referred to as Washington Number 7?

A. I believe so.

Q. And I can't recall what that had to do with at the moment, but those were my notes.

A. It's Washington 3 for that particular one.

Q. Washington 3 was the West Valley?

A. Yes.

Q. And 7 was something else?

A. 7 has to do with A&G stretch goals.

Q. And that also has a deferred accounting aspect to it?

A. True.

Q. And Mr. Wrigley testified that all of the other rate credit or revenue requirement affecting adjustments are essentially hold harmless provisions and don't include deferred accounting; do you agree with that characterization?
A. This is written it such a convoluted way to start with I certainly wouldn't have signed it myself, but. I'm not saying that facetiously. They're hold harmless, but from what I don't know, from the costs or the possible credits that have been incurred to date from not going up or down, yes, but I guess I don't really see much value in them. So yes, I think he characterized it properly, but I don't know what effect that truly has.
Q. Okay. And then I had asked Mr. Wrigley some questions about his spreadsheets, I just have one on yours. Do you have your exhibit 633 or I think it's TES-3?
A. Yes.
Q. All right, if you look at page 13.
A. Yes.
Q. And look at adjustment 7.1, the interest true up.
A. Yes.
Q. I think it's the question has to do with how

you calculated the adjustment and whether you used the rate base on page 21 of this exhibit.

A. The formula for calculating that is in the disks provided, I assume they were provided with the testimony. In that formula it literally uses the rate base on page 1 of 21, the total is $541 Million plus. And from that it deducts the SO2 allowance rate base impact as that's not a part of it. And then it multiples that by the weighted cost of debt and subtracts it from the actual interest.

Q. Okay. Well, and the Commission issued a Bench request I think to you or to the Staff, and I believe it was Bench Request Number 8, and I guess what I would ask you to do is for your most recent revised version of this, which is Exhibit 644, if you would perform the same calculation that we asked in Bench Request Number 8, if you could make that same calculation for your Exhibit 644 as in Bench Request 8, and that would be Bench Request Number 36. Does that make sense?

A. It does. I don't recall what number 8 says, but I guess I can look it up.

Q. And you can refer to it. All right, I can read it to you if you would like on the record.

A. Okay.

Q. (Reading.)
The adjusted rate base in Staff's case is identified as $541,157,929 in your Exhibit 633, page 1, line 56, column 5, but the rate base used in Staff's calculation of adjustment 7.1 is $543,355,900. Please explain the difference and provide the calculation for the adjustment.
So if you could provide that same clarification for your Exhibit 644, that would be appreciated.
A. I can explain it now if you like.
Q. Okay, that would be helpful, then we avoid the Bench Request.
A. It's the difference you see in adjustment 3.6, page 7 of 21.
Q. And this is your Exhibit 644?
A. Yes.
Q. Okay, 7 of 21.
A. The $2,197,971 total rate base reduction for SO2 allowances has been added back to the rate base on page 1, column 3, line 56.
Q. Okay, well, with that, we don't need Bench Request 36 or 35 or whatever I just said.

A. Okay.

JUDGE RENDAHL: So thank you very much, and with that, I don't have any further questions.

Is there anything further for Mr. Schooley this afternoon?

Thank you, Mr. Schooley, you may step down.

Are there any other housekeeping matters or clarifications we need to make before tomorrow morning?

Okay, in the interests of trying to finish tomorrow by noon, does it make sense to start at 9:00, does it look like we're going to have an argument tomorrow morning on the issue of oral rebuttal by Mr. Vander Weide or do we know yet?

MR. WOOD: I have had a fairly limited opportunity this afternoon to confer, Your Honor, but the testimony, if any, is going to be short. As soon as I get back, I will have a chance to decide. If there's going to be any, I will send it out. I don't anticipate one way or the other we're going to argue a long time about it. If there is any, there will be one speech, two, you will rule, and we'll go at it.

JUDGE RENDAHL: All right. As I understand what we have for tomorrow is we have 45 minutes of cross for Mr. Vander Weide plus approximately 15 minutes of Bench time, that's about an hour, and the same for

Mr. Selecky, and the possible questions from the Bench for Mr. Gorman and Mr. Hill. Mr. Falkenberg and Mr. Effron will not be appearing, and so we don't have their time, so we have two hours factored in, but we really don't have more than two and a half hours, so should we start at 9:00 just to finish up by noon, is that acceptable?

MR. TROTTER: We're still on the record?

JUDGE RENDAHL: Yes, we're still on the record.

MR. TROTTER: That's fine.

JUDGE RENDAHL: All right, well, we'll start at 9:00 tomorrow morning, and now we will be off the record.

(Hearing adjourned at 4:15 p.m.)